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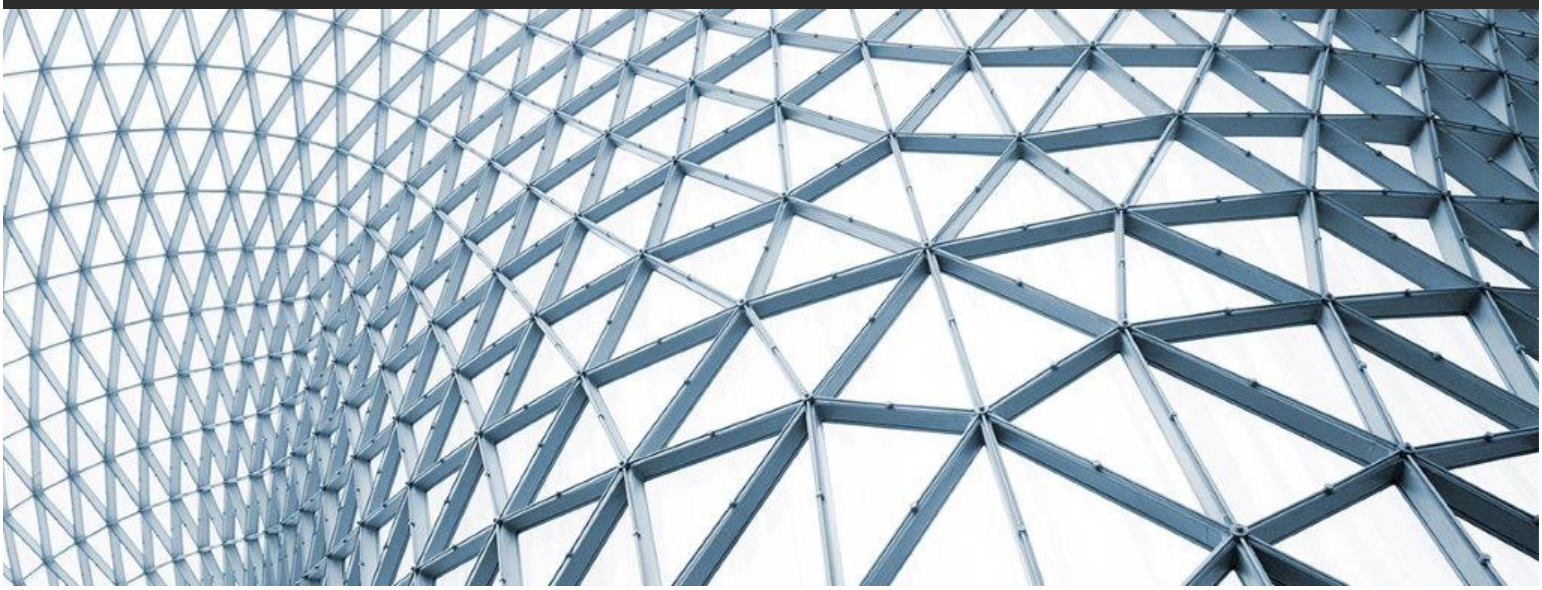
The Government's New Tool Against Insider Trading



In two recent criminal cases involving insider trading based on non-public information from government agencies, prosecutors in the Southern District of New York have resurrected an old statute for a new purpose. The novel use of a 19th century statute arms the government with a new and potent weapon for prosecuting insider trading cases.

By Robert S. Frenchman and Kedar S. Bhatia | January 25 2019 | New York Law Journal

It is a familiar refrain. The government alleges insider trading on a securities fraud theory, charging violations of §10(b) and Rule 10b-5 under the Securities and Exchange Act of 1934 (the Exchange Act). The elements of securities fraud are notoriously complex, and have been made even more complex by recent appellate decisions. The government must prove, among other things, that the information disclosed by the tipper was material and non-public, that the tipper had a duty to maintain the confidentiality of the information and breached that duty, that the tipper received some personal benefit from the tippee, and that the tippee knew there was a breach. These are challenging requirements, especially in criminal cases where the government must prove each element beyond a reasonable doubt.

There are other legal theories that are far less complex. In two recent criminal cases involving insider trading based on non-public information from government agencies, prosecutors in the Southern District of New York have resurrected an old statute for a new purpose. That statute, 18 U.S.C. §641, makes it unlawful to embezzle, steal, or convert property of the federal government. The government need only prove that the defendant knowingly stole or converted a "thing of value" belonging to the federal government, or that the defendant knowingly received a stolen or converted "thing of value" with the intent to convert it to his or her gain. The government has already won convictions under §641 in insider trading cases in which it struggled to prove traditional securities fraud.

The novel use of this 19th century statute arms the government with a new and potent weapon for prosecuting insider trading cases. And because the statute omits many of the most difficult elements of proof required in traditional securities fraud cases, we think it will become an increasingly common charge against insider trading defendants.

Differences Between §641 and Securities Fraud

Title 18, U.S. Code §641, the earliest predecessor of which dates to 1875, was most recently revised in 1948. The statute criminalizes the embezzlement, theft, or conversion of any "thing of value" of the federal government. To establish a violation, the government is required to prove four elements: (1) stealing or converting, (2) with intent to steal or convert, (3) a "thing of value" (4) that belongs to the government. *United States v. Lee*, 833 F.3d 56, 65 (2d Cir. 2016).

Section 641 and its predecessor statutes were originally used in cases in which there was a straightforward theft of the government's tangible property, such as where an individual took a firearm belonging to the United States. See *United States v. Jermendy*, 544 F.2d 640 (2d Cir. 1976). It is now well-established, however, that a "thing of value" includes intangible property, such as confidential government information. Section 641 has been used to prosecute theft of information from a government agency's files, the knowing conversion of a law enforcement intelligence manual, and theft of pricing information submitted by a prospective government contractor. *United States v. Girard*, 601 F.2d 69 (2d Cir. 1979); *United States v. Barger*, 931 F.2d 359 (6th Cir. 1991); *United States v. Matzkin*, 14 F.3d 1014 (4th Cir. 1994).

The legal requirements of securities fraud are far more complex, imposing elements of proof that simply do not exist under §641. In a securities fraud case, the government must prove that the tipper had a duty to maintain the confidentiality of information that was material and non-public, and breached that duty. The government must prove the tipper received a personal benefit from the tippee, such as by receiving payment for the information or giving the information to a family member or friend as a gift. *See Dirks v. SEC*, 463 U.S. 646 (1983). The government must prove that the tipper expected that the information disclosed would be used in securities trading. If the government brings cases against downstream tippees—like the hedge fund defendants discussed below in the *Visium* and *Deerfield* cases—it must prove those tippees knew that the original source of the inside information received a personal benefit. See *Salman v. United States*, 137 S. Ct. 420 (2016); *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

The government is not required to prove any of these elements under §641. All the government must prove is that the defendant knowingly or intentionally stole or converted property belonging to the federal government, or made use of property belonging to the federal government knowing it to have been stolen or converted.

The 'Visium' Case

In 2016, the government brought a series of charges under §641 against individuals in an insider trading scheme involving Visium Asset Management, L.P. (Visium), a hedge fund in New York. Prosecutors in the Southern District of New York alleged that Sanjay Valvani, a portfolio manager at Visium, instructed Gordon Johnston, a former Food and Drug Administration (FDA) official, to use his contacts at the FDA to obtain material, nonpublic information about the status and approval of drugs. Johnston, who was in the "political intelligence" industry, obliged, and Valvani shared the information that he learned with Christopher Plaford, another portfolio manager at Visium. Prosecutors alleged that this unlawful scheme generated profits of over $30 million through Valvani's trading.

Johnston pleaded guilty to, among other things, securities fraud and conspiracy to convert government property, and has been cooperating with prosecutors to provide information about the political intelligence business. In January 2018, Johnston was ordered to forfeit the $108,000 that he made from the conspiracy and was ordered to pay a fine of $12,500. Plaford also pleaded guilty and agreed to cooperate with the government. Plaford testified in the trial of David Blaszczak, a political consultant to Deerfield Capital (Deerfield). Plaford is awaiting sentencing. Valvani passed away shortly after being indicted and the government subsequently dropped the charges against him.

The 'Deerfield' Case

In 2017, prosecutors in the Southern District of New York brought similar charges against individuals in an insider trading scheme involving Deerfield, a health care-focused hedge fund in New York. The government alleged that Christopher Worrall, an employee at the Centers for Medicare and Medicaid Services (CMS), tipped confidential information about changes to the Medicare and Medicaid reimbursement schedule for certain medical treatments to his close friend and former CMS colleague, David Blaszczak. Even small changes to the Medicare and Medicaid reimbursement schedule can have a significant impact on the companies that sell the medical treatments. The government alleged that Blaszczak, who ran a "political intelligence" consulting business, was paid by Theodore Huber and Robert Olan, traders at Deerfield, for this confidential CMS information. In turn, Huber and Olan traded on that information and earned about $7 million in trading profits.

After a month-long trial, the jury returned a mixed verdict. The defendants were acquitted of the securities fraud charges under §10(b) of the Exchange Act and Rule 10b-5. Prosecutors had far more success with §641, securing convictions on six of nine counts. Prosecutors also secured convictions on some but not all counts of conspiracy, wire fraud, and securities fraud under Title 18, which has different requirements than its Exchange Act counterpart. Worrall was sentenced to 20 months imprisonment, Blaszczak was sentenced to 12 months imprisonment, and Huber and Olan were each sentenced to 36 months imprisonment. The defendants' appeals are pending in the Second Circuit.

Implications of §641 Moving Forward

Section 641 was a significant factor in the *Visium* and *Deerfield* cases. The statute requires prosecutors to satisfy fewer elements of proof, while providing fewer available defenses for the accused. Indeed, §641 does away with concepts of materiality, breach of duty, and personal benefit, and associated jurisprudence, all to the benefit of the government. Without these challenging elements of proof, which are so often attacked by defendants at trial and at the appellate level, we expect more guilty pleas, more convictions, and more convictions affirmed on appeal.

On a more practical note, the *Visium* and *Deerfield* cases highlight the dangers for companies utilizing political intelligence. The careful monitoring of public information to predict government decisions is common in many businesses. Government decision-making affects virtually every industry: from defense

contractors, to pharmaceutical companies, to real estate firms. A company could conceivably be accused of violating §641 if it decided to relocate a plant based on non-public government information, or chose to invest money in a public project ahead of a government announcement. The recent criminal prosecutions under §641 highlight the need for companies in every industry to carefully monitor the information they receive to ensure that it does not include non-public government information.

Hedge funds, asset managers, and trading firms should be especially careful in educating their employees about the dangers of using political intelligence firms. As the *Visium* and *Deerfield* cases make clear, §641 gives prosecutors a powerful new tool to leverage guilty pleas, or to win convictions at trial, from defendants who trade on confidential government information.

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