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Legal Sidebar

Second Circuit Applies Supreme Court Decision to Limit the Reach of Federal Fraud Statutes

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In December 2022 the United States Court of Appeals for the Second Circuit issued its second decision in *United States v. Blaszczak* (*Blaszczak II*), overturning convictions for wire fraud, securities fraud, and conversion of government property. These convictions arose from an insider trading scheme in which an intermediary obtained information from his government contacts regarding planned actions of a federal agency and conveyed that information to health-care-focused hedge funds. The Second Circuit had originally upheld those convictions in a 2019 decision (*Blaszczak I*), but the Supreme Court vacated that judgment and returned the case to the Second Circuit for reconsideration in light of the Supreme Court's intervening decision in *Kelly v. United States*. In *Kelly*, the Supreme Court had narrowly construed the meaning of government property under the federal statutes criminalizing wire-fraud and fraud on a federally funded program. On remand in *Blaszczak II*, the Second Circuit applied *Kelly* to hold that the confidential, predecisional regulatory information from the Centers for Medicare and Medicaid Services (CMS) conveyed during the insider trading scheme did not constitute government property under federal fraud statutes.

This ruling has implications for the federal government's ability to prosecute insider trading cases involving government information. There is no federal statute that specifically targets insider trading, and *Blaszczak* narrowed the scope of several statutes that prosecutors within the Second Circuit can use to target such activity. The Sidebar recounts chronologically the facts and holdings in the *Blaszczak I*, *Kelly*, and *Blaszczak II* decisions. The Sidebar then offers relevant considerations for Congress.

Blaszczak I

The facts at issue in *Blaszczak* concern two insider trading schemes centered on confidential nonpublic information from CMS, an agency within the U.S. Department of Health and Human Services that administers Medicare and Medicaid.

The first scheme involved four defendants: a consultant for hedge funds and former CMS employee, partners at the health-care-focused hedge fund Deerfield Management Company, L.P. (Deerfield), and a

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current CMS employee. Under this scheme, the Deerfield partners approached the consultant over several years to obtain "predecisional" information about CMS's contemplated rules and regulations. They contacted the consultant because of his access to "inside sources" at CMS. The consultant availed himself of those inside sources to funnel information about planned changes to CMS rules and regulations—specifically, reimbursement rates for certain medical treatments. Deerfield then traded and profited from that advance and inside information. The second scheme involved only the consultant and an investment manager at a different hedge fund, Visium Asset Management, L.P. (Visium). In this scheme, the consultant provided inside information about planned CMS regulatory changes to a portfolio manager at Visium.

As pertinent here, the government charged the defendants with three federal crimes: (1) wire fraud under 18 U.S.C. § 1343, which occurs when a person intentionally participates in a scheme to use wire transmissions to defraud another of money or property; (2) securities fraud under 18 U.S.C. § 1348 (Title 18 securities fraud), which creates criminal liability for knowingly executing, or attempting to execute, "a scheme or artifice" to either defraud a person in connection with certain commodity and securities transactions or obtain money or property in connection with such transactions through fraudulent means; and (3) conversion of government property under 18 U.S.C. § 641, which makes it a crime for anyone to embezzle any money or property belonging to the United States with a value of more than $100. A federal jury returned a verdict finding all of the defendants guilty of at least one of those crimes.

On appeal to the Second Circuit, the defendants challenged their convictions on the ground that predecisional CMS information about its plans for announcing changes in medical service reimbursement rates is not government property or a thing of value under the three statutes. In a divided opinion, the court rejected the defendants' argument and affirmed the convictions. The Second Circuit analogized the CMS information at issue in *Blaszczak* to confidential business information—specifically, "the publication schedule and contents of forthcoming articles in a Wall Street Journal column"—that the Supreme Court previously had held to be property within the scope of the federal mail and wire fraud statutes. The Second Circuit held that, "[l]ike the private news company . . . , CMS has a 'property right in keeping confidential and making exclusive use' of its nonpublic predecisional information."

The defendants petitioned the Supreme Court to review the Second Circuit's judgment. While that petition was pending, the Supreme Court decided *Kelly*.

The Supreme Court's Decision in *Kelly*

Kelly concerned actions taken by officials in the administration of New Jersey's then-Governor Chris Christie. The officials ordered the closing of two of three toll lanes leading from Fort Lee, NJ, to the George Washington Bridge in retaliation for the Fort Lee mayor's refusal to support Governor Christie's re-election bid. The Port Authority of New York and New Jersey—a bistate agency that administers bridges, tunnels, airports, and other transportation facilities in the two states—administered this entryway to the bridge. A jury convicted the defendants on charges of federal wire fraud under 18 U.S.C. § 1343 and fraud on a federally funded program or entity under 18 U.S.C. § 666(a)(1)(A).

The Supreme Court reversed. It began its analysis by explaining that, "[u]nder settled precedent, the officials could violate those laws only if an object of their dishonesty was to obtain the Port Authority's money or property." The Court then rejected the government's argument that the New Jersey officials' acts implicated government property because they sought to commandeer the bridge's access lanes and to divert the wage labor of Port Authority employees used in that effort. The Court held instead that the defendant officials' realignment of the toll lanes "was a quintessential exercise of regulatory power"—albeit "for bad reasons"—not a scheme to appropriate government property. The Court further held that the time and labor of Port Authority employees implicated in the toll-lane reduction was only an

incidental byproduct of the officials' scheme and that conviction under the federal fraud statutes requires "that property must play more than some bit part in a scheme: It must be an 'object of the fraud.'"

The Court explained that it was applying a decades-long "limiting construction" of the federal fraud statutes that precludes those statutes from "criminalizing all acts of dishonesty by state and local officials." As such, the federal fraud statutes leave "much public corruption to the States (or their electorates) to rectify."

Blaszczak II

After deciding *Kelly*, the Supreme Court granted the *Blaszczak* defendants' petitions for certiorari, vacated the Second Circuit's judgment in *Blaszczak I*, and remanded the case for further consideration in light of *Kelly*. On remand in *Blaszczak II*, the parties agreed that, under *Kelly*, the convictions for wire fraud, Title 18 securities fraud, and conversion of government property could not stand. The government therefore asked the Second Circuit to remand the cases to the federal trial court to permit the government to dismiss those charges against the defendants.

In a divided opinion, the Second Circuit granted the government's request as a proper exercise of prosecutorial discretion, but also ruled on the merits. Following *Kelly*, the Second Circuit held that confidential predecisional information of CMS is not agency property for purposes of the federal fraud statutes at issue in *Blaszczak*. The court acknowledged that confidential information may constitute property of a commercial entity that engages in the business of gathering and distributing that information to parties willing to pay for it, making control over such information a thing of value. By contrast, the court reasoned, a planned CMS regulation remains within the exclusive control of CMS even if disclosed to outsiders prematurely, insofar as CMS can decide whether or not to implement it. Even if the regulation is disclosed prematurely, that "disclosure has no direct impact on the government's fisc." Echoing the holding in *Kelly*, the Second Circuit therefore held that predecisional CMS information concerning the substance and timing of its decisions is "regulatory in character and do[es] not constitute money or property of" CMS that can create criminal liability under the federal fraud and conversion statutes.

The Second Circuit further observed that the object of the defendants' actions in *Blaszczak* was not to deprive the government of agency property, but rather to trade on nonpublic CMS information for their own benefit. The court explained that this scenario was actually one step further beyond the reach of the federal fraud statutes than the actions of the defendants in *Kelly*, which sought actively to alter an agency's exercise of its regulatory power. Thus, the court concluded that if "the conduct in *Kelly*—altering regulation—does not constitute a deprivation of government property, *a fortiori* merely obtaining advance information as to what the agency's preferred regulation would be" likewise cannot amount to such a deprivation.

Considerations for Congress

Kelly and *Blaszczak* articulate the principle that federal fraud statutes reach a narrower band of misconduct involving government activities than those existing under state law. Congress may not act, allowing the judiciary's interpretation of existing statutes to stand. Alternatively, Congress could respond to this judicial interpretation of the federal fraud statutes with legislation that expressly criminalizes a wider range of such activity.

Besides adjusting the reach of existing statutes, Congress might also consider a federal insider trading statute. One could categorize *Blaszczak* as an insider trading case, but there is no specific federal insider trading statute. This fact has led federal prosecutors to target insider trading through other existing statutes, including securities fraud under Titles 15 and 18 of the *U.S. Code* and associated regulations. A

federal statute that expressly criminalizes insider trading and identifies the elements for such an offense could obviate these indirect prosecutorial approaches and bring greater uniformity to this area of the law.

Author Information

Michael D. Contino
Legislative Attorney

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