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INSIDER TRADING

Political Intelligence and U.S. Insider Trading Regulations

BY RICHARD A. ROSEN AND UDI GROFMAN

Imagine you are a portfolio manager and you routinely receive advice from a political consultant who has sources in Washington, D.C., including high-level officials in the U.S. Department of Energy. Your funds have a significant investment in a company that is developing innovative wind energy technology. You have scheduled a meeting tomorrow with your Investment Committee at which you are going to present a detailed analysis in which you recommend that you quickly reduce your exposure to this company and immediately shift your focus to an up-and-coming competitor. For months, your consultant has been advising you to expect the Secretary of Energy to announce that tens of millions of dollars in federal funds will be earmarked for investment in wind energy initiatives. During this time, the media has widely anticipated such an announcement at a scheduled speech by the Secretary of Energy. One day before the expected date of the announcement, the consultant calls you and says: ''Based on new information I just received from my sources, I am no longer confident in the advice I have given you concerning the Secretary of Energy's support of wind energy initiatives.''

Richard A. Rosen and Udi Grofman are partners at Paul, Weiss, Rifkind, Wharton & Garrison, LLP and are both resident in the New York office. Mr. Rosen is a litigation partner and co-chairs the Securities Litigation Practice. Mr. Grofman is a corporate partner and co-chairs the firm's Private Funds Practice Group and is a member of the Investment Management Practice Group.

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What may you do with this information? What obligations might you have concerning the use or disclosure of this information? Does it matter how or from whom the consultant obtained the information, or what he or she might have given in exchange for it? Most pointedly, are you now obligated to scrap your presentation and simply hold your position until after the Secretary's speech? This article explores these and similar questions in light of the Stop Trading on Congressional Knowledge Act (the ''STOCK Act'') enacted by Congress in 2012. The article considers the implications of the STOCK Act as it applies to situations like the hypothetical described above. In particular, we explore the potentially dire consequences of receiving—even inadvertently—material information that bears on the value of an entire industry or sector of the economy, as sensitive information about governmental initiatives often does. The article also outlines best practices for complying with the STOCK Act's requirements.

When Congress enacted the STOCK Act, it prohibited members of Congress and their staffs, as well as all Executive and Judicial Branch officers and their employees, from trading on insider information learned in the course of their official duties. By applying insider trading regulations to these covered government employees, the STOCK Act created liability under both the classical tipper/tippee theory of insider trading—*e.g.*, where a covered person provides material information to a trader or intermediary and receives a benefit in return—as well as under the ''misappropriation'' theory, which will generally arise if a consultant obtains confidential information from a government source and passes that information on to clients who trade. The passage of the STOCK Act portends an increased focus by regulators on trading activity based on material, non-public information shared by a government source in breach of the source's duty of trust and confidence.

Investment professionals may come into possession of information covered under the STOCK Act through direct contact with government officials (such as in meetings government officials have with ''industry groups'' and political fundraisers), or, more commonly, through communications with consultants and experts who convey pertinent information about government officials' ''state of mind'' and government intended actions. Traders often receive so-called ''political intelligence'' from consulting, expert, and research firms that sell government information to investment professionals through publications, alerts and newsletters, and subscription models for access to this information. All of these sources could come within the ambit of the STOCK Act, and these communications raise a difficult set of questions about what information is material as defined by the STOCK Act and when it is permissible to trade on non-public information. In certain circumstances, trading activity based on client alerts, research reports and calls from consultants about government information may be considered a violation of insider trading laws under the STOCK Act.

This article describes the STOCK Act's key provisions and discusses how the STOCK Act applies to the key elements of insider trading: the duty of confidentiality, the test for materiality and the definition of non-public information. In addition, the article explores the decision in *United States v. Newman*, which required that a tippee be shown to have had knowledge that the tipper had received a personal benefit, and addresses the question whether judicial construction of the elements of insider trading apply to offenses under the STOCK Act.

The article also provides practical suggestions for compliance departments to avoid violations of the STOCK Act, including recommendations for adopting internal policies, procedures, and materials to comply with the STOCK Act's requirements. To mitigate liability risks, investment firms should train their employees about the STOCK Act and update their internal risk management policies and procedures to cover interactions with federal government employees and political consultants. In this regard, the policies and procedures many firms adopted to cover their interactions with expert networks furnish a good template.[1]

Among the most important protective measures firms can take is to require investment professionals to conduct appropriate due diligence designed to verify that their interlocutor is not breaching a duty in disclosing information. Moreover, investment professionals should be alert to the risks they face when receiving government information that may be material and non-public. That risk is heightened if the information is specific, imminent, or definitive, which is also when it will be most attractive as the basis for trading activity. Firms should train their employees that the best policy is to contact Legal and Compliance whenever they believe they may be in possession of information that may implicate the STOCK Act.

The STOCK Act: Key Provisions, Purpose, and Legislative History

On April 4, 2012, President Obama signed the STOCK Act into law. This law applies the current insider trading prohibitions under U.S. federal securities and commodities laws to covered public officials. The STOCK Act provides that such persons owe ''a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States.''[2] This duty prohibits covered public officials from sharing ''material nonpublic information derived from such person's position'' as a Member of Congress or employee of Congress,[3] an Executive Branch officer or employee, or a Judicial Branch officer or employee.[4]

The STOCK Act has directed increased public focus, as well as attention from the Securities and Exchange Commission, on ''political intelligence,'' which the legislation defines as information ''derived by a person from direct communication with an executive branch employee, a Member of Congress, or an employee of Congress; and provided in exchange for financial compensation to a client who intends, and who is known to intend, to use the information to inform investment decisions.''[5] But insider trading laws as applied to public officials are *not* limited to ''political intelligence'' as the STOCK Act defines the term, however, but cover *all* material non-public information sourced from political consultants.

The legislative history of the STOCK Act contained in the Senate Report from the Homeland Security and Governmental Affairs Committee (the ''Committee Report'') is relatively meagre, but provides some important insight into Congress' purpose and intent. The Committee Report states that the STOCK Act ''responds to concerns that Members of Congress and their staff may be exempt from laws prohibiting persons from engaging in financial transactions based on so-called insider information.''[6] The Committee summarized the

[1] Needless to say, compliance requires more than a set of canned forms and policies that an investment adviser can simply adopt. The need to adopt policies and procedures covering this subject matter, and their content, may vary depending upon an investment adviser's business and activities.

[2] Pub. L. No. 112-105, § 4(b)(2), 126 Stat. 291, 292 (2012). The STOCK Act explains that the prohibition of insider trading applies to Members of Congress and employees of Congress in § 4(a). § 9(a)(1-3) provides that the prohibition of insider trading also applies to executive branch employees, judicial officers, and judicial employees.

[3] Pub. L. No. 112-105, § 4(b)(2), 126 Stat. 291, 292 (2012).

[4] Pub. L. No. 112-105, § 9(a)(1-3), 126 Stat. 291, 297-298 (2012).

[5] Pub. L. No. 112-105, § 7(b)(1-2), 126 Stat. 291, 295 (2012).

[6] S. Rep. No. 112-244, at 1 (2012).

method by which the legislation accomplishes this goal: "It amends securities and commodities laws to make clear that Members and staff are not so exempt, and it amends financial disclosure laws to ensure that Members and their staffs more quickly and transparently report their financial transactions."[7]

The Committee Report discusses the broad definition of duty, creating a relationship of trust and confidence to Congress, the U.S. Government, and the American people. This duty "ensures that Members and staff are subject to the same liabilities and remedies as any other person who violates the securities laws."[8] However, "while Members and their staff should not be shielded from prosecution if each element of insider trading law is shown, they also should not fall inadvertently into violation of Rule 10b–5 when, in good faith, they engage in discourse with members of the public on matters related to their official duties."[9]

In that regard, the Committee Report also responds to concerns that the restrictions of the STOCK Act were so broad that Members of Congress could be liable for the "routine sharing of information between Congress and constituents."[10] The Committee Report clarifies that such conduct would not violate the insider trading laws because:

> The Committee believes that such fears are unfounded and that the STOCK Act should have no chilling effect on the flow of information from Congress to the citizenry. To prove a case of insider trading, the SEC must show that a trade was made, in breach of a duty of trust and confidence, based on material, nonpublic information. In the case of tipping, there must also be some personal benefit to the tipper in communicating the information to the tippee.[11]

Another barrier to claims against government officials under the STOCK Act, the Committee Report notes, will be the scienter requirement for 10(b) claims. Quoting from the opinion in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Committee Report adopts the Court's definition of scienter: "a mental state embracing intent to deceive, manipulate or defraud."[12] Moreover, the Committee Report quotes Robert Khuzami, the former Director of Enforcement for the SEC, during his testimony before the House Financial Services Committee:

> [Scienter] is the single biggest thing that protects the unwary from being trapped in a violation that inadvertently occurred. You have to be acting with corrupt intent, knowledge, or recklessness. If you act in good faith, you are not going to be guilty.[13]

Breaches of Duty Under the STOCK Act

The STOCK Act confirms that covered public officials and their employees have a duty to maintain the confidentiality of certain information—but what information qualifies as confidential? In the hypothetical presented at the introduction of this article, there are ambiguities regarding the underlying information received and transmitted by the consultant. Recall the message delivered to you by your consultant: "Based on new information I just received from my sources, I am no longer confident in the advice I have given you concerning the Secretary of Energy's support of wind energy initiatives." Is this information covered by the STOCK Act? The answer turns on the nature of the underlying information and the manner in which the consultant obtained it. Liability under the STOCK Act could arise in this situation if the information was non-public, came form a government source, and was obtained by the consultant as a tippee or through misappropriation, and if the investment professional knew or should have known that it came from a tainted source.

1. General Duties Under the STOCK Act

To violate the federal securities laws, a person must sell or purchase a security in breach of a duty of trust or confidence based on a fiduciary duty. The STOCK Act defines fiduciary duty broadly such that each covered official owes "a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States" for information derived from their government position.[14] This is similar to the duty a private actor owes to the public company that employs her. The SEC defined that duty for public companies in 10b-5 as: ". . . a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information."[15] In either the government or publicly traded company context, there needs to be a breach of this duty for a violation of insider trading laws. But in the STOCK Act context, the analysis is trickier to apply than in the commercial sphere. The question breaks down into two distinct issues; one will usually be easy but the other is not: (a) was the information obtained by the government actor in connection with her duties, and (b) was it a breach of her duty to make the disclosure that she did? In the absence of judicial interpretation, it is prudent to assume that any information in the hands of a public official that would significantly change your analysis of a position was likely obtained in connection with his or her duties.

But it will often be much harder to determine whether the information you receive was disclosed in *breach* of such duty. That is because—as the Committee Report quoted earlier recognized—officials in both the legislative and executive branches of our government communicate constantly with the public, to narrower constituency groups, and to experts, lobbyists and so on all the time. And it is in the very nature of policy-making—and indeed, desirable from a public policy standpoint—that lawmakers and employees of the federal agencies discuss potential policy initiatives and their consequences with a wide variety of groups. Moreover, think in this context about the political intelligence consultants that you retain; in many instances their value to your firm lies in the fact that they are for-

[7] S. Rep. No. 112-244, at 1 (2012).
[8] S. Rep. No. 112-244, at 6 (2012).
[9] S. Rep. No. 112-244, at 8 (2012).
[10] S. Rep. No. 112-244, at 8 (2012).
[11] S. Rep. No. 112-244, at 8 (2012).
[12] S. Rep. No. 112-244, at 8 (2012) (quoting *Ernst & Ernst*, 425 U.S. at 193, n.12).
[13] S. Rep. No. 112-244, at 8 (2012).
[14] Pub. L. No. 112-105, § 4(b)(2), 126 Stat. 291, 292 (2012).
[15] 17 C.F.R. § 240.10b5-1(a) (2014).

mer government employees who maintain professional and personal contacts with current officials. Further, it is commonplace for such consultants to be invited to briefings, roundtables and the like at which policy initiatives and their pros and cons are weighed and discussed so that government officials can draw from such consultants' knowledge and experience. At least as important, consultants rely on their web of relationships to learn about pending developments from more informal, one-on-one communications. So how can you know whether the information you have received about something that the government may do or is about to do was communicated by a government employee *in breach* of a duty not to disclose it?

There are some red flags to watch out for. Most obviously, you need to know how in fact your source obtained the information. Was it in a public forum? Or was she invited to a policy discussion at which ground rules about confidentiality had been set? Was there an explicit or implicit *expectation* that the information will not be shared? Did she learn about it from a former colleague after their third drink at a local hangout? Second, what is the nature of the information itself? Is the information of the sort that you would expect to be publically disseminated, or—at the other end of the spectrum—are you learning about specific, imminent government action that appears to have been intended to remain confidential until a broad public announcement? Common sense will often be your best guide here. Take the example with which we began: whoever was privy to the substance of the public announcement that the Secretary of Energy is about to make surely was not supposed to be talking about it in advance!

In assessing the possibility that you have received information in violation of a duty owed by the source, it is important to bear in mind how the two principal paradigms of insider trading liability can be expected to play out in the STOCK Act context.

2. Tippee/Tipper Liability

The STOCK Act creates the potential for tippee liability even though the investment funds that have received the non-public information may be several steps removed from the covered public official who learned the information in the course of her duties. Just as in the context of more traditional insider trading law, an investor who receives material, non-public information may be found liable for trading on that information if the tippee knew or should have known that the tipper disclosed the information in violation of a fiduciary duty. *Dirks v. SEC*, 463 U.S. 646, 659 (1983).

Consistent with other SEC enforcement proceedings, the investor may have received sensitive political information through a chain of intermediaries and thus may well lack actual knowledge that the source of the information is a covered public official who has disclosed it in violation of her duty of trust and confidence. Here, too, context matters a lot. The SEC is likely to take the position that there are some circumstances, based on the nature of the information and the circumstances and timing of its transmission, that the investor at a minimum should have been aware that the information was transmitted through a breach of duty by a covered person, or by someone who misappropriated the information from a government source. In our hypothetical, you could be a tippee covered by the STOCK Act if the tipper received a benefit in exchange for the information and you knew or should have known that it was obtained from a government source in breach of a duty of confidentiality and in exchange for that benefit.[16]

3. Misappropriation Liability

In the private context, the misappropriation theory of insider trading liability applies to non-employees who illicitly obtain information from public companies. This theory also applies to a non-government actor, such as a consultant, who becomes privy to government secrets and uses that information for her own purposes. In the STOCK Act context, the misappropriation theory is most likely to come into play when: (1) an investment firm or consultant gains access to information from a public official in a context (such as a policy briefing) in which the government official has imparted the information for non-trading purposes; and (2) the government official or agency either (a) has explicitly placed limits on its use or (b) has a reasonable expectation that his interlocutor will not take the information and trade on it or disclose it to investment industry clients.

The practical problem is that the investment professional will not often have information about the context in which the information has been imparted, but understanding that context is crucial to an appreciation of whether there is a risk that the information has been misappropriated. The SEC may determine based on the nature of the information that the investment professional should have been aware that the information was obtained through misappropriation. For example, if in our hypothetical the consultant somehow obtained a confidential copy of the text of the Secretary of Energy's forthcoming speech, or told you that he shouldn't have the information he has, it would be reasonable for you to suspect that the information may have been misappropriated.

Materiality Under the STOCK Act

One of the most important practical differences between private sector insider trading law and the contexts in which the STOCK Act may apply is attributable to the fact that persons covered by the STOCK Act will often be privy to information that is material to an entire sector of the economy. This can be a real trap for the unwary.

Materiality has never been limited to information about a specific company or security, but historically the SEC has not pursued enforcement actions concerning information that is material to an entire section of the economy. That could change in the STOCK Act enforcement context.

The House of Representatives Ethics Committee defines materiality: ''Material non-public information is any information concerning a company, security, industry or economic sector, or real or personal property that is not available to the general public and which an investor would likely consider important in making an investment decision.''[17] The House Ethics Committee gives more specific examples of material non-public in-

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[16] This article explores the tipper/tippee context further below through a series of hypotheticals highlighting the issues in this area. *See* page 1667, *infra*.

[17] H. Comm. on Ethics, 112th Cong., New Ethics Requirements Resulting from the STOCK Act, 6 (April 4, 2012).

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formation, including: "Legislation and amendments prior to their public introduction, information from conference or caucus meetings regarding votes or other issues, and information learned in private briefings from either the public or private sector."[18]

The consequences of coming to possess material nonpublic information about government action that may impact a broad sector of the economy could have far-reaching consequences. Take, for example, our initial hypothetical. You now know about an important government initiative that will foreseeably impact the entire wind energy sector, and that may also have indirect but concrete consequences for other energy companies. Are you now constrained to refrain from making any trades in that entire sector until the information is made public? In our hypothetical, we assume the speech will reveal the information in a day or so. But what if your consultant tells you about a policy decision that is still weeks away from disclosure? How long may you be frozen in place?

Another hypothetical illustrates the point. On June 25, 2015, the Supreme Court upheld the Obama Administration's interpretation of a critical provision of the Affordable Care Act in *King v. Burwell*.[19] The price of shares in the major health insurers all jumped on the news. Now, suppose that three months earlier, your old college roommate, now a clerk for a Supreme Court Justice, confided in you that the Court was going to come out the way it did. Material information, for sure. But material to which investment decisions? Would you and your firm be foreclosed from making any changes whatsoever in your portfolio of investments in health insurers, hospitals, medical device companies, pharmaceutical companies and so on? Similarly, suppose a political consultant to a portfolio manager was in touch with a policy analyst to the President of the Federal Reserve Bank of Kansas City and discloses an upcoming rate increase. If the consultant then conveys the information to the portfolio manager, he now possesses information that is so broad that it could potentially freeze the portfolio manager's entire portfolio. The point here is just that. In the STOCK Act context the persons covered by the statute will often have information that is material to a much larger part of the economy and thus to many more public companies at the same time.

In light of the broad definition of materiality under the STOCK Act, investment professionals must use caution when seeking non-public government information. Any trading decisions, moreover, need to take into account that materiality will be judged in hindsight. Information that is specific, definitive, or about government action that is imminent, is more likely to be material. In contrast, information that is speculative, broad, or ambiguous in nature, and that pertains to future events, may be more easily characterized as immaterial. Moreover, the materiality of non-public government information is likely to be analyzed in the context of what the market *already* knows or believes. There may often be a difference between information that *confirms* what has been widely reported (and is thus already expected) and new information that *unsettles* public expectations. In our hypothetical, for example, the information in the tip relayed by the consultant is clearly material—it relates to an imminent event, and it unsettles rather than confirms public expectations.

Personal Benefit Requirement: *United States v. Newman* and the STOCK Act

Under the securities laws, liability arises in the tipper/tippee context only if some personal benefit has been exchanged for the information. It is not clear if this personal benefit requirement applies under the STOCK Act. The legislative history of the STOCK Act suggests that some personal benefit would be required in the tipper/tippee context.[20] There is no explanation of what this personal benefit might mean, however, in either the legislative history or the text of the law. The Senate Ethics Committee has provided some guidance by defining "personal benefit" broadly to include intangibles such as career advice, goodwill, or a reputational boost.[21]

Even based on new Second Circuit law interpreting the personal benefit requirement, it would not seem advisable for an investment professional to trade because they are not aware of the benefit the tipper might have received. That is especially so because there now appears to be a Circuit split on this issue.

On Dec. 10, 2014, the Second Circuit Court of Appeals clarified the personal benefit element of insider trading liability in *United States v. Newman* by dismissing the indictments against two insider trading defendants.[22] Concerned that tippees in recent insider trading cases were becoming further removed from insiders, the Court in *Newman* required that the tippee know about the "personal benefit received by the insider in exchange for the disclosure."[23] Further, the court held that the personal benefit must be "of some consequence."[24] The court articulated the elements of insider trading as:

> (1) the corporate insider was entrusted with a fiduciary duty;
>
> (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit;
>
> (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and
>
> (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.[25]

[18] H. Comm. on Ethics, 112th Cong., New Rules Regarding Personal Financial Transactions, 3 (Nov. 29, 2011).

[19] 135 S.Ct. 2480 (2015).

[20] S. Rep. No. 112-244, at 8 (2012) ("To prove a case of insider trading, the SEC must show that a trade was made, in breach of a duty of trust and confidence, based on material, nonpublic information. In the case of tipping, there must also be some personal benefit to the tipper in communicating the information to the tippee.").

[21] S. Select Comm. on Ethics, 112th Cong., Restrictions on Insider Trading Under Securities Laws and Ethics Rules, 2 (Dec. 4, 2012).

[22] *United States v. Newman*, Nos. 13-1837-cr (L), 13-1917-cr (con), slip op. (2d Cir. Dec. 10, 2014).

[23] *Id.* at 14.

[24] *Id.* at 22.

[25] *Id.* at 18.

However it is unclear how far-reaching *Newman* will be, which should caution any investment professional against trading under a *Newman* theory that there was no personal benefit. The decision only applies as binding authority in the Second Circuit, and the Government has indicated that it does not intend to follow *Newman* outside the Second Circuit, even in the classical insider trading context.

In *United States v. Salman*, the Ninth Circuit faced the question whether a non pecuniary benefit—in that case, the feeling of brotherly love—is sufficient to constitute a ''benefit'' for purposes of insider trading law. The Ninth Circuit splits with the Second Circuit's *Newman* decision only insofar as the Second Circuit may be read to suggest that a relevant ''benefit'' is not created by the gift of confidential information to a family member. The Ninth Circuit said the following:

> Salman reads *Newman* to hold that evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit. In particular, he focuses on the language indicating that the exchange of information must include ''at least a potential gain of a pecuniary or similarly valuable nature,'' *id*. at 452, which he reads as referring to the benefit received by the tipper. Salman argues that because there is no evidence that Maher received any such tangible benefit in exchange for the inside information, or that Salman knew of any such benefit, the Government failed to carry its burden.
>
> To the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an ''insider makes a gift of confidential information to a trading relative or friend.'' *Dirks*, 463 U.S. at 664. Indeed, *Newman* itself recognized that the '' 'personal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, . . . the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.' '' *Newman*, 773 F.3d at 452 (alteration omitted) (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)).
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> In our case, the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information. Specifically, Maher Kara testified that he disclosed the material nonpublic information for the purpose of benefitting and providing for his brother Michael.

Applying the STOCK Act: Height Securities

Height Securities is a pending SEC investigation about political intelligence disseminated through a client alert. This investigation raises difficult and important questions about when information is ''public''. It also will provide some insight into how the SEC will enforce the STOCK Act and how Congress interprets the law.

In February 2013, the U.S. Centers for Medicare and Medicaid Services announced an anticipated 2.3% reduction in reimbursement rates. In fact, the actual rates released 20 minutes after the close of market trading on April 1, 2013, amounted to a 3.5% increase.[26] About 70 minutes before the rate announcement, a lobbyist at Greenberg Traurig LLP emailed an analyst at Height Securities, giving notice of the unexpected increase in reimbursement rates. Height Securities sent out an email alert to more than 150 clients ''predicting'' the changes.[27] Humana stock increased approximately 6% between the time of the alert (3:40PM) and the market close.[28]

The question is whether dissemination of this information to multiple professional traders makes the information ''public,'' even though the broader marketplace knows nothing about it. Traditionally, the SEC has taken the view that to qualify as ''public'', information must have been disseminated broadly to investors in the marketplace, such that the information had been fully absorbed into the stock price.[29] However, this definition is difficult to apply to the types of information covered by the STOCK Act. Thus, when a Congressman makes a speech in a public forum in his district, which is covered only by the local press, if at all, the information has not been transmitted to the public in the sense that the SEC's standards require—yet, it would be absurd to take the view that such a public statement cannot be factored into investment decision-making.

Height Securities presented a much more challenging question about whether information was public, even when disseminated to over one hundred people. Unlike the example with the Congressman making a speech in his district, at an event open to everyone and with no expectation that the information would be treated as confidential, the whole point of the Height Securities disclosure was that it went to a tightly restricted circle of persons who effectively paid for access and that the recipient could actually use the disclosure. The value to those investment professionals lay precisely in the fact that others did not know about it.

In connection with the Height Securities matter, the Wall Street Journal reported that the SEC is investigating the propriety of conduct of several investors—manifesting that the SEC has not been deterred from acting by the fact that many firms received the same alert.[30] This suggests that the SEC may take the view that disseminating information to 150 traders through a research report does not make the information public. An alternative theory is that the SEC is meeting with these firms to build a case against the government insider and the lobbyist.

News articles state that the SEC has identified 44 firms that received the alert and traded shares ahead of

[26] Brody Mullins, Susan Pulliam & Juliet Chung, *Washington Trading Probe Broadens to Hedge Funds: SEC Examines Communications Between Investors and Height Securities After Alert on Health-Insurance Policy Shift*, WALL ST. J., Sept. 10, 2014, http://www.wsj.com/articles/washington-trading-probe-broadens-to-hedge-funds-1410382788.

[27] *Id.*

[28] *Id.*

[29] *Dirks* v. *SEC*, 463 U.S. 646, 653 n. 12, (1983) (citing *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973)).

[30] Brody Mullins, Susan Pulliam & Juliet Chung, *Washington Trading Probe Broadens to Hedge Funds: SEC Examines Communications Between Investors and Height Securities After Alert on Health-Insurance Policy Shift*, WALL ST. J., Sept. 10, 2014, http://www.wsj.com/articles/washington-trading-probe-broadens-to-hedge-funds-1410382788.

the announcement.[31] Reportedly, the characteristic distinguishing the four firms currently under scrutiny from the others is that they all contacted Height Securities to request more information about the alert. However, it would be a mistake to draw the conclusion that you are therefore better off not quizzing your sources of information. To the contrary, the lesson from Height Securities is that the critical step, when new ''political'' information comes to a trader through any non-official governmental channel, is to pause and try to determine whether you have a potential STOCK Act problem. In most instances, consultation with the Legal and Compliance Departments will also be essential.

In addition to the SEC's investigation into the investment firms that traded on the client alert, Senator Charles Grassley opened an investigation into the matter, stating that it raises ''serious questions regarding how political intelligence brokers are able to gather information.''[32] The SEC subpoenaed the House Ways and Means Committee and a top congressional healthcare aide relating to possible criminal and civil charges. However, the Committee is contesting the validity of the SEC's subpoenas based on the Speech or Debate Clause of the Constitution.[33]

This example raises the question of whether it is permissible to trade when an investment professional is not the only person who receives information from a broker or other financial intermediary in the form of an alert or newsletter. It also shows that distribution to a large group of professionals likely is insufficient to make the information public according to the SEC.

Proposed Amendments to the STOCK Act

In 2015, Senator Grassley is expected to introduce a bill that will increase disclosure requirements for the political intelligence industry. Senator Grassley introduced a similar amendment in 2012 when the bill was proposed, but that amendment was removed from the bill.[34] Some speculate that Senator Grassley's expected bill will be similar to the Political Intelligence Transparency Act, which was introduced by a bipartisan group of members of the House in the fall of 2014. That bill would have required political intelligence firms to comply with the disclosure requirements of the Lobbying Disclosure Act. The bill would have covered firms that ''extract information not available to the public'' from Congress or the executive branch for the purpose of analyzing securities markets or guiding investment decisions.[35] It is expected that Senator Grassley will have bipartisan support for his bill in both the Senate and the House.[36]

Potential Applications of the STOCK Act: A Series of Hypotheticals

A. Example 1

A congressional committee staffer, on her own initiative or at the request of a Congressman on the Committee, leaks information to a lobbyist for a political purpose. The lobbyist passes the information on to a consultant, whose clients trade on the information. Has the staffer breached her fiduciary duties?

Answer: Probably yes. This hypothetical illustrates the particular difficulty of determining, in the STOCK Act context, when the disclosure of information is serving a legitimate public policy purpose.

B. Example 2

An administration official meets a former colleague now at a political intelligence firm for a drink and discloses nonpublic policy planning developments, at a time when the official is ready to search for private sector employment. Has there been a breach of duty?

Answer: Yes.

C. Example 3

Based on discussions with a senior adviser to the President, a political intelligence consultant gives advice to a trader about a prospective White House policy initiative, *confirming* what has already been widely reported in the media. Is the confirmation material?

Answer: Possibly yes, depending on whether the earlier media reports were quoting unattributed rumor as opposed to authoritative sources.

D. Example 4

The consultant gives the same advice from Example 3 to a trader, but later learns—based on non-public information—that the Administration will not take the action. The new information is certainly material. Can the consultant change her advice to the trader? Can she tell the trader she no longer can stand behind the prior advice, without disclosing the reasons for her change of view?

Answer: No to both questions.

E. Example 5

A prominent Member of Congress has made—but not announced—his or her decision with respect to an upcoming vote. Can this information be considered material? What if the public knows the position of most members of Congress and this vote from a Member who is publicly undecided means that the bill will pass? What if a member of the majority is going to vote against a bill, even though the public thinks she will vote for it?

Answer: The voting intentions of one congressman are unlikely to be material in most circumstances, but the views of the leadership and of members whose vote can change the outcome could be material. This hypo-

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[31] *Id.*

[32] Brody Mullins, Susan Pulliam & Juliet Chung, *Grassley Keeps Up Pressure on Political Intelligence*, Wall St. J., April 8, 2013, http://blogs.wsj.com/washwire/2013/04/08/grassley-keeps-up-pressure-on-political-intelligence/.

[33] Brody Mullins, Susan Pulliam & Juliet Chung, *Washington Trading Probe Broadens to Hedge Funds: SEC Examines Communications Between Investors and Height Securities After Alert on Health-Insurance Policy Shift*, Wall St. J., Sept. 10, 2014, http://www.wsj.com/articles/washington-trading-probe-broadens-to-hedge-funds-1410382788.

[34] Senator Grassley attributes the removal of his proposed amendment to the work of lobbyists. *See* ''Grassley: House GOP doing Wall Street's bidding on STOCK Act'', available at http://thehill.com/policy/finance/209421-grassley-house-gop-doing-wall-streets-bidding-on-stock-act.

[35] Kenneth P. Doyle, *'Political Intelligence' Bill Set for Revival With Grassley in Position to Move Measure*, Bloomberg BNA – Securities Regulation & Law Report (Apr. 16, 2015).

[36] *Id.*

thetical illustrates the point that the materiality judgments are highly contextual.

F. Example 6

Often, consultants will receive broadly consistent information from a multitude of sources, including both persons covered by the STOCK Act and non-covered persons like reporters and lobbyists. Would this make the information received from any given source less likely to be considered material?

Answer: Yes.

G. Example 7

The White House invites thirty private sector energy experts to a meeting, closed to the press, to discuss policy alternatives, and it is disclosed that the President is likely to issue an Executive Order implementing a regime that will affect the oil and gas industry. Has a participant who alerts private sector investment clients to the news misappropriated the information? What if the government set ground rules (*e.g.*, ''pencils down'', ''off the record'', or ''Chatham House rules'') before beginning the closed door meeting? Should the participants reasonably expect that the information is confidential?

Answer: Yes, this is context in which the misappropriation theory is likely to come into play.

Best Practices and Recommendations for Compliance with the STOCK Act

Investment management firms should consider the following recommendations when trading on government information to avoid liability under the STOCK Act.

Investment firms need to be particularly cautious about the consequences of receiving unsolicited material nonpublic information. This is especially true when the information could potentially restrict activities relating not to one issuer, but to multiple issuers or a whole sector of the economy.

SEC enforcement actions over the past several years have focused on the flow of information from outside consultants working in the *private* sector. Investment firms have accordingly developed robust policies and procedures dealing with this matter and expert networks and consultants have done the same. By contrast, the focus (and to some extent the law) with respect to information flow from *governmental* sources is significantly less developed.

The confluence of these two factors—information applicable to more than just one issuer and the developing nature of government information—warrants particular caution when developing ''safety valves'' or policies and procedures that control the information flow that might restrict a firm in its trading activities.

A. Establish Internal Policies and Procedures.

Your policies and procedures should apply to government investment contacts regardless of whether such contacts are paid for their services. Your policies may include the following elements:

- Employees may not communicate with consultants about government information (or directly with relevant government officials covering securities or industries the Company may want to trade) without first obtaining approval from the Research Director and Chief Compliance Officer.
- Employees may not communicate directly with government officials, and must obtain approval from Legal and Compliance to communicate with former government officials who left their government employment within a certain period of time, such as the past 12 months.
- All contracts with consultants must be in writing and approved by Legal and Compliance. A written consent form signed by Legal and Compliance must be obtained before an investment professional can engage a consultant or expert. These consent forms must be re-signed by the consultants at least once every three years.
- Investment professionals, working with Legal and Compliance, must conduct due diligence on prospective consultants and experts who may convey government information in order to evaluate what risks they might pose under the STOCK Act.
- Before speaking to a consultant about government information, an employee must submit to Legal and Compliance a list of questions or specific topics that the employee plans to discuss with the consultant. A Compliance officer may choose to participate in the call/meeting to ensure compliance with the STOCK Act and insider trading laws.

Require employees to read disclaimers to consultants before beginning any discussion about government information to confirm they will comply with insider trading regulations, including the STOCK Act. This disclaimer could include language such as:

- We are an investment advisor and may use information from this call/meeting to inform an investment decision.
- Do not provide the Company with material, nonpublic information or any other information that you are required to keep confidential or that you are not sure whether you are required to keep confidential.
- Do not to provide the Company with any information that you have reason to believe was obtained from someone who breached a duty of confidentiality or fiduciary obligation to another party.

In the course of conducting diligence on your government contacts or experts, critically examine their compliance infrastructure, and their understanding of the insider trading laws and the STOCK Act.

Specific steps may include:

- Review the consultant's compliance policies and procedures to make sure the consultant understands his or her obligations with respect to potential material non-public information and has policies and procedures reasonably designed to prevent provision of such information to his or her clients.
- Discuss recent updates in the law with your consultants.
- Require your consultants to provide periodic logs of calls with any of your employees to ensure compliance with these procedures.

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Consider developing a call confirmation form that asks the employee to verify that he or she did not receive any material non-public information during a call with a consultant. Further consider whether to require each consultant to sign a similar confirmation that he or she did not provide any material non-public information in breach of a duty of trust or confidence.

Consider requiring STOCK Act training for consultants and experts who may convey government information. Investment firms should offer to provide this training for their consultants.

Establish a reporting and pre-clearance policy for any personal securities trading by employees of the Company.

Train your employees on the STOCK Act, the permissible uses of government information, and insider trading regulations more generally. Develop a policy explaining and prohibiting insider trading by employees with examples for all elements of insider trading. Provide examples of types of government information that could potentially be material, including information about approvals or impediments to mergers; information concerning criminal matters or civil litigation between the government and a private company; or announcements of bankruptcies, receiverships, government rates, government contracts, or government investigations.

B. Ask Consultants To Identify Their Sources of Information.

Investment professionals should ask consultants about their sources of information when they are unsure of the source. If you receive a non-public tip that is specific and related to an imminent event, like the tip in our hypothetical or in the case of Height Securities, you should ask your consultant or expert for his or her source of information to determine whether it is a government source covered by the STOCK Act.

The best practice in this type of situation is to direct investment professionals to not make any judgment calls, but rather to contact Legal and Compliance.

C. Exercise Caution When Receiving Imminent or Definitive Information.

Investment professionals may wonder how to determine what information in newsletters and alerts from consultants could violate the STOCK Act. A good rule of thumb is to watch for information that is specific, imminent, or definitive. Such information is more likely to be material and could violate insider trading laws.

Similarly, investment professionals should be sensitive to the difference between information that may confirm public expectations and information that unsettles public expectations. When you receive information from a consultant that unsettles public expectations, consult with Legal and Compliance before trading on it.

D. Unpackage Information.

The packaging of information can make it difficult to identify which components might come from a covered person. Consultants synthesize multiple sources of information and may not identify their specific government contact for each component. Traders similarly do not generally rely on only one piece of information in making investment decisions. If you intend to trade based on packaged information received from a consultant who has not identified the sources of all components of the information, consult Legal and Compliance before trading.

Conclusion

Enforcement agencies are attempting to draw appropriate lines for what conduct violates the federal securities laws under the STOCK Act. Because the STOCK Act defines the duty of confidentiality owed by public officials and their employees broadly, it is important for investment professionals to work closely with Legal and Compliance when receiving any government information. The Height Securities investigation—the first known investigation conducted by the SEC under the STOCK Act—offers some insight about how the SEC views client alerts about material non-public government information, but it is difficult to predict how the Height Securities investigation will be resolved, and how broadly the SEC might apply the STOCK Act's requirements in other investigations. By developing consultant compliance policies and training employees on the STOCK Act's requirements, firms can take proactive steps to avoid liability for trades using government information under the STOCK Act.

If you receive information on a call from a consultant that you think might be covered under the Stock Act, don't hang up the phone. Ask for your consultant's sources, determine the nature of the information and the circumstances surrounding its disclosure, and do not trade while in possession of the tip until you are comfortable that it is not material, non-public information obtained from a government source covered under the STOCK Act.