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Securities

The Stop Trading on Congressional Knowledge Act, which forbids members of the three branches of the federal government and their employees from profiting from insider information, will give rise to difficult issues concerning private parties who routinely obtain information from those covered by the new statute, write Paul, Weiss, Rifkind, Wharton & Garrison LLP partners David S. Huntington, Daniel J. Kramer, and Richard A. Rosen. There are important differences between the company-specific nonpublic information that has been the traditional concern of the laws against insider trading and the far broader categories of information concerning industry sectors and the prospects of legislative or regulatory action with which the STOCK Act is concerned. Legislation is in constant flux, so it remains to be seen when trading will and will not be permitted on such information. Without language in the STOCK Act and without any precedents of SEC-enforcement of insider trading laws against those covered by the legislation, potential tippers and ''tippees'' will be left to make tough judgment calls.

STOCK Act Bans Insider Trading by Federal Employees—Unintended Consequences

David S. Huntington, Daniel J. Kramer, and Richard A. Rosen

On April 4, 2012, President Obama is slated to sign into law the Stop Trading on Congressional Knowledge Act (S. 2038). The core of the STOCK Act amends the securities laws to forbid members of the three branches of the federal government and their employees from profiting from insider information.

It does so by specifying that, for purposes of the securities laws, each covered person ''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 with respect to material, nonpublic information'' derived from such person's position or gained from the performance of such person's official responsibilities (56 DER EE-18, 3/23/12).

Much of the public debate concerning the STOCK Act has centered on this explicit establishment of a duty of trust and confidence, but less attention has focused on the bill's practical implications for private parties who routinely obtain information from those covered by the new statute.

Many constituents, including of course representatives of private sector interests that could be affected by legislation or rulemaking, regularly communicate with members of the executive branch, Congress, and their staffs regarding pending legislation and other governmental initiatives. As a matter of fundamental public policy, it is desirable that government officials communicate openly with the public; an exchange of information and perspectives is normally regarded as healthy in a democracy.

But the new legislation leaves unanswered practical questions about whether and when a person who learns information from dialogue with a covered person has become a ''tippee'' under the securities laws, and therefore must refrain from trading securities whose value may be materially affected by the disclosure of the information imparted.

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Defining 'Material,' 'Nonpublic' Information

Liability may arise under the securities laws when the ''tipper'' discloses material, nonpublic information in breach of a duty of trust or confidence, and the recipient of that material nonpublic information trades on it. Although earlier versions of the STOCK Act sought to require the SEC to define ''material'' and ''non-public'' information through rulemaking, the final version of the bill contains no such language, leaving the Select Committee on Ethics of the Senate and the Committee on Standards of Official Conduct of the House of Representatives to ''issue interpretive guidance'' on the new legislation.

In the absence of a definition of ''material information'' in the governmental context, the STOCK Act gives rise to difficult questions of how broadly the ban on trading based on insider information is to be applied. Federal statutes and rules often apply to entire sectors of the economy rather than to individual companies. If a person learns through a communication with a congressional staffer that a new statute is being drafted, or that a key senator is leaning against voting for a bill, is that information material to trades in companies that may foreseeably be affected by the legislation? It is fair grounds for concern that judgments about materiality, often difficult enough to make in the traditional context of company-specific information, will be far more difficult in this new and very different context. Materiality questions will come up in at least two key respects.

Two Aspects of Materiality

First, legislation or rules can have a foreseeable effect on both specific companies and on entire sectors of the economy. To take a simple example, does the recipient of information about a new solar energy bill require the tippee to refrain from buying or selling stock in all solar energy companies? All energy companies? In a statement before the Senate Homeland Security and Governmental Affairs Committee in December 2011, Senator Scott Brown (R-Mass.), one of the bill's sponsors, seemed to suggest this might be the case.

A member of Congress hears during a meeting that a program is going to be cut the next day. That member could then sell his or her stock in that sector and score a profit—or avoid losses—when the news breaks.

Second, given the vicissitudes and unpredictability of the legislative process, judgment calls will also need to be made about whether the information received is genuinely material to an assessment of the likelihood of the federal action actually occurring. Take our prior example: Would knowledge of the leanings of one senator, however prominent her role, be material information in this context?

A related question about the scope of the legislation's applicability arises due to the major difference between the SEC's definition of ''public'' information and the manner in which information is disclosed in the political arena, including hearings and town hall meetings. While those meetings are undeniably public in the colloquial sense, the information so disseminated is not likely to meet the SEC's definition of ''public'' information, which requires dissemination in a manner that makes the information available to investors generally.

Conclusion

The STOCK Act will give rise to difficult issues concerning the circumstances that will permit our hypothetical tippee to resume trading. Legislation is in constant flux. Must a tippee wait until the legislative initiative or rule is enacted or defeated? Can he resume trading while the bill is still alive but the key senator has announced how she will cast her vote? Or may he buy once the congressional rumor mill has picked up on the senator's inclinations? Without language in the STOCK Act, and without any precedents of SEC-enforcement of insider trading laws against those covered by the legislation, potential tippers and ''tippees'' will be left to make tough judgment calls.

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