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# E-ALERT | Securities Law, Election and Political Law

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## STOCK ACT SPOTLIGHTS TRADING ON GOVERNMENT INFORMATION

On March 22, 2012, the Senate passed the House version of the Stop Trading on Congressional Knowledge Act of 2012 (the "STOCK Act"), sending it to the President who is expected to sign within the next several days.[1] The core provisions of the STOCK Act affirm that the insider trading prohibitions of the federal securities and commodities laws apply to members and employees of Congress, certain executive branch officers and employees, and judicial branch officers and employees. While the STOCK Act was enacted to address potential insider trading by those inside government, it may have significant implications for individuals outside of government who obtain information from government sources. We discuss these implications below.

## THE STOCK ACT'S INSIDER TRADING PROHIBITIONS

### Background

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder prohibit fraudulent statements or actions in connection with the purchase or sale of securities. Courts have interpreted these provisions to prohibit corporate insiders and certain other persons from trading on the basis of material non-public information. Rule 10b5-1 under the Exchange Act codifies this case law by defining securities fraud to include purchasing or selling a security on the basis of material non-public information, in breach of a duty of trust or confidence owed to the issuer or to the party providing the information.

### Insider Trading Liability for Governmental Officers and Employees

Congress. Prior to the adoption of the STOCK Act, many questioned whether Members and employees of Congress had a duty not to trade on material non-public information derived from their official duties, although the staff of the Securities and Exchange Commission (the "SEC") has taken the position that Members of Congress and their staffs could be held liable for such trades.[2] Section 4(b) of the STOCK Act resolves this debate by making it clear that "each Member of Congress or employee of Congress 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, non-public information derived from such person's position...."

Executive and Judicial. The SEC and the Department of Justice ("DOJ") have brought enforcement cases against federal executive branch employees for insider trading based on information derived from their official duties.[3] Section 9(b) of the STOCK Act, however, affirms that executive branch

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[1] http://www.gpo.gov/fdsys/pkg/BILLS-112s2038eah/pdf/BILLS-112s2038eah.pdf. The STOCK Act will be effective immediately upon being signed into law by the President.

[2] Testimony of Robert Khuzami, Director, Division of Enforcement, SEC, before the House Committee on Financial Services, December 6, 2011.

[3] *See, e.g., SEC v. Cheng Yi Liang, et al.,* Civil Action No. 8:11-cv-00819-RWT (D. Md. filed June 2, 2011) (SEC enforcement action alleging a U.S. Food and Drug Administration employee traded in advance of public

employees (defined broadly to include the President and other senior appointed officials as well as lower-level employees) and judicial officers and employees are not exempt from the insider trading prohibitions under the securities laws and that each such person "owes a duty arising from a relationship of trust and confidence to the United States Government and the citizens of the United States with respect to material, non-public information derived from such person's position as an executive branch employee, judicial officer, or judicial employee or gained from the performance of such person's official responsibilities."

Interpretive Guidance. The STOCK Act directs the Congressional ethics committees, the Office of Government Ethics and the Judicial Conference to issue interpretive guidance clarifying that Members and employees of Congress, executive branch employees and judicial officers and employees, respectively, may not use non-public information derived from their positions as a means for making a private profit.[4]

Constitutional Issues. A question not directly addressed by the STOCK Act is how the Speech or Debate Clause of the U.S. Constitution might affect insider trading claims against Members of Congress or their staffs. The Speech or Debate Clause provides that "for any Speech or Debate in either House, [Members of Congress] shall not be questioned in any other Place."[5] The U.S. Supreme Court has said that this protection covers not only actual speech or debate but also a broader range of "legislative acts,"[6] and that it protects a Member's aides in those cases where their conduct would be protected if performed by the Member.[7] It is not clear whether or when this would protect Members of Congress and their staffs from insider trading liability. It seems likely, however, that the Speech or Debate Clause would have its greatest effect in cases where a Member or staffer is not accused of having traded on material non-public information but rather is alleged to have shared the information with a third party, who in turn traded on the information. This purely communicative act would seem to fall most squarely within the ambit of the Speech of Debate Clause. Members of Congress and staff in recent years have increasingly relied upon the Speech or Debate Clause as a defense against criminal investigations. There remains considerable uncertainty regarding the scope of the Speech or Debate Clause, however.

The STOCK Act also includes a provision that appears to have been intended to protect Members and staff, as well as executive and judicial branch persons, from liability for at least some communications that they may make in the course of their official duties. Section 10 of the Act provides that "[n]othing in this Act . . . shall be construed to be in derogation of the obligations, duties, and functions of a Member of Congress, an employee of Congress, an executive branch employee, a judicial officer, or a judicial employee, arising from such person's official position." It is not entirely clear, however, what effect this provision will have, nor how it may relate to the Speech or Debate Clause protections for Members and Congressional staff.

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announcements about drug approval decisions); *United States v. Royer*, 549 F.3d 886 (2d. Cir. 2008) ("*Royer*") (FBI agent convicted of insider trading in connection with trades resulting from information provided by the agent regarding ongoing investigations obtained from a government database ); *SEC v. John Acree*, 57 SEC Docket 1579 (Sept. 13, 1994) (SEC enforcement settlement involving trading in bank securities based on information obtained from an employee of the Office of the Comptroller of the Currency).

[4] The STOCK Act's other provisions include, among others, new financial reporting and disclosure requirements for certain government officials and employees (Sections 6, 8, 11 and 13), a required report on "political intelligence" activities (Section 7), limitations on participation in initial public offerings by certain government officials (Section 12) and a prohibition on bonuses to executives of Fannie Mae and Freddie Mac (Section 16).

[5] U.S. Const. Art. 1, § 6, cl. 1.

[6] *Gravel v. United States*, 408 U.S. 606, 618 (1972).

[7] *See id*. at 625.

### Extension of Insider Trading Prohibitions to Commodities Trading

Until the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), commodities trading was not subject to insider trading prohibitions comparable to those that applied to securities trading. The Dodd-Frank Act added an insider trading provision to the Commodity Exchange Act that prohibited the use of inside information relevant to commodities prices held by executive branch employees.[8] This provision did not address information held by Members or employees of Congress.

The STOCK Act extends the Dodd-Frank Act's prohibition against insider trading in commodities to cover Members and employees of Congress and judicial officers and employees, in addition to the executive branch employees already covered. As a result, these parties now are prohibited from using non-public information "that may affect or tend to affect the price of any commodity" for personal gain, and any person who receives such information may not knowingly use it for trading purposes. The Commodity Futures Trading Commission has said that in enforcing its rules on manipulative and deceptive contrivances under the Dodd-Frank Act it will be "guided, but not controlled" by judicial precedent interpreting and applying the Rule 10b-5 under the Exchange Act, and this may indicate that precedent under Rule 10b-5 will inform enforcement of the STOCK Act's commodity trading provisions.

## WHAT THE STOCK ACT MAY MEAN FOR THOSE DEALING WITH GOVERNMENT

Anyone who receives information that could be considered "material non-public information" from government officials will need to consider the potential implications of the STOCK Act with respect to the use of that information. This is especially true for firms that obtain such information for the purposes of trading in or giving advice with respect to securities or commodities. But it is also a serious concern for others who regularly interact with government officials in furtherance of the legislative and regulatory goals of the firms they represent, including lobbyists, legislative affairs personnel, financial institutions, and entities that provide "political intelligence"[9] to investors about the status of potential legislation or other political outcomes.

Under current case law, a person may be liable for insider trading when he or she "misappropriates" confidential information for trading purposes in breach of a duty owed to the source of the information.[10] That duty can arise when a person agrees to maintain information in confidence, or where a pattern or practice exists such that the person learning the information knows or reasonably should know that the speaker expects the information to be kept confidential.[11] Thus, for instance, an individual could not trade on information about the purchase or sale of U.S. Treasury bonds obtained during an embargoed press conference until it was released to the public.[12] Accordingly, any material information obtained from a government source on a confidential basis (whether the confidentiality is explicit or implicit) could not be used for trading purposes, at least until such information becomes public or is no longer clearly material.

There is another line of insider trading cases that will be relevant under the STOCK Act. This involves a situation where a person who receives material non-public information from an insider can be held

[8] Pub. L. 111-203 § 746 (adding Section 4c(a) of the Commodity Exchange Act (7 U.S.C. 6c(a))).
[9] Section 7(b) of the STOCK Act defines "political intelligence" as "information that is (1) derived by a person from direct communications with an executive branch employee, a Member or an employee of Congress; and (2) provided in exchange for financial compensation to a client who intends . . . to use the information to inform investment decisions."
[10] *United States v. O'Hagan*, 521 U.S. 642 (1997).
[11] Rules 10b5-2(b)(1) and (2) under the Exchange Act.
[12] *See In the Matter of John M. Youngdahl,* Exchange Act Release No. 48900 (Dec. 10, 2003).

liable as a "tippee." Tippee liability results if two elements are satisfied: (i) an insider has disclosed information to a third party, the tippee, in breach of a fiduciary duty and (ii) the tippee knew or should have known that the information was disclosed in breach of such duty.[13] The STOCK Act makes the first element of tippee liability easier to establish by clarifying that a government insider does have an explicit duty of trust and confidence with respect to material non-public information obtained in his or her position. When the insider communicates the information to another party rather than using it personally, courts have held that the insider's duty is breached if the insider receives a direct or indirect personal benefit from the communication. Whether a personal benefit exists is a fact-based analysis, and courts have found a reputational benefit to be sufficient.[14] Thus, for example, under the STOCK Act, a Congressional staffer disclosing material non-public information about the status of legislation potentially may benefit from an increase in his status in the eyes of the tippee or as part of a pattern of reciprocal information sharing.[15] Accordingly, the STOCK Act should be read as confirming that the tippee in such case could be liable for insider trading if securities were purchased on the basis of the tip.

The cases applying both the misappropriation theory and tippee liability have nearly all involved corporate inside information, but under the STOCK Act the same principles could be applied to very different fact patterns involving government insiders. Because questions of misappropriation and tippee liability are fact-driven, it is difficult to predict how the law will apply to cases of alleged insider trading based on government-sourced information.

## WHAT TYPES OF INFORMATION COULD GIVE RISE TO INSIDER TRADING CLAIMS UNDER THE STOCK ACT?

Under current securities law, to give rise to an insider trading claim, information used in connection with a trade must be both material and non-public. There is little guidance as to how the SEC or the courts will apply these terms in the government context under the STOCK Act.

### Whether Information is Material

Under existing precedent, information is material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.[16] For contingent or speculative information, the materiality of an event depends on the probability of the event occurring and the anticipated magnitude of the event as it relates to the security in question.[17]

Certain information held by government insiders resembles the type of information about which current insider trading law is clear -- for instance, there may be little question regarding the materiality or the non-public status of confidential information obtained from the Food and Drug Administration about a drug's regulatory path. But, much of the information covered by the STOCK Act will look very different from the information that has been addressed by insider trading cases to date. For example, suppose that a Congressional staff member tells a constituent in confidence that he has learned that a particular Senator plans to withdraw her support for a provision that would eliminate tax credits for certain alternative fuels and which is part of a broad transportation bill. The

[13] *Dirks v. SEC*, 463 U.S. 646, 660-662 (1983).
[14] *See id*. at 664 (holding that the benefit may include a reputational benefit or an intention to benefit the tippee).
[15] *See, e.g., SEC v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) (holding that "maintaining a good relationship between a friend and a frequent [business] partner" is sufficient to establish the benefit element); *U.S. v. Rajaratnam*, 802 F.Supp.2d 491, 514 (S.D.N.Y. 2011) (holding that evidence of a close personal relationship and description of inside information as a "present" sufficient evidence to establish the benefit element).
[16] *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).
[17] *Id*. at 238-239.

materiality of the information would depend, among other factors, on (i) the importance of that Senator's support for the provision's inclusion in the bill, (ii) the broader bill's prospects for enactment (with or without the provision), (iii) the stage of the legislative process and (iv) the importance of the tax credits to the value of the securities of a particular affected company. Information about the tax credit may be material to companies that produce the fuels in question, companies that provide inputs for the fuels and companies selling products that compete with the fuels, among others.

We expect that many of the groups that interact with Members of Congress or their staffs may take the position that the information obtained from Members or their staffs is not material individually. This argument is analogous to the currently debated "mosaic" approach to information gathering for the purposes of trading. Under this theory, a trader gathers numerous pieces of information from a variety of sources, each of which is immaterial standing alone, but which when combined give the trader valuable insights into a company. Although the SEC staff continues to support the mosaic theory in principle,[18] there often is considerable risk in relying on it in fact. In the insider trading context, SEC enforcement staff and criminal investigators always assess the materiality of information in hindsight, typically after the information was publicly disclosed and the stock price moved in a direction favorable to the trade under review. At that point, it is often an uphill climb for the trader to show that any particular piece of information was not important to the trading decision and that the stock price moved for reasons other than the disclosure of the information. Accordingly, groups that interact with Members of Congress and their staffs (or other government employees), particularly those that do so for the purposes of trading or giving advice on trading, should not assume that information which they perceive to be immaterial standing alone could not be relied upon by the SEC or DOJ to bring an insider trading case.

### Whether Information is Non-Public

Information is considered non-public if it has not been broadly disseminated to investors. In the corporate context, information becomes public when it has been distributed through a press release, a filing with the SEC or publication in the financial press and sufficient time has passed for the information to have been broadly disseminated. Presumably, a similar level of public access will be needed for government-sourced information to be considered public. In practice, however, determining whether information is public is not always clear-cut. Under existing insider trading law, the fact that information can be obtained from an insider or is known by a handful of other persons does not by itself make information public.[19] As a result, groups would be well advised to treat information obtained in such interactions as non-public until it has been disclosed publicly by the Member or other Members of Congress (or other relevant government officials) or reported by major media outlets or is otherwise widely disseminated.

## POTENTIAL STEPS TO LIMIT RISKS ARISING FROM THE STOCK ACT

The STOCK Act may affect a wide range of people interacting with government officials, including firms that actively seek information from government sources for trading purposes, lobbyists and legislative affairs personnel. All of these affected groups must be careful that they do not come into possession of material non-public information that would hinder their ability to trade, and that if they

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[18] *See* Carlo di Florio, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (March 21, 2011) ("I believe these cases do not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory").

[19] *See Royer*, 549 F.3d at 898 (2d Cir. 2008) (holding that the fact that information could be found publicly by someone knowing where to look is not sufficient to make information "public" for purposes of insider trading laws).

do possess such information, that there are procedures in place that would prevent them from inadvertently violating insider trading laws.

Examples of steps anyone affected by the STOCK Act may want to consider include the following:

- Before meeting with a government official subject to the STOCK Act, discuss ground rules with such official or staff confirming that the information being provided is public, immaterial or being given in accordance with (and not in violation of) any duty owed to the government.
- After meeting with a government official, evaluate the information discussed and determine whether such information is likely to be material non-public information, and if so, whether to self-impose a trading restriction until such information becomes public or immaterial.
- Consider the use of pre-arranged trading plans for securities that might be affected by the information to be discussed with a government official who is subject to the STOCK Act.[20]
- Consider establishing information barriers between a firm's legislative affairs staff and the staff that engages in trades on behalf of the firm to ensure that the firm does not trade on information that could subject it to insider trading liability.[21]
- Review insider trading policies to address contact with potential government sources of material non-public information.
- Consider training for individuals interacting with government sources; in certain cases it may be appropriate to require pre-approval for communications with government sources and/or limit the types of interaction between employees and government sources. Alternately, the firm could consider appointing a "chaperone" to supervise these discussions.
- Prior to engaging a political intelligence group, firms should consider conducting due diligence to assess the group's insider trading policies and how it addresses the possibility of obtaining material non-public information from government sources. The contract between the source of political intelligence and the firm could include representations that no one will convey information that is material, non-public information.

## CONCLUSION

The enactment of the STOCK Act will have implications beyond the trading in securities or commodities by government officials and raises significant new questions that likely will take years to resolve, including what constitutes material non-public information, when such information ceases being material or non-public and what procedures can be put in place to mitigate a firm's potential liability for trading on information obtained from government officials. In the meantime, however, anyone who interacts with Members of Congress or other government officials should be thoughtful in how they approach the information received from such interactions and their trading activities.

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[20] Rule 10b5-1(c)(1) under the Exchange Act provides that trades pursuant to a written plan for trading securities will not be considered to have been made on the basis of material non-public information if the plan meets certain criteria.

[21] Rule 10b5-1(c)(2) under the Exchange Act provides conditions under which a firm's trades will not be considered to have been made on the basis of material non-public information if the firm has implemented reasonable policies and procedures to prevent the individuals who make trading decisions from becoming aware of such information.

If you have any questions concerning the material discussed in this client alert, please contact the following attorneys or other members of our securities law and election and political law practice groups:


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