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STOCK ACT OPENS UP NEW FRONT FOR INSIDER TRADING CASES

The Securities and Exchange Commission has opened what the Washington Post calls a "new front" in its "escalating … crackdown on insider trading." At the center of this new front are entities that trade securities based on government information. Unless they are careful, lobbying or consulting firms that obtain non-public government information and clients of those firms may find themselves in the middle of this crackdown. In this advisory, we summarize the insider trading provisions of the Stop Trading On Congressional Knowledge Act (the "STOCK Act"), explain why these restrictions matter to those outside of government, and offer guidelines for companies and firms seeking to reduce the risk of becoming enmeshed in a potentially burdensome and expensive government investigation.

INTENSIFYING INTEREST IN POLITICAL INTELLIGENCE

The recent and intensifying attention trained on inside government information traces its origins to the last 18 minutes of trading on April 1, 2013. During that brief period, a frenzy of trading in major health-care firms broke out, allegedly sparked by an alert from Height Securities, a D.C. and New York-based research and advisory firm, which warned clients that the government would soon take action that would benefit health insurers participating in Medicare Advantage. Following a Wall Street Journal story connecting the alert to the trading surge, the SEC and Senator Charles Grassley (R-Iowa) opened separate investigations. According to media reports, the SEC has since issued subpoenas to an employee of Height Securities, the Greenberg Traurig law firm, and a Greenberg Traurig lobbyist.

THE STOCK ACT

The STOCK Act lies at the heart of the increased SEC and public focus on "political intelligence." The law overwhelmingly passed Congress last year in the wake of a *60 Minutes* exposé of alleged insider trading by Members of Congress. The core provisions of the law affirm that the insider trading prohibitions of 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 almost all insider trading cases to date have involved *corporate* inside information, the STOCK Act clarifies that such cases can be brought on the basis of *government* inside information, including information from Congress. This means that an insider trading case can be brought against a Member of Congress who buys or sells securities on the basis of material, non-public information. It also means, however, that a case can potentially be brought against *anyone* who buys or sells securities on the basis of material, non-public information obtained from the government, including firms that specialize in so-called political intelligence gathering and their clients. The broad universe of those affected by the STOCK Act therefore includes individuals, lobbying firms, financial

institutions, hedge funds, political intelligence consultants, and even corporations employing or retaining Washington representatives – to the extent they may use government information for trading purposes.

During last year's fiscal cliff negotiations in Congress, for example, many firms were pushing their Washington representatives for real-time information on developments in the negotiations. If anyone traded on such information, and it was material and non-public, the STOCK Act's insider trading provisions could have been implicated.

GUIDELINES FOR LIMITING RISKS ARISING FROM THE STOCK ACT

Given the growing SEC interest in insider trading based on government information, now is a good time for individuals, lobbying firms, financial institutions, hedge funds, political intelligence consultants, and corporations to consider several measures to limit their potential STOCK Act exposure.

Before obtaining information from government sources. Organizations can take some simple steps to reduce the risk of obtaining material non-public government information that could be used for trading purposes. A disclaimer like the following, for example, may be appropriate at the beginning of meetings with government officials in which material non-public information may be obtained:

> *In view of your obligations under the STOCK Act, we do not wish to receive any information that could be construed as material and non-public, or which violates your duty to the U.S. Government.*

Moreover, during these meetings, the lobbyist, consultant, or other entity must not mislead the government official into believing that the information will be used for a purpose unrelated to trading in securities if that is not true.

Firms should also consider reviewing their employee training programs and insider trading policies to ensure they address contact with potential *government* sources of material, non-public information. In certain cases, it may be appropriate to require pre-approval for communications with government sources, to limit the types of communications with government sources, or to appoint a "chaperone" to supervise those discussions.

Where a financial institution, hedge fund, or corporation retains an individual, outside lobbying firm, or political intelligence consultant to communicate with government officials, protections against obtaining material non-public information can also be built into the contract. The contract might, for example, include representations that no one will convey information obtained from government sources that is material and non-public. Prior to entering into such contracts, contracting parties should also adopt due diligence programs to assess the other's insider trading policies and procedures. In some cases, an inadequate government information insider trading policy, or other red flags regarding compliance with these policies, may be grounds for a firm to decline a client or for a client to decline a representation.

Once information is obtained from government sources. Following a meeting with a government official, an organization can take a number of steps to reduce STOCK Act risks. Most importantly, information should not be transmitted to clients who may trade on the information if it fits within any of the following categories:

- The information is material and non-public (*i.e.*, the material is not broadly disseminated to the investing public and there is a substantial likelihood that a reasonable investor would consider the information important in deciding whether and at what price to buy, sell, or hold securities). This is a facts-and-circumstances analysis based on the "total mix" of publicly available information.
- Disclosure of the information caused someone to breach a duty of confidence.
- The source of the information believes that the recipient agreed to hold the information in confidence or would expect the client to hold the information in confidence.
- Disclosing the information would result in a violation of applicable laws or regulations or a duty owed to a third party.

Often, the situation will need to be discussed with legal counsel to determine whether the information falls within one of these categories. If an entity does obtain potential material non-public information, it may need to restrict trading until the information becomes public or immaterial. Some firms and clients may also need to establish firewalls between legislative affairs staff and traders to ensure that the firm or client does not trade on information that could subject it to insider trading liability.

CONCLUSION

Congress's passage of the STOCK Act and the uptick in attention to its insider trading provisions pose compliance challenges for a wide range of individuals, lobbying firms, financial institutions, hedge funds, political intelligence consultants, and corporations. These challenges, however, also provide an opportunity for these individuals and organizations to reassess their risk profiles and adopt policies and procedures to mitigate those risks.

Covington has assembled a cross-disciplinary advisory team of political lawyers, lobbying compliance experts, and securities lawyers, who have advised clients on the STOCK Act since before it became law. For additional information regarding STOCK Act compliance and enforcement cases, please see the team's prior advisories and follow us on InsidePoliticalLaw.com.

If you have any questions concerning the material discussed in this client alert, please contact any of the following members of Covington's cross-disciplinary team of lawyers advising clients on STOCK Act issues:

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