Wall Street LAWYER
Securities in the Electronic Age
June 2013 ■ Volume 17 ■ Issue 6

The Coming Crackdown: Insider Trading & Government Sources

BY KERRY BURKE, ROBERT KELNER & ZACHARY PARKS

Kerry Burke and Robert Kelner are partners in the Washington, D.C. office of Covington & Burling LLP. Zachary Parks is Special Counsel at the firm. The authors wish to thank their colleagues Keir Gumbs, David Kornblau, David Martin, Brian Smith, and Erik Durbin for their assistance. Contact: kburke@cov.com, rklener@cov.com or zparks@cov.com.

The U.S. Securities and Exchange Commission (SEC) has opened what *The Washington Post* calls a "new front" in its "escalating… crackdown on insider trading."[1] 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 nonpublic government information and their clients may find themselves in the middle of this crackdown.

The Intensifying Interest on "Political Intelligence"

For decades, Congress's "Code of Ethics for U.S. Government Service" has provided that Members of Congress should not use confidential information they receive "in the performance of governmental duties as a means for making private profit."[2] Nevertheless, until recently, the law surrounding the trading of securities based on inside government—rather than inside corporate—information remained largely undeveloped. Indeed, many questioned whether Members of Congress had a duty not to trade on material nonpublic information derived from their official duties, although the staff of the SEC has taken the position that Members of Congress and their staffs would be held liable for such trades.[3]

Congress clarified the issue last year when it quickly and overwhelmingly passed the Stop Trad-

ing On Congressional Knowledge Act of 2012 (the STOCK Act) in the wake of a *60 Minutes* exposé of alleged insider trading by Members of Congress.[4] The STOCK Act affirmed that the insider trading prohibitions of the federal securities laws apply to Members and employees of Congress, certain executive branch officers and employees, and judicial branch officers and employees.[5]

Now, just over a year after the STOCK Act's passage,[6] the media is once again focusing in on purveyors and users of so-called "political intelligence," defined in Section 7(b) of the STOCK Act 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.**

The recent and intensifying attention trained on the issue 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. The alert warned clients that the government would soon take action that would benefit health insurers participating in Medicare Advantage. Following *The Wall Street Journal* story connecting the alert to the trading surge,[7] the SEC and Sen. Charles Grassley (R-Iowa) opened separate investigations.[8] 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.[9]

The STOCK Act

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 nonpublic 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 nonpublic information, in breach of a duty of trust or confidence owed to the issuer or to the party providing the information.

Section 4(b) of the STOCK Act makes 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…**

Section 9(b) of the STOCK Act similarly affirms that executive branch 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. Under this section, 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.**

What the STOCK Act May Mean for Those Dealing with Government

While almost all insider trading cases to date have involved *corporate* inside information, the above-referenced provisions of the STOCK Act clarify that such cases can be brought on the basis of *government* inside information, including information obtained from Congress. This means that an insider trading case may be brought against a Member of Congress who buys or sells securities on the basis of material, nonpublic information derived from the Member's official du-

ties. It also means that a case potentially may be brought against anyone who buys or sells securities on the basis of material, nonpublic information obtained from the government, including firms that specialize in so-called political intelligence gathering and their clients. These cases likely can be pursued against political intelligence firms and their clients under two theories.

First, 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 cannot trade on information about the purchase or sale of U.S. Treasury bonds obtained during an embargoed press conference until the information is released to the public.[12] Accordingly, under this misappropriation theory, any material information obtained from a government source on a confidential basis (whether the confidentiality is explicit or implicit) may not be used for trading purposes, at least until such information becomes public or is no longer clearly material.

Another line of insider trading cases is also relevant under the STOCK Act. This involves situations where a person who receives material nonpublic information from an insider can be held 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 has 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, but courts have found even a reputational benefit to be sufficient.[14] A Congressional staffer disclosing material non-public information about the status of legislation may be deemed to have received a personal "benefit" from sharing information because his status may increase in the eyes of the tippee or because the sharing of information might be part of a pattern of reciprocal information sharing.[15] The STOCK Act therefore 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. For instance, during last year's fiscal cliff negotiations in Congress, 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 nonpublic, the STOCK Act's insider trading provisions could have been implicated. 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.

Information that Could Give Rise to Insider Trading Claims under the STOCK Act

Under the current securities laws, to give rise to an insider trading claim, information used in connection with a trade must be both material and nonpublic. 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 nonpublic 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 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.

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 recognize that information they perceive to be immaterial standing alone could still be relied upon by the SEC or the Department of Justice as a basis for bringing an insider trading case.

Whether Information is Nonpublic

Information is considered nonpublic 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 nonpublic until it has been disclosed publicly by the Member or other Members of Congress (or other relevant government officials), reported by major media outlets or otherwise widely disseminated.

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 nonpublic 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 nonpublic 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 also should consider reviewing their employee training programs and insider trading policies to ensure they address contact with potential *government* sources of material, nonpublic information. In certain cases, it may be appropriate to require preapproval 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 nonpublic information can also be built into the contract. The contract might, for example, include a covenant that neither party will convey to the other party information obtained from government sources that is material and nonpublic. 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 insider trading 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 nonpublic. 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 must be discussed with legal counsel to determine whether the information falls within one of these categories. If an entity does obtain potential material nonpublic information, it may need to restrict trading until the information becomes public or immaterial. Some firms and clients also may 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 that likely will take years to resolve 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.

END NOTES

1. Tom Hamburger and Dina ElBoghdady, "SEC subpoenas firm, individuals in a case of leaked information," *The Washington Post*, May 1, 2013, available at http://articles.washingtonpost.com/2013-05-01/business/38957569_1_sec-subpoena-the-sec-law-firm.
2. *See* Code of Ethics for U.S. Government Service ¶ 8, H. Con. Res. 175, 72 Stat., Part 2, B12 (1958).
3. The SEC has not brought any insider trading enforcement actions against Members or employees of Congress for trading based on material non-public information obtained through government service. However, in December 2011, Robert Khuzami, the Director of the SEC's Division of Enforcement told the House Committee on Financial Services that "[t]here is no reason why trading by Members of Congress or their staff members would be considered 'exempt' from the federal securities laws, including the insider trading prohibitions." Testimony of Robert Khuzami, Director, Division of Enforcement, SEC, before the House Committee on Financial Services, December 6, 2011. In contrast to the absence of insider trading cases brought against Members and employees of the legislative branch, the SEC has pursued insider trading cases against executive branch officials based on information allegedly derived from their official duties. *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 announcements about drug approval decisions); *U.S. v. Royer,* 549 F.3d 886 (2d Cir. 2008) (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. *See* "Insiders: The Road to the STOCK Act," *CBS News*, June 17, 2012 (*available at* http://www.cbsnews.com/8301-18560_162-57451721/insiders-the-road-to-the-stock-act).
5. Pub. L. 112-105, S. 2038, 126 Stat. 291, enacted April 4, 2012.
6. On April 12, both houses of Congress repealed a portion of the STOCK Act without debate, sending the measure through by unanimous consent, which Pres. Obama later signed. The repealed section would have required members of Congress, their aides, and certain other federal employees to disclose their financial dealings in an online database. Although government officials still have to file disclosures of securities trades of more than $1,000 within 45 days, and those filings are publicly available upon request, that information will not be in an online database that would have been accessible to the general public.
7. *See* Brody Mullins and Tom McGinty, "Tip on Policy Shift Jolted Health Shares," *The Wall Street Journal*, April 3, 2013, *available at* http://online.wsj.com/article/SB10001424127887323916304578400981652818670.html.
8. *See supra* note 1.
9. *Supra* note 1.
10. *U.S. v. O'Hagan,* 521 U.S. 642, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (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).
13. *Dirks v. S.E.C.,* 463 U.S. 646, 660-662 103 S. Ct. 3255, 77 L. Ed. 2d 911, Fed. Sec. L. Rep. (CCH) P 99255 (1983).
14. *See Dirks* at 664 (holding that the benefit may include a reputational benefit or an intention to benefit the tippee).
15. *See, e.g., S.E.C. v. Yun,* 327 F.3d 1263, 1280 Fed. Sec. L. Rep. (CCH) P 92408, 14 A.L.R. Fed. 2d 819 (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" are to establish the benefit element).
16. *Basic Inc. v. Levinson,* 485 U.S. 224, 231-32 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).
17. *Basic* at 238-239.
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 (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).