THE INVESTMENT LAWYER™
covering legal and regulatory issues of asset management

Vol. 20, No. 12 • December 2013

Political Intelligence Firms – Insider Trading and Enforcement Shifts from Wall Street to K Street

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Insider trading remains a top priority for the Securities and Exchange Commission (SEC) and Department of Justice (DoJ). In fiscal year 2012, the SEC filed 58 enforcement actions against 131 individuals and entities and the DoJ charged and convicted dozens of individuals.[1] The regulators continued their crackdown on hedge funds and their information suppliers associated with expert networks, which began in 2010. Now, with the passage of the Stop Trading on Congressional Knowledge Act (STOCK Act)[2], we are experiencing déjà vu, as the law has "teed up" a new category of experts – political intelligence firms – as the next source of potential investigations and actions in an ever changing landscape of insider trading laws.

In April 2013, the press began to report about an SEC investigation into possible insider trading based on information provided by political intelligence firms.[3] The case emerged when a Washington-based stock brokerage firm, Height Securities, allegedly alerted clients of an imminent government decision favoring private health insurers who participate in a Medicare program. The matter also caught the attention of Senator Chuck Grassley, who started investigating whether a lobbyist at a K Street law firm tipped Height Securities with news of the government decision.[4]

This shifting focus on the use of information provided by political intelligence firms is not a surprise. It is a logical progression of prior investigations by the SEC because political intelligence firms resemble expert networks in terms of the services provided to hedge funds and other investment firms. The

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value of the information provided by political intelligence firms, largely collected from Washington insiders, is based on the realization among market participants that decisions in Washington can move markets. And, the political intelligence industry is a lucrative industry that is said to have doubled in size in the past decade, which provides added inducement for enforcement focus.[5]

The government recognizes that there are many legitimate ways to utilize experts and expert networks.[6] And the same is certainly true for political intelligence firms. However, just as with expert networks, political intelligence firms and the investors who use them should be aware of the potential insider trading issues raised by the use of political intelligence and take steps to reduce their regulatory risk. This is especially true given that, going forward, the STOCK Act potentially will provide an additional legal basis for enforcement in circumstances where the intelligence transmitted is improper information.

I. The STOCK Act

The STOCK Act was signed into law on April 4, 2012, and explicitly extends the prohibitions on insider trading under the federal securities laws to members of Congress, their congressional staff and other congressional employees, certain executive branch officials and their employees, and judicial officers and their employees (covered public officials).[7] Although covered public officials were not previously exempt from insider trading laws, the STOCK Act attempts to eliminate any ambiguity with respect to whether public servants may profit from information they garner during the course of their duties.

The STOCK Act amends Section 21A of the Securities Exchange Act of 1934[8] (Exchange Act), to provide that covered public officials[9] 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 with respect to material, nonpublic information derived from such person's position . . . ."[10] Importantly, however, the STOCK Act does not specifically identify what information is subject to the duty of trust and confidence and thus would create liability if disclosed.

A. What Political Intelligence Might Constitute Material Nonpublic Information?

The scope of what information is subject to the duty under Section 21A of the Exchange Act is certainly significant. For example, would a member of Congress breach the duty if he or she disclosed the mere intent to support a particular bill? In this regard, the STOCK Act instructed the Select Committee on Ethics of the Senate (Senate Committee) and the Committee on Ethics of the House of Representatives (House Committee) to issue interpretative guidance regarding the duties of their members and employees.

1. Committee on Ethics of the House of Representatives Guidance

The House Committee issued guidance in April 2012 that advised House members and their employees of their duties under the STOCK Act.[11] When identifying what information might be considered material nonpublic information, the House Committee's guidance referenced the House Committee's Rules Regarding Financial Transactions (Rules),[12] which generally state:

> Material nonpublic 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. A good rule of thumb to determine whether information may be material nonpublic information is whether or not the release of that information to the public would have an effect on the price of the security or property.

Thus, it is important to note that material nonpublic information need not relate to a specific company or security. Rather,

according to the House Committee's Rules and guidance, material nonpublic information can include information regarding industries and economic sectors more generally.

The Rules note that much of the information available during the legislative process, such as information from public briefings or hearings, is considered public information. However, the guidance also suggests that some information gained during the course of government service may be material nonpublic information, including, but not limited to:

> 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.[13]

This guidance may be viewed by some as troubling as it is commonplace in Washington for lawmakers, government officials and regulators to "float" potential legislation and ideas for potential legislation, rulemaking or possible political appointments prior to their public introduction or official announcement. The Rules, together with the guidance and obligations under the STOCK Act, suggest that merely communicating information regarding potential legislation may constitute a violation of a covered public official's duty.

2. Select Committee on Ethics of the Senate Guidance

The Senate Committee issued guidance in December 2012[14] and noted at the outset that:

> [The STOCK Act] is not intended … to chill legitimate communications made in good faith between public officials and their constituents, inhibit government transparency, or otherwise hinder the dissemination of public information about government activities.

The Senate Committee's guidance additionally notes that obligations under the STOCK Act apply to "information obtained in a variety of circumstances, including information received in a closed, nonpublic hearing; information gathered during the confidential stages of a committee investigation; and classified national security information." This guidance does not line up with the House Committee guidance in that it does not specifically state that information about potential legislation or amendments to legislation would be considered material nonpublic information, but instead focuses on information disseminated during a proceeding or subject to investigation where there would be an inherent expectation of confidentiality.

B. Liability under the STOCK Act

The STOCK Act makes covered public officials liable for breaching their duty, and trading on or disclosing (that is, tipping), certain material nonpublic information that is revealed to them during the course of their duties. Consequently, market participants who trade after interacting with, and receiving information from, covered officials may themselves face increased risk of enforcement under the expanded insider trading regime.

1. Tippee Liability

The STOCK Act creates the potential for new insider trading "tippee" liability for private citizens and organizations that receive material nonpublic information from covered public officials who disclose such information in violation of what is now an express statutory duty of trust and confidence owed by covered public officials with respect to material nonpublic information to which they are privy during the course of their duties.

Under traditional insider trading theories, a market participant who receives material nonpublic information (the "tippee") would be liable for trading on that material nonpublic information when the tippee knows or should have known that the person from whom he has received the material nonpublic information (the "tipper") provided that information in violation of a duty to the tipper's source.

Because the STOCK Act clearly creates a duty for covered public officials, should such persons provide material nonpublic

information to tippees in exchange for a personal benefit, traditional tipper/tippee principles regarding what qualifies as a personal benefit may well apply. The STOCK Act does not define personal benefit and the threshold for what may constitute personal benefit, pursuant to prior case law, is extremely low. Indeed, courts have found an inference of a personal benefit based solely on the close friendship between the tipper and the tippee, and the "hypothetical benefits" that may have been derived from it.[15] This raises unique problems in the political context, where obtaining goodwill is often a core part of an elected official's job.

2. Misappropriator Liability

An investor may be liable for trading on material nonpublic information obtained from a source when there is a relationship of trust and confidence between the source and the investor.[16] In these situations, the source reasonably expects, by implicit or explicit agreement, that the client/investor will keep the information provided confidential and will not use the information for investment purposes. Thus, market participants who trade on material nonpublic information obtained from covered public officials or political intelligence firms may be subject to insider trading liability based on the misappropriation theory depending on the circumstances surrounding their receipt of the material nonpublic information, as well as their or their consultant's relationship with a covered public official. The STOCK Act broadly asserts a covered public official's duty of trust and confidence and thereby might arguably raise the inference that a covered official would not disclose material nonpublic information without a reciprocal duty by the recipient to maintain the information as confidential.

It is important to remember that the government will often look to whether a duty was breached by the source of that information and will argue that the breach taints any additional disclosures down the chain. So, if Congressman A gives material nonpublic information to Lobbyist B, who provides the information to Political Intelligence Firm C, who then informs Trader D, the SEC and DoJ may very well take the position that Trader D should have known that the information came to him or her in breach of a duty and thus may be liable for insider trading.

C. Government Accountability Office (GAO) Report[17]

The STOCK Act mandated that the Comptroller General of the United States, in consultation with the Congressional Research Service, submit a report to Congress on the role of political intelligence firms in the marketplace.[18] The GAO was required to provide findings on, among other items, the prevalence of the sale of political intelligence, the effect of political intelligence on financial markets, and the potential benefits of disclosure requirements on those who engage in political intelligence activities. On April 4, 2013, the GAO issued the required report (Report), which included the findings of a 12-month study that interviewed regulators, individuals at political intelligence firms, trade associations, law firms, financial services firms, and advocacy organizations.

The Report highlights that currently there are no specific laws or ethics rules that govern the business of political intelligence firms in terms of the sale of political intelligence. But, the Report does acknowledge that securities laws, including insider trading laws, and executive and legislative branch ethics rules do require covered political officials to protect nonpublic information. The Report found that the "prevalence of the sale of political intelligence is not known and therefore is difficult to quantify."[19] The Report notes that compensation provided to political intelligence firms is often not tied to either a particular source or specific investment decision. Moreover, the Report observes that "even when a connection can be established between discrete pieces of government and investment decisions, it is not always clear whether such information could be categorized as material … and whether such information stemmed from public or nonpublic sources at the time the information was exchanged … "[20]

Responses from political intelligence firms illustrate that "information is often bundled and provided to clients with other information

such as research, opinions, and policy analysis."[21] In addition, investors responded that "investment decisions are most likely to be based on an overall analysis of the political climate and not necessarily on a single piece of political intelligence."[22] As such, it may be difficult for prosecutors (or the SEC's enforcement Staff) to clearly establish a connection between the information provided by a political intelligence firm to a client and a particular investment decision by that client to a particular piece of material nonpublic information from a covered public official.

The Report reviewed whether a disclosure requirement for political intelligence firms would be advantageous. However, the Report side-steps the issue and simply suggests that Congress should weigh the potential costs and benefits of such a disclosure regime. Not surprisingly, certain public advocacy groups and the SEC were in support of the disclosure regime and noted that it would add transparency and lead to investor protections. But, one response from the SEC does suggest uncertainty regarding the utility of a disclosure regime to protect investors given the "pace of market movements."[23] Other respondents noted concerns regarding the restrictions on anonymity of their clients, cost of enforcements, restrictions on First Amendment rights, and the potential "chilling effect" on communications between government officials, the media and political intelligence firms.

Ultimately, the Report provided no recommendations in connection with its findings. Nevertheless, the Report may provide context for compliance professionals and political intelligence firms when considering policies and procedures to reduce enforcement exposure.

II. Shifting Enforcement Focus: Insider Trading Based on Political Intelligence

The investigation of Height Securities and a Washington lobbyist in connection with the Medicare leak is objective evidence that the SEC has its eye on political intelligence firms and clients/investors that subscribe to their services. It has been reported that the SEC opened an insider trading investigation and is reviewing trading in certain health insurance stocks in the days leading up to a policy change by the Centers for Medicare & Medicaid Services. The concern is that certain government employees and policy makers at the Centers for Medicare & Medicaid Services provided information to lobbyists and other Washington insiders, who in turn provided the information to political intelligence firms, like Height Securities, who then provided information to hedge funds and other Wall Street traders – all before the actual policy decision was effective and known to the public.

Such a chain of events may create the appearance of impropriety by any number of parties. However, before generating an enforcement action, the traditional insider trading questions must still be asked. For example, was the information public? Recent news reports have indicated that Height Securities was not the only political intelligence firm disseminating such information.[24] Indeed, at least one other firm held a conference call discussing the policy decision. If such information was widely shared, it could create an inference that the information was not necessarily "non-public" for the purposes of the insider trading laws.

In light of the government's scrutiny of Height Securities, clients/investors should be cognizant of whether information received from a political intelligence firm, or similar service provider, was provided by a covered public official in violation of the duties imposed by the STOCK Act with respect to the dissemination of material nonpublic information.[25]

III. Practical Considerations and Protective Measures

To date, there have been no enforcement actions under the STOCK Act.[26] Nevertheless, it is evident that the new law will have effects on market participants, particularly those that rely to any extent upon information obtained from covered public officials, political intelligence firms and lobbyists or consultants providing information about legislation and regulatory changes. Although the STOCK Act does signify a new twist on insider

trading regulation, the considerations of market participants are not unlike traditional considerations when analyzing insider trading generally.

A. Duty

When analyzing insider trading issues, market participants often focus on whether the information is "material" and whether it is "nonpublic." However, in the expert network investigations it appears that the first question prosecutors have been asking is whether the information was obtained in violation of a duty. Under these circumstances, and as a result of the STOCK Act, in order to properly protect themselves, political intelligence firms and their clients/investors also must focus on the question of duty and understand that, if there was arguably a duty violation, the government may discount even reasonable arguments that the information was immaterial or public.

The question of duty becomes more difficult the further away one gets from the original source of the information. For example, a client/investor who hires a political intelligence consultant may not know that the information was obtained by the consultant in violation of an official's duties. However, if the information provided resulted in a monetary benefit to the recipient, the client/investor should expect that prosecutors may be quick to accuse the client/investor (rightfully or wrongly) of willful blindness if the government believes a duty was breached.[27]

B. Public Information

Prior to executing a trade on the basis of information from a covered public official or a political intelligence firm, market participants should consider whether the information is in fact public. Here, the inquiry generally should be whether the information is already available to the investing public. In answering this question, it is important to remember that, in the United States, information is "public" in the context of insider trading if investors' trading has caused the information to be fully absorbed into the price of the stock.

C. Materiality

Market participants must also consider whether the information upon which they are trading is material. In the political intelligence context, this may be difficult to determine. For example, if a congressional staffer remarks upon the general sentiments of one member of Congress during a committee meeting, there could be strong arguments that it is not material information, given, for example, that the information only reflects the views of one Congressman out of many and he could always change his mind. However, information regarding a confidential meeting of a group of influential members could be material depending on the particular circumstances. Of course, materiality is often inferred after the fact. In addition, while a good defense attorney might be able to successfully argue the materiality issue, prosecutors may still assume that information bought from consultants is material – otherwise why would one pay for it?

D. Surrounding Circumstances

Prudent investors must also be aware of the circumstances in which the information, which they will potentially trade on, was obtained. Here, it is important to consider whether the information was disseminated by a covered public official in furtherance of his or her responsibilities as a public official and therefore not a breach of a duty, or, alternatively whether the information was exchanged pursuant to a *quid pro quo* arrangement whereby the covered public official would receive a personal benefit. Such an arrangement could result in a presumption that the information obtained was material. Furthermore, clients/investors should consider whether there is a relationship of trust and confidence between the direct recipient of the information and the covered public official providing the information that would imply that the information exchanged was confidential and subject to the covered public official's duty with respect to information obtained during the course of his or her duties. Also, clients/investors should assess whether the source knew that the information would ultimately be used for trading

purposes. If this fact was concealed from the covered public official, the government may be more prone to argue that a duty owed to the original source (that is, the covered public official) had been violated.

E. Considerations for Advisors and Funds

Given the increased regulatory focus in this area, if an adviser is engaging in business with political intelligence firms or executing trades based upon information received from government sources, advisers should consider exploring whether it makes sense for them to undertake certain precautionary measures, such as:

- Amending insider trading policies and programs and training to specifically cover the STOCK Act and the use of political intelligence firms, lobbyists and consultants;
- Putting provisions in contracts with political intelligence firms that ensure such firms will not provide material nonpublic information obtained improperly or in violation of a source's duty;
- Informing political intelligence consultants, prior to sharing information, that the adviser anticipates using the information obtained to trade and does not want material nonpublic information or information obtained in violation of a source's duty;
- Requiring advisers or their investment personnel to obtain approval from the firm's compliance department before using the services of political intelligence firms;
- Vetting political intelligence firms before their use, including reviewing their policies and procedures designed to protect against the misuse of material nonpublic information; and
- Implementing compliance reviews of the adviser's use of political intelligence firms.

F. Considerations for Political Intelligence Firms

Although there is a regulatory spotlight on political intelligence firms, the services they provide in the marketplace do not *per sé* violate federal securities laws. Nevertheless, political intelligence firms that provide market participants with information for the purposes of investment should evaluate their relationships with covered public officials and consider whether it makes sense for them to take certain other precautions to mitigate enforcement exposure. Such precautions might include:

- Informing covered public officials from whom they receive information that they act as consultants and may provide the information to clients/investors who may trade upon the information;
- Implementing insider trading policies and training programs that focus on, *inter alia*, the meaning of material nonpublic information in the political context and the duties owed by and to covered public officials who provide information and the STOCK Act;
- Implementing compliance reviews to check that their insider trading policies are being followed; and
- Requiring their employees to attest that they will not seek material nonpublic information or information that would violate a source's duty.

The insider trading enforcement environment is in a continuous state of flux. Not only are the lines between what is proper and improper blurry, but they are shifting. Thus, it is important that firms remain vigilant in evaluating what insider trading risks they are facing and how they can mitigate those risks. The proper use of political intelligence firms can provide advisers with important information and significant opportunities – but, especially in today's enforcement environment, political intelligence must be used intelligently. This means identifying, understanding, and mitigating against insider trading risks posed by using such information. We hope that this article provides the tools to do so.

Notes

1. *See* "SEC Enforcement Actions: Insider Trading Cases," available at *www.sec.gov/spotlight/insidertrading/cases.shtml;* Preet Bharara, Securities Fraud, available at *www.justice.gov/usao/briefing_room/fin/securities_fraud.html*.

2. STOCK Act, S.2038, 112th Cong. (2012).

3. *See* Tom McGinty, Brody Mullins & Jenny Strasburg, "Stock Surge Linked to Lobbyist," WALL ST. J.,

Apr. 17, 2013, available at *online.wsj.com/article/SB10001424127887324345804578427102504475618.html*; Dina El Boghdady & Tom Hamburger, "SEC Subpoenas Firm, Individuals in a Case of Leaked Information," WALL ST. J., May 1, 2013, available at *articles.washingtonpost.com/2013-05-01/business/38957569_1_sec-subpoena-the-sec-law-firm*.

4. According to the news article, the lobbyist in question sent an email to Height Securities at 3:12 p.m. on April 1. Subsequently, Height Securities sent a notice to clients approximately half an hour later. Then, the government decision by the Centers for Medicare & Medicaid Services came out at approximately 4:30 p.m. Jason Milliman, "Chuck Grassley Eyes Former Aide in Medicare Advantage Leak," POLITICO, Apr. 17, 2013, available at *http://www.politico.com/story/2013/04/grassley-eyes-former-aides-role-in-market-intelligence-90197.html*.

5. Jerry Markon & Jia Lynn Yang, "Intel for Investors: What's Going on Behind Closed Doors in Washington," WASH. POST, May 2, 2013, available at *http://www.washingtonpost.com/politics/political-intelligence-industry-in-washington-under-scrutiny-amid-federal-inquiry/2013/05/02/e284e08e-b364-11e2-9a98-4be1688d7d84_story.html?hpid=z1*.

6. *See, e.g.,* "SEC Brings Expert Network Insider Trading Charges - Moonlighting Employees Passed Company Secrets to Hedge Funds and Others," SEC Press Release (pub. avail. Feb. 3, 2011) (stating, "While it's legal to obtain expert advice and analysis through expert networking arrangements, it's illegal to trade on material nonpublic information obtained in violation of a duty to keep that information confidential."), available at *http://www.sec.gov/news/press/2011/2011-38.htm.*

7. Momentum to pass the law began after a "60 Minutes" exposé, and several related publications, reported that members of Congress and hedge funds had profited off of securities transactions based upon "political intelligence" or inside information concerning pending legislation and regulatory matters. *See 60 Minutes: Insiders* (CBS television broadcast Nov. 13, 2011).

8. 15 U.S.C. 78u-1.

9. Covered officials and employees include: members of Congress, employees of Congress, executive branch employees, judicial officers and judicial employees. *See* STOCK Act, §§ 2(1) – 2(7).

10. The STOCK ACT also extends the insider trading prohibitions under the Commodity Exchange Act to cover members of Congress and staff.

11. Staff of H. Comm. on Ethics, 112th Cong., Memorandum to all House Members, Officers and Employees, New Ethics Requirements Resulting from the STOCK Act (2012) available at *http://ethics.house.gov/sites/ethics.house.gov/files /Stock%20Act%20Pink%20Sheet.pdf*.

12. Staff of H. Comm. on Ethics, 112th Cong., Memorandum to all House Members, Officers and Employees, Rules Regarding Financial Transactions (2011), available at *http://ethics.house.gov/sites/ethics.house.gov/files/fin%20trans%20pink%20sheet.pdf*.

13. *Id.* at 3.

14. Staff of S. Comm. on Ethics, 112th Cong., Restrictions on Insider Trading Under Securities Laws and Ethics Rules, Dec. 4, 2012, available at *http://www.ethics.senate.gov/public/index.cfm /guidance?I D=409cd1e7-2f41-4e12-8d19-32a4333b6367*.

15. *See, e.g., SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *see also, SEC v. Warde*, 151 F.3d 42 (2d Cir. 1998).

16. 17 C.F.R. § 240.10b-5-2.

17. U.S. Gen. Accountability Office, Political Intelligence: Financial Market Value of Government Information Hinges on Materiality and Timing, Apr. 4, 2013 (GAO Report), available at *www.gao.gov/products/GAO-13-389*.

18. STOCK Act, §7.

19. *See* GAO Report, *supra* n.17 at 2.

20. *Id.* at 9.

21. *Id.* at 8.

22. *Id.*

23. *Id.* at 16.

24. *See* Brody Mullins, "Health Policy Move Widely Shared," WALL ST. J., May 13, 2013, available at *http://online.wsj.com/article/SB10001424127887324031404578481461859150402.html*.

25. It is worth noting that early versions of the STOCK Act contained provisions that would require political intelligence firms to register with the government and provide certain information regarding their activities and the names of clients. Although this requirement was not adopted, after significant lobbying by financial services firms seeking to protect their anonymity, the STOCK Act charged the Government Accountability Office with the responsibility of performing a study on political intelligence firms. *See* S.2038.ES, 112th Cong. (2012), available at *www.gpo.gov/fdsys/pkg/BILLS-112s2038es/pdf/BILLS-112s2038es.pdf*.

26. Although no individuals have been charged with violations of the STOCK Act, while the legislation was being considered by Congress, House Financial Services Committee Chairman Spencer Bachus was investigated by the House's Office of Congressional Ethics (OCE) for possible insider trading. Media reports indicate that the investigation focused on several short options traded by Rep. Bachus in September 2008 subsequent to participating in a confidential meeting with then Treasury Secretary Henry Paulson and Federal Reserve Chairman Benjamin Bernanke. Ultimately, OCE did not recommend any enforcement. *See* Scott Higham and Dan Keating, Published, "Rep. Spencer Bachus faces insider-trading investigation," Wash. Post, February 9, 2012, available at *www.washingtonpost.com/politics/2012/02/09/gIQA-21Ui2Q_story.html*.

27. *See generally,* Jennifer Banzaca, "RCA Symposium Focuses on Hedge Fund Governance, Form PF, Enterprise Risk Management, Regulatory Enforcement, Criminal Prosecution, CCO and GC Liability and Third Party Relationships," Hedge Fund Law Report, June 8, 2012, available at *www.hflawreport.com/article/1530*.