Client Alert

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The STOCK Act and the Political Intelligence Industry: No Easy Answers

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Investors who hire political intelligence firms to collect information from government sources should take notice of the Stop Trading on Congressional Knowledge (STOCK) Act, according to panelists at a recent American Bar Association event. The panel, which included Stephen Cohen of the SEC's Division of Enforcement, gathered in the wake of recent scandals and increased government scrutiny of the political intelligence industry—in particular, the SEC's investigation of Height Securities, a political research and advisory firm. According to *The Wall Street Journal*, on April 1, 2013, Height Securities alerted investors to a government decision to reverse funding cuts to certain health-care companies before the agency formally announced its decision. In the 18 minutes before the markets closed, investors traded the suddenly promising health-care stocks, making exorbitant profits.

THE STOCK ACT

Under the STOCK Act, investors who rely on material, non-public information obtained through government channels can be liable under the federal securities laws for insider trading. Irrespective of the Act, insider-trading laws prohibit trading in securities while in possession of material non-public information obtained in breach of a fiduciary duty. The Act explicitly expanded insider-trading restrictions to members of Congress and legislative branch employees, and made clear that a government employee owes a duty to the United States with respect to material non-public information derived from his or her position.

THE POLITICAL INTELLIGENCE INDUSTRY

According to the panel, the political intelligence industry is composed of organizations that collect information from government sources for the purpose of predicting future outcomes. On a day-to-day basis, these organizations collect information through interviews, research and policy analysis, often presenting their forecasts to clients. The panel noted that this industry is distinct from lobbying, as lobbying firms work to alter, rather than simply forecast, government action.

The panel reported that the number of political intelligence firms has increased significantly over the last five years. This growth is perhaps driven by a growing demand for political intelligence among hedge funds and other trading operations. Investors view the industry as critical to their core operations; for these firms especially, forecasting government actions is crucial because those actions often directly affect their bottom lines.

THE SEC'S PLANS TO APPLY THE ACT TO THE POLITICAL INTELLIGENCE INDUSTRY

The panel clarified that, while the STOCK Act does not directly target the political intelligence industry, the Act exposes the industry and its clients to liability by expanding existing insider-trading laws. Specifically, the Act imposes a fiduciary duty on members and employees of Congress; should a public official breach that duty by

disclosing material non-public information, that official and anyone who subsequently uses that information to trade can be liable under insider-trading laws.

Indeed, Cohen warned that the SEC will apply the STOCK Act to tippees just as it has applied traditional insider-trading laws to tippees, scrutinizing a recipient of insider information even if that recipient is two or three times removed from the original source. The SEC will look for (1) a breach of a fiduciary duty; and (2) the use of material, non-public information. According to Cohen, the SEC will work backwards, identifying investors who profited from investments, and then following their information channels back to the source.

Moreover, the SEC will apply the presumption of use set forth in SEC Rule 10b5-1, which provides that "the purchase or sale of a security of an issuer is 'on the basis of' material non-public information about that security or issuer if the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale." This presumption will likely be useful to the SEC in "mosaic" theory situations—that is, where a defendant alleges that he or she pieced together data and public information to complete a "mosaic" that, taken as a whole, was material. Generally, Cohen thought that the analysis of insider trading under the STOCK Act will be similar to that applied in the traditional context.

THE SEC'S CHALLENGES IN APPLYING THE ACT

Cohen and the panel acknowledged that the SEC might face challenges applying the STOCK Act to anything but the most blatant insider-trading violations.

First, the panel argued that the Act failed to adequately define the fiduciary duty imposed on members and employees of Congress. The panel asked whether a congressional staffer assigned to leak information for a political purpose might breach his or her fiduciary duty by doing so; Cohen noted that, in such a case, the SEC would have to consider the staffer's competing fiduciary duty to his or her employer. The panel's concerns mirror those of George Canellos, co-director of the SEC's Enforcement Division, who commented recently that the Act defined the fiduciary duty imposed very ambiguously; in fact, Canellos questioned whether the SEC could even enforce the Act when a member of Congress discussed upcoming legislation with industry officials and constituents (see the related Mofo Client Alert), which is an important part of a member's job.

Second, identifying information that is material or non-public presents difficult questions. Cohen acknowledged that these analyses will be very fact-specific; it is impossible to draw a bright line defining appropriate uses of political intelligence. Regarding materiality, the SEC typically asks whether the information was something that an investor would want to know in order to make an investment decision. As the panel pointed out, however, this analysis might be difficult if the information's potential economic impact is hard to predict. For example, the disclosure might forecast the timing of an upcoming vote rather than the result of the vote; the SEC will have the difficult task of determining whether content-neutral information can also be material.

Third, the panel noted the importance of considering a tippee's scienter; if an investor does not know the source of his or her information, it might be unfair to charge him or her with insider trading. Cohen acknowledged that mental state might play some role in the SEC's analysis, but noted the difficulty in assessing whether an investor unwittingly obtained illicit information.

TAKEAWAYS

Because the STOCK Act imposes a fiduciary duty on public officials not to disclose confidential information obtained by reason of their positions, those officials and any recipients who trade on that information can be held liable for securities-law violations. Considering the Act's potential impact on the political intelligence industry, anyone who relies on political intelligence firms should implement certain measures to protect against liability. While no policy guarantees compliance, reasonable safeguards may help minimize or avoid SEC scrutiny.

Companies using political intelligence firms should carefully vet them to ensure compliance with the Act by investigating their policies—often described on their websites—and histories of compliance. Similarly, those companies would do well to implement internal training and controls to ensure that employees recognize potential violations before they occur. Moreover, when contracting with political intelligence firms, companies should insist on certain provisions, such as express prohibitions, disclaimers and indemnification clauses. While Cohen cautioned that the SEC might look beyond any contractual agreement to determine what he called the "true" relationship between the parties, these provisions can provide evidence of an investor's intent.

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