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The STOCK Act: Implications for Trading on Political Intelligence

On March 22, 2012, the Senate voted 96-3 to adopt the House version of the Stop Trading on Congressional Knowledge Act (the "STOCK Act"), which most notably extends insider trading laws to members of Congress, their staffs, and other government officials and employees and prohibits them from using "nonpublic information derived from such person's position [or] . . . official responsibilities as a means for making a private profit." It is expected that the President will sign the bill into law next week.

The STOCK Act has potentially significant implications not only for government officials, but also for market participants who interact with and otherwise receive information from government officials. This memorandum provides a summary of the STOCK Act and highlights certain key issues market participants should be aware of as a result of the Act.

I. The STOCK Act: Background and Overview

No Insider Trading Exemption for Lawmakers

The most prominent aspect of The STOCK Act is the express application of insider trading laws to public officials. Covered persons include elected representatives, their staffs, members of the judicial and executive branches, and other government employees.

Although public officials were never exempt from insider trading laws, according to the SEC's Director of Enforcement, Robert Khuzami, applying those laws to such individuals was previously "without direct precedent" and thought to "present some unique issues." The STOCK Act eliminates any ambiguity: public officials may not personally enrich themselves based on market moving information they learn of during the course of their duties. For example, if a congressman learns that the House Appropriations Committee is set to provide for a multimillion dollar contract to a given firm, the congressman may not buy shares in that firm – or sell that information to an investor – before that information is publicly known.

Other Provisions

The STOCK Act also includes additional measures requiring members of Congress and others to disclose the terms of their mortgages; accelerating the disclosure requirements for lawmakers and other officials engaged in certain securities transactions; mandating online filing for, and public availability of, financial disclosure forms filed by legislators and other officials; prohibiting executives at Fannie Mae and Freddie Mac from receiving bonuses while the companies are in conservatorship; expanding the list of felony convictions which would cause a member of Congress to forfeit his or her pension; prohibiting lawmakers and certain government officials from participating in IPOs "in any manner other than is available to members of the public generally"; and extending post-employment negotiation restrictions to certain officials in the executive and judicial branches.

Comptroller's Report on Political Intelligence

The STOCK Act also directs the Comptroller General, in consultation with the Congressional Research Service, to issue within 12 months of the bill's passage a report "on the role of political intelligence in the financial markets," including the prevalence, effect and scope of political intelligence in the financial markets, and the legal, ethical and practical implications of any limits on its use or distribution. Political intelligence is defined by the Act as: "information that is (1) derived by a person from direct communications with an executive branch employee, a Member of Congress, or an employee of

Congress; and (2) provided in exchange for financial compensation to a client who intends, and who is known to intend, to use the information to inform investment decisions." The Senate version of the STOCK Act would have created an extensive registration and reporting regime for "political intelligence consultants" triggered in the event of a single "political intelligence contact." The Act, as enacted, does not create such a regime, but instead mandates the Comptroller General's study summarized above.

II. Liability for Recipients of Inside Information

Because the STOCK Act makes clear that public officials are liable for trading on material nonpublic information ("MNPI") learned during the course of their duties, market participants who trade after interacting with and receiving information from such officials may themselves face increased risk under traditional theories of insider trading liability.

1. As a Tippee

A market participant who receives MNPI (the "tippee") will be liable for trading on that MNPI when the tippee knows or should have known that the person from whom he has received the MNPI (the "tipper") provided that information in violation of a fiduciary duty to the tipper's source. When the tipper discloses information he or she is otherwise obligated to protect in exchange for personal benefit, the breach of duty element is typically satisfied and, in such a case, both the tippee and the tipper may be liable. The obvious example is a cash gift from the tippee to the tipper in exchange for information. In some instances, however, the benefit can be far less tangible, including goodwill or a reputational boost. Because the STOCK Act clearly creates a duty for public officials, should such officials provide MNPI to tippees in exchange for a personal benefit, traditional tipper/tippee principles may well apply. This raises unique problems in the political context, where obtaining goodwill and reputational benefits is a core part of an elected official's job. The STOCK Act does not define personal benefit, so it remains to be seen what kinds of exchanges will trigger liability.

2. As a Misappropriator

An investor will be liable for trading on MNPI obtained from a source when there is a relationship of trust and confidence between the source and the trader. In these situations, the source reasonably expects by implicit or explicit agreement that the trader will keep the information confidential and will not trade. The misappropriation theory focuses on the relationship between the trader and the source. In a misappropriation case, it is only the trader who is liable. Market participants who trade on MNPI obtained from public officials thus may be subject to insider trading liability based on misappropriation theory depending on the circumstances surrounding their receipt of the MNPI as well as their relationship with the public official. This is especially true given that the STOCK Act broadly asserts a public official's duty of trust and confidence and thereby could raise the inference that a public official would not disclose MNPI without a reciprocal duty by the recipient to maintain the information as confidential and not trade.

III. Implications for Market Participants

In light of the STOCK Act's prohibition on insider trading for public officials, what factors should market participants consider before trading on information they receive from public officials?

1. Is the information public? If a public official provides information already known in the investing community, then there no risk trading on that information.

2. Is the information material? Materiality is defined as information a reasonable investor would consider significant in deciding whether to trade on a company's securities. In the political intelligence context, materiality may be difficult to determine. The simple case will be news of concrete market-moving events, like a government contract or a criminal investigation. But in other instances, materiality may be harder to determine, for example, if a Congressman describes an Appropriations Committee

meeting where a government contract is being discussed as 'contentious,' or if a staffer speculates on the likelihood of success for a pending bill. Materiality is often inferred after the fact, so caution is advisable.

3. What were the circumstances in which information was exchanged? If the tip is clearly MNPI, then the trader must consider the tipper's motivations and/or expectations in providing the tip:

- Is there a reasonable basis to assume the public official conveyed the information in furtherance of her responsibilities as a public official and therefore did not breach a duty by doing so? Alternatively, has the public official received a personal benefit?
- Even if one is confident that the public official received nothing personally in return, was there a relationship of trust and confidence? Did a fiduciary-like relationship with the public official exist in the past? Did the public official express or imply that the information was confidential? Has the public official provided expressly confidential information before?
- Did the public official suggest the information should not be used for trading or that it should only be used for a specific limited purpose and should be treated confidentially?

Increased regulatory focus on the collection and use of political intelligence makes it extremely important to consider both the nature of the information, and the circumstances by which it was received, before making a trade.

IV. Conclusion and Precautionary Steps

Market participants who trade based on information obtained from public officials would be well advised to assess their relationship with such officials to ensure that there is not a relationship of trust and confidence that could give rise to insider trading liability based on a misappropriation theory. Likewise, market participants should be careful not to provide personal benefits to public officials, particularly if they receive political intelligence from such officials. In all events, market participants should carefully analyze the circumstances surrounding any tip that may have originated with a person covered by the Act. It would also be advisable to review and update policies and diligence regarding the use of consultants in obtaining political information, as that issue will now be under increased scrutiny, given the research directive contained in the Act.

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