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Please contact the author below if you have any questions regarding this alert.

Scott E. Gluck
sgluck@Venable.com
202.344.4426

Robert L. Smith, II
rlsmith@Venable.com
202.344.4077

STOCK Act Could Expand Insider Trading Laws and Restrict Investment Advisers' Use of "Political Intelligence"

Last month, the Senate Homeland Security & Governmental Affairs Committee passed the "Stop Trading on Congressional Knowledge Act," or "STOCK Act"[1] and the House Financial Services Committee held hearings on similar legislation.[2] The primary purpose of this Act is to close a loophole in the law that may allow Members of Congress to legally trade securities based upon nonpublic "political intelligence." However, the legislation could have significant, perhaps unintended, consequences for investment advisers and those in the financial services industry.

The current Senate and House versions of the bill differ significantly. The House version would expand insider trading laws to prevent any person – including investment advisers – from purchasing or selling securities while in the possession of material nonpublic "political intelligence" they received from certain federal sources. It would also regulate "political intelligence" firms and establish a disclosure regime for "political intelligence activities" similar to the reporting requirements now in place for federal lobbying activities. The Senate bill is narrower, and merely confirms that Members of Congress owe a duty of trust and confidence and calls for a study of political intelligence firms.

This article provides a brief overview of federal insider trading laws as they apply to "political intelligence" then describes the main provisions of the STOCK Act, highlighting the differences between the current Senate and House versions. It then analyzes the impact that the proposed legislation could have on investment advisers, including the use of political intelligence firms, lobbying shops and consultants by investment advisers to gather political intelligence. It closes by identifying several key issues investment advisers should keep an eye on as the proposed legislation makes its way through the Congress.

[1] The bill that came out of Committee has not yet received a number. Two initial bills introduced in the Senate were S.1871 (Sen. Brown) and S.1903 (Sen. Gillibrand).
[2] H.R. 1148

Depending on what provisions (if any) are ultimately enacted, the legislation could alter the way investment advisers conduct basic regulatory due diligence in connection with their investments. The legislation could weaken a key provision of Regulation FD, which confirms the "Mosaic Theory" defense to federal insider trading laws.[3] It could also impact the way investment advisers use employees, expert networks, lobbyists and political intelligence firms to research federal legislative and political activities in connection with their investments. In fact, the legislation could fundamentally alter the way that investment advisers interact with federal employees, including Members of Congress.

Background on the STOCK Act – Insider Trading by Members of Congress

Although versions of the STOCK Act have been introduced in each of the past two Congresses, the bill has gained significant momentum over the past few months due to a new book,[4] a '60 Minutes' report[5] and numerous articles[6] alleging that Members of Congress or hedge funds traded securities based upon inside information or "political intelligence."

These stories have created pressure on Congress to do something to ban this practice. Unfortunately, the demand for quick action increases the risk of unintended consequences.

Brief Overview of Insider Trading Laws

Insider trading laws generally prohibit an individual from purchasing or selling securities if such person possesses material nonpublic information and the purchase or sale of such securities would violate a duty of trust or confidence[7] owed directly or indirectly to an issuer, an issuer's shareholder or the source of the information.

An employee of a corporation owes a duty of trust and confidence with respect to nonpublic material information concerning the company he or she works for. Thus, a corporate employee is generally prohibited from trading on such nonpublic material information or providing (tipping) the information to third parties so they may trade on it.[8] Likewise, it is generally illegal for third parties (tippees) to purchase or sell securities while in possession of nonpublic material information they received (i) from a source who owes a duty of trust and confidence or (ii) where the purchase or sale of securities would violate a duty of trust and confidence owed to the source of the information.[9]

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[3] The "mosaic theory" defense provides that a "skilled analyst with knowledge of the company and the industry may piece together seemingly inconsequential data with public information into a mosaic which reveals material, nonpublic information." *State Teachers Retirement Board v. Fluor Corp.,* 654 F.2d 854 (2d. Cir. 1981), citing *Elkind v. Liggett & Myers, Inc.,* 635 F.2d 156, 165 (2d. Cir 1980).

[4] Peter Schweizer, *Throw Them All Out: How Politicians and Their Friends Get Rich Off Insider Stock Tips, Land Deals, and Cronyism That Would Send the Rest Of Us To Prison,* Houghton Mifflin Harcourt (2011).

[5] 60 Minutes Report, *"Insiders,"* November 13, 2011.

[6] *See,* e.g. Richard Teitelbaum, *"How Paulson Gave Hedge Funds Advance Word of Fannie Mae Rescue,"* Bloomberg Markets Magazine, November 29, 2011.

[7] There are two primary theories regarding the establishment of a duty of trust and confidence: the "classical theory" and the "misappropriation theory." The classical theory relates to corporate insiders and will generally not apply to Members of Congress. Most situations involving this legislation will fall under the "misappropriation theory."

[8] Insiders may establish a 10(b)5-1 trading plan where they agree to purchase or sell securities according to a set schedule, but even this plan may not be adopted based upon material nonpublic information.

[9] The recent case of *SEC v. Cuban,* 09-10996 (5th Cir. 2010) makes clear that the agreement not to purchase or sell securities based upon the nonpublic material information must be explicit.

It is unclear whether Members of Congress, Congressional staff and other federal employees owe a duty of trust and confidence with respect to information they become aware of through their work for the federal government.[10] The information at issue – known generally as "political intelligence" – includes information relating to federal legislation, Congressional hearings, agency decision-making, executive branch directives, etc. Without a duty of trust and confidence, these individuals could enjoy significant leeway to both trade on their own account as well as provide such information to third parties, who themselves might be able to purchase and sell securities while in the possession of such information.[11]

Provisions of the STOCK Act

The STOCK Act attempts to rectify this ambiguity. However, instead of merely confirming that Members of Congress and federal employees owe a duty of trust and confidence,[12] the House version would ban any person from purchasing or selling securities if they are in possession of material nonpublic information relating to the federal government. The legislation could broaden insider trading laws in some respects while narrowing them in others, disrupting the case law that has developed over many years.

Some of the provisions of the bill may change as the legislation makes its way through Congress and there is no guarantee that any legislation will ultimately be enacted. However, here is a summary of some key provisions that investment advisers should keep an eye on:

Ban on Purchasing or Selling Securities While in Possession of Material Nonpublic "Political Intelligence"

The initial Senate and House versions banned any person from purchasing or selling any security[13] while in possession of material nonpublic information involving legislative activity relating to such security if the information came from certain federal sources, including a Member of Congress or an employee of Congress or a federal agency. The current Senate bill now merely (i) reaffirms that each Member and employee of Congress owes a duty of trust and confidence and (ii) states that no Member shall use any nonpublic information derived from the individual's position for personal benefit. The House version of the bill still contains the broad restriction on purchasing or selling securities.

Disclosure of "Political Intelligence" Activities

Another key provision in the initial Senate and House bills related to the regulation of so-called "political intelligence firms."[14] Both initial versions of the bill would amend the Lobbying Disclosure Act of 1995 ("LDA") to require that individuals, firms and clients disclose all "political intelligence contacts" and "political intelligence activities" similar to how they are now required to

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[10] Academics differ on this topic. *See*, Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment,* 91 B.U. L. REV. 1105 (2011) (Members of Congress and Congressional staff owe duty of trust and confidence); *But see,* Stephen M. Bainbridge, *Insider Trading Inside the Beltway,* 36 J. CORP. L. 281, 285 (Quirks of relevant laws would almost certainly prevent Members of Congress from being successfully prosecuted for insider trading based on inside political intelligence).

[11] *But see, SEC v. Cheng Yi Liang, et al.,* Exchange Act Rel. No. 21097 (March 29, 2011) (SEC brought insider trading charges against a FDA employee alleging that he violated a duty of trust and confidence owed to the federal government for trading in advance of confidential FDA drug approval announcements).

[12] This was the route preferred by Robert Khuzami, Director of the SEC's Enforcement Division, who testified during the House hearing that "The approach that I personally might prefer would be a narrower bill that simply declares that there is . . . a duty on Members of Congress to keep the information they obtain in the course of their congressional service confidential and not use it for private gain."

[13] The ban on purchasing or selling securities also applies to commodities, swaps and security-based swaps, with the SEC responsible for regulating securities and securities-based swaps and the CFTC responsible for regulating commodities and commodities-based swaps.

[14] Rep. Louise Slaughter, an original author of the bill in 2006, expressed significant concern about the growth and influence of political intelligence firms. Political intelligence is now a $100 million per year industry.

disclose all federal lobbying activities.

The definition of a "political intelligence contact" is broad[15] and relates to information "intended for use in analyzing securities or commodities markets, or in informing investment decisions." This would presumably include most, if not all, communications between investment advisers and Members of Congress or Hill staff or concerning any legislation that could impact their investments, potential investments and/or positions. Although there is a $5,000 compensation threshold before registration under the LDA is required, the definition of "political intelligence consultant" in the initial Senate and House versions of the bill does not contain an exception for individuals who spend less than 20 percent of their time engaging in political intelligence activities for a client.[16]

The Senate bill that passed Committee does not require registration of political intelligence activities. Instead, the Senate bill requires the Comptroller and Congressional Research Service to prepare a report within 12 months of enactment of the Act on "the role of political intelligence in the financial markets."[17]

No Restrictions on Political Contributions
The Act would not restrict the ability of investment advisers to make contributions to elected officials, and contribution(s) alone would not constitute a "political intelligence contact."

Reporting Requirements
The Act strengthens the reporting requirements for Members of Congress and certain federal employees. This would not impact most private parties.

Issues for Investment Advisers to Watch Out For Regarding the Proposed Legislation

As the STOCK Act makes its way through Congress, there are several issues investment advisers should be on the lookout for:

• ***Broad Prohibition Against Purchasing Or Selling Securities While In Possession of Nonpublic Material Information –*** The current House version of the bill prohibits the purchase or sale of securities by any third party while "in the possession of" material nonpublic information obtained from certain federal sources. This could represent a broadening of current insider trading laws and restrict the trading practices of investment advisers who are privy to political or regulatory information.

The bill could also hamper the ability of advisers to conduct political and regulatory due diligence into potential investments. Because the bill could weaken a key defense to federal insider trading laws (see below), advisers should make sure that their internal investment analysis is based solely

[15] A "political intelligence contact" means any oral or written communication to or from a covered executive or legislative branch official.
[16] The definition of a "lobbyist" under the LDA excludes an individual whose lobbying activities constitute less than 20 percent of the time engaged in services to such client over a six-year period. Several high-profile former elected officials do not register as federal lobbyists based upon this exemption.
[17] The bill mandates that the report include a discussion of (i) what is known about the prevalence of the sale of political intelligence and the extent to which investors rely on such information, (ii) what is known about the effect that the sale of political intelligence may have on the financial markets, (iii) the extent to which information which is being sold would be considered non-public information, (iv) the legal and ethical issues that may be raised by the sale of political intelligence, (v) any benefits from imposing disclosure requirements on those who engage in political intelligence activities and (vi) any legal and practical issues that may be raised by the imposition of disclosure requirements on those who engage in political intelligence activities.

upon nonmaterial information and not upon any nonpublic material information. If the legislation passes Congress and becomes law, all employees should be trained on the new law, particularly those who interact with Members of Congress or Hill staff.

• *Use of Expert Networks, Lobbyists and Consultants* – Investment advisers will be able to continue to use expert networks, lobbying firms and consultants if the STOCK Act is passed. However, if a firm has sufficient "political intelligence contacts" with covered legislative or executive branch officials, the firm would need to register under the LDA as a "political intelligence firm" and the investment adviser would then be required to disclose the use of the firm. Many expert networks expressly prohibit current Members of Congress, Congressional staff and federal employees from participating in their network. However, if the Act passes, investment advisers will need to do proper due diligence prior to using an expert network to ensure the firm is in compliance with all regulations and, if necessary, is registered under the LDA. In addition, advisers will need to update their contracts with these third parties to ensure that all political or regulatory diligence performed is based upon nonmaterial information and does not contain any nonpublic material information. Also, expert networks should strengthen their internal controls to ensure no federal or legislative covered employee inadvertently becomes part of their network.

• *Potential Weakening of the "Mosaic Defense" to Federal Insider Trading Laws*–
In 2000, the Securities and Exchange Commission adopted Regulation FD to address selective disclosure of material non-public information by issuers.[18] Regulation FD confirmed the validity of a "mosaic defense"[19] to federal insider trading laws, stating that an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a "mosaic" of information that taken together is material.[20]

Thus, Regulation FD expressly allows analysts to sift through non-public, non-material information and, through their own "persistence, knowledge and insight," discern or extract conclusions that are material. However, the "mosaic" must consist exclusively of non-material information – if even one piece of the "mosaic" is both nonpublic and material the defense will not be available.

Many political intelligence and lobbying firms sift through non-public, non-material information for example when they "count votes" or provide insight regarding certain legislative activity. It is possible that by broadening the insider trading laws and regulating political intelligence firms, the STOCK Act could weaken this important defense to insider trading laws as it applies to "political intelligence."

• *Application to Investments in Private Companies* – The ban on the purchase or sale of securities in the House bill would include investments in private companies. Thus, any private equity or venture capital fund that purchased

[18] 17 C.F.R. Parts 240, 243 and 249.
[19] Some have suggested the "mosaic defense" suffered a blow when Raj Rajaratnam, founder of the Galleon Group family of hedge funds, was found guilty of insider trading after the jury rejected his argument that his trades were based on many small pieces of non-material information he was able to cobble together. *See Raj Verdict Deals A Blow To Mosaic Defense,* LAW 360, May 11, 2011; *Implications of the Rajaratnam Verdict for the 'Mosaic Theory,'* HEDGE FUND LAW REPORT, Vol. 4, No. 18. Many experts, however, believe the jury was justified in finding that some of the individual pieces of information Mr. Rajaratnam was aware of were material and nonpublic – thereby negating the mosaic defense.
[20] Regulation FD goes on to say "Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend by Regulation FD, to discourage this sort of activity."

or sold shares in a private company – i.e. invested in or sold a portfolio company – while one of its employees was in possession of material nonpublic "political intelligence" could be in violation of the insider trading laws.

• ***Types of Legislative Activities the Act Applies to*** – The House bill applies to information gained from Members of Congress, Congressional staff and employees of federal agencies. As currently drafted, the restriction would not include information obtained from Executive Branch employees – such as the Secretary of Treasury. Investment advisers should watch for whether the final bill covers information derived from any federal employee or only certain federal employees.

• ***Types of Trades Prohibited*** – The House bill applies to the purchase or sale of securities, commodities for future sale, swaps and securities-based swaps. It does not include the purchase or sale by any party of options or derivatives, exchange traded funds (ETFs) or mutual funds – an important exception. Several commentators during the Congressional hearings recommended that the bill include all such instruments, and it is likely that the final version of the bill will apply to a broader group of financial instruments.

• ***Disclosure of Political Intelligence Contacts*** – As noted above, the House bill expands the disclosure requirements of the LDA to include political intelligence contacts and firms that engage in political intelligence activities. However, the threshold for making a "political intelligence contact" – i.e., essentially any contact with a federal employee regarding federal legislation or rulemaking in connection with informing investment decisions – is lower than the threshold for engaging in lobbying efforts. In addition, unlike current LDA regulation, there is no registration carve-out for individuals who devote less than 20 percent of their time to political intelligence activities for a particular client.

As a result, any investment adviser who asks a Member of Congress for his or her thoughts on a piece of legislation could be deemed to have made a "political intelligence contact" under the Act. If the investment adviser or any of its affiliates were already registered under the LDA, this contact would need to be disclosed. If enough political contacts were made, the individual(s) and firm could be required to register under the LDA.

In sum, the STOCK Act is a well-intentioned piece of legislation that could have significant unintended consequences for investment advisers. Please feel free to contact us if you have any questions regarding the legislation.

For more information, please contact the author at sgluck@Venable.com or 202.344.4426.