PRESIDENT OBAMA SIGNS THE STOCK ACT

April 4, 2012

To Our Clients and Friends:

Today, President Obama signed into law the Stop Trading on Congressional Knowledge Act of 2012 (the "STOCK Act"). The STOCK Act bans members of Congress and their staff, as well as certain members of the Executive and Judiciary branches of government, from trading securities based on material, nonpublic information obtained through the official performance of their jobs. The law affirms that members of Congress, their staff and other employees of the federal government are not exempt from federal insider trading laws and delineates a clear fiduciary duty that they owe to Congress, the United States and the American people. Although some questions remain about the scope of what constitutes "material, nonpublic" information under the STOCK Act, this newly-defined fiduciary duty also could create potential insider trading liability for hedge funds, private equity firms, and other investors that obtain and trade on "political intelligence."

The Senate version of the STOCK Act included registration and disclosure obligations for individuals and firms engaged in "political intelligence," defined as "any oral or written communication . . . to or from a covered executive branch official or a covered legislative branch official, the information derived from which is intended for use in analyzing securities or commodities markets, or in informing investment decisions, and which is made on behalf of a client with regard to the formulation, modification, or adoption" of legislation, rules, regulations, executive orders, or any other federal policy, position, program, contract or grant. The final text does not include those provisions; however, the law does require within one year a report by the Comptroller General of the United States, in consultation with the Congressional Research Service, on the role of political intelligence in the financial markets. As political intelligence has become a more common source of information for investors, the relationship among members of Congress and political intelligence firms, and the nature of the information obtained from congressional or other government sources, have come under greater scrutiny.

THE FIDUCIARY DUTY OWED BY MEMBERS OF CONGRESS

There are two basic theories of insider trading under which a member of Congress, or any individual, can be found liable: the "classical theory" and the "misappropriation theory."

The classical theory imposes liability when a company insider, or a constructive insider, breaches a fiduciary duty to the company by trading or tipping based on material, nonpublic information.

Members of Congress and their staff are subject to the classical theory of insider trading liability like any other company insider or constructive insider; however, such cases are extremely rare because members of Congress and their staff do not often serve as company executives or board members.

The misappropriation theory, by contrast, creates liability when a trader or tipper breaches a fiduciary duty to the source of the information, even if the trader or tipper is not a company insider or constructive insider. When members of Congress or their staff obtain material, nonpublic information in the course of their duties and then use it either to trade in securities or tip another individual, their conduct could be described as theft (or "misappropriation") of the information.

Liability under the misappropriation theory also requires proof of a fiduciary duty between the trader/tipper and the source of the information. For many years, legal academics and practitioners have disagreed about whether members of Congress owe a fiduciary duty to any individual or institution. The STOCK Act intends to end that debate by stating that:

> each Member of Congress, or employee of Congress [as well as certain Executive and Judiciary branch employees] 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, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[1]

A member of Congress, or any other federal employee subject to the STOCK Act, who divulges to a third party any material, nonpublic information obtained through the performance of the employee's or public official's job, would violate this newly established duty. Additionally, any person who knowingly receives and trades on material, nonpublic information obtained in violation of this duty could potentially be liable as a "tippee."

OPEN QUESTIONS AFTER THE STOCK ACT BECOMES LAW

Although the STOCK Act certainly answers the question of whether members of Congress and employees of the federal government have a fiduciary duty, it also raises new questions about the scope of what constitutes "material, nonpublic" information, and the constitutionality of limiting

[1] *STOCK Act, Section 4(b)(2).*

elected officials' and government employees' interactions with constituents and other third parties.

The boundaries of what constitutes "material, nonpublic" information under the STOCK Act is complicated by the means by which members of Congress and their staffs may obtain information and the nature of information they possess. Some information, such as information obtained from the private sector, might be easily characterized as material, non public information, whereas the categorization of information obtained through discussions with other members of Congress and staff regarding positions on legislation is more ambiguous.

According to a recent U.S. House of Representatives Committee on Ethics memorandum, "material, nonpublic" information may include "information from conference or caucus meetings regarding votes or other issues" and "information learned in private briefings from either the public or private sector."[2] Such an expansive definition could significantly hinder a member of Congress's ability to communicate with the public about the prospects of pending legislation. The STOCK Act directs the Select Committee on Ethics of the Senate and the Committee on Ethics of the House of Representatives to "issue interpretive guidance of the relevance rules of each chamber,"[3] which should provide some clarification on the scope of these issues. The Act similarly instructs the Office of Government Ethics and the Judicial Conference of the United States to issue interpretive guidance for Executive and Judicial branch employees, respectively.[4]

Opponents of the STOCK Act argue that members of Congress have the right, and even the obligation, to meet and engage in conversations with special interests, constituents, and other stakeholders about pending legislation, and the broad fiduciary duty established in the STOCK Act inhibits members of Congress from upholding their sworn, Constitutional responsibilities. For example, a member of Congress's position on an issue might be critical to whether a particular piece of legislation will pass, but treating such information as material, nonpublic information would limit his or her ability to communicate with constituents.

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[2] *See U.S. House of Representatives Committee on Ethics, Rules Regarding Personal Financial Transactions, at 3 (Nov. 29, 2011), available at http://ethics.house.gov/ financial-disclosure-pinksheets/rules-regarding-personal-financial-transactions.*

[3] *STOCK Act, Section 3.*

[4] *Id., Sections 9(a)(1) and 9(a)(3).*

Finally, the Speech and Debate Clause of the U.S. Constitution protects members of Congress' speech and debate on the floor of the House or Senate, as well as any "legislative acts" that are "an integral part of the deliberative and communicative processes . . . with respect to the consideration and passage or rejection of proposed legislation."[5] That may also impose a Constitutional barrier to enforcement of the STOCK Act in certain circumstances.

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It seems likely that, even after the STOCK Act becomes law, questions will remain about how a member of Congress's fiduciary duty will interact with other responsibilities, and what constitutes "material, nonpublic" information.

Until guidance is issued and these Constitutional and definitional questions are tested, members of Congress and their staff are likely to be cautious about how they engage with the public, and in particular, with any third parties representing potential investors. Hedge funds, private equity firms, and institutional investors should, in turn, closely monitor their lobbyists' and other representatives' interactions with members of Congress, as well as consider new compliance policies to govern those interactions, because liability under the insider trading laws also extends in certain circumstances to third parties who receive and trade on material, nonpublic information.

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5 *Gravel v. United States, 408 U.S. 606, 616, 625 (1972).*