Political Insider Trading

Mitigating a risk

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The allegation that some US senators, including Richard Burr and Kelly Loeffler, selling equities in February 2020 might have taken advantage of political intelligence around the coronavirus pandemic crisis has highlighted a risk for hedge fund managers: political insider trading.

In March 2020, the US Securities and Exchange Commission (SEC) took the opportunity to reiterate the need for vigilance in this area, having previously stated the importance of this in relation to certain investigations and actions. The potential scope of political insider trading is broad in terms of: the types of information covered; the regulatory and justice bodies involved in enforcement; the markets and instruments traded; and the legal basis for bringing actions.

Since the 2012 Stop Trading on Congressional Knowledge Act (STOCK Act) – which Richard Burr and just two other senators voted against – it has been clear that various US laws used to prosecute insider trading potentially apply to US politicians, and also to any confidential information they may share with third parties, including asset managers.

"Any information derived from politicians' positions, including with respect to US, foreign, international or supranational governmental policies, may be considered sensitive and confidential, and they have a duty to treat it as such," says Craig S. Warkol, a partner in the Broker-Dealer Regulatory & Enforcement, Litigation and Securities Enforcement Groups at Schulte Roth & Zabel in New York. A former federal prosecutor and former SEC enforcement attorney, Warkol serves as co-chair of the SRZ Broker-Dealer Regulatory & Enforcement Group.

As of this writing, only one US politician – former congressman Chris Collins – has been charged with insider trading, in relation to sales of stock in an Australian biotechnology company. He was charged under federal laws 10(b)(5).

"Indeed, various legal and regulatory bodies could get involved in insider trading cases such as this. Insider trading cases are primarily brought by the SEC and US Department of Justice. However, nearly every state has its own securities laws, several of which are very broad such as New York's Martin Act, and they too could bring cases. In addition, the CFTC could get involved in any case involving futures, though it has, to date, only pursued so-called insider trading cases involving market abuse such as front running," explains Warkol.

Insider trading most often involves single stocks, but it can occur with other asset classes and instruments. "Insider trading can happen with any securities, whether they are traded on a public or private exchange or traded over the counter (OTC). This could include bonds, corporate credit or commodity futures," says Warkol. In theory it could also apply to index derivatives, with the caveat that materiality matters, or as Warkol points out, "Is information on a single company likely to be material for the performance of a stock index? The legal basis for proving insider trading under 10b is in a state of flux. For example, since 1983, to prove insider trading the government had to prove a personal benefit to the tipper. That ruling has been under attack in several appellate courts and is likely to be revisited by the US Supreme Court," says Warkol.

Whatever the last word is on the personal benefit criterion, prosecutors recently have used another law – 18 USC § 1348 – to bring insider trading cases without the need to prove personal benefit. "Though the STOCK Act references 10b, the Department of Justice has been resourceful enough to use § 1348, a part of Sarbanes Oxley, in insider trading cases," explains Warkol. In some cases, a defendant has been acquitted under 10b but found guilty under § 1348. "Whatever the status of the personal benefit requirement, prosecutors will choose which cases to bring based on conduct they find offensive," says Warkol. Facing a prosecution is damaging no matter what. Even if individuals and companies are ultimately exonerated (as some have been), a multiyear insider trading case can destroy reputations, careers, companies and livelihoods – and cost millions in legal fees.

Mitigating risks

The onus is on asset managers to be vigilant about the risks inherent in looking for informational advantages. "Lobbyists and political consultants may be required to register with the US government, but many are not registered and very few are registered with any financial regulator. If a consultant or even an academic discloses inside information, it is not going to be a defence to say that the asset manager, or even the consultant, did not know the information was confidential or did not mean to disclose it," says Warkol.

Therefore, it is worth vetting and selecting consultants carefully, which may include background checks. Asset managers should review their policies and procedures, conduct adequate due diligence and beware of any red flags. "Having been a prosecutor, I can tell you that the government uses hindsight, which is always perfect, to look for things that may jump out as a problem, such as consultants that charge exorbitant fees or have undisclosed business interests," Warkol commented.

Once political intelligence consultants have been selected, there is ongoing monitoring to do, and in principle, this should be similar to the routines used to monitor expert networks – but in practice it is not always adequately implemented. "Everyone developed policies around expert networks after a series of high-profile cases focused on experts, but they have not always done the same for political intelligence. In a recent case, the SEC explicitly pointed out that the firm had extensive policies for experts but not for political consultants," says Warkol.

As a best practice, asset managers should consider requiring calls with consultants to be chaperoned, typically by in-house compliance staff, in the same way as expert network contacts are overseen, and contemporaneous notes should be made.

This recordkeeping is also the responsibility of asset managers. "Documenting the provenance of information is just good compliance practice. You don't want to be in a situation where prosecutors are trying to subpoena congressional committee briefing notes to see where you got your information, as happened in one recent case," explains Warkol.

In all of this, a delicate balance needs to be struck whereby asset managers should be able to inform the policymaking process without trading on inside information. The situation is complicated because politicians, think tanks and lobbyists will share information with constituents, trade groups and so on in the normal course of their work in gauging the potential impact of new proposed legislation. They need to sound out opinions and canvass responses to possible new laws. "If managers do inadvertently end up in possession of inside information on a security, they must avoid trading," says Warkol. It is not defensible to carve out the inside information and argue that a trade was based only on public information, and this is inconsistent with the legal standard that prohibits trading while in possession of nonpublic information. **THFJ**

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