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Political Intelligence

Political Intelligence Firms and the STOCK Act: How Hedge Fund Managers Can Avoid Potential Pitfalls

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The political intelligence industry has grown substantially over the last few years. Political intelligence firms, which are typically comprised of lobbyists and former legislative and executive branch employees, are often retained to help gather information about government policy and pending legislation. Every day officials in Washington make decisions that affect the prospects and profitability of individual companies and entire industries. Thus, it is not surprising that the use of political intelligence firms has become increasingly common among sophisticated investors such as hedge funds.

Depending on the focus of the engagement, these firms can help hedge funds in a variety of areas, including conducting research and due diligence, developing an investment idea or strategy and informing trades in financial markets. Political intelligence consultants differ from lobbyists as they do not advocate for or try to influence legislation, but rather, specialize in obtaining information and monitoring developments. They can provide a fund with information on new or pending congressional bills or executive orders and offer unique insight into the political process as well as the personalities and insider views of key legislators, staffers and agency stakeholders. For funds that need to follow legislative or regulatory developments closely, political intelligence consultants can serve as their eyes and ears in Washington. By leveraging their relationships with lawmakers and agency officials, these consultants can deliver real-time "inside the Beltway" information thereby providing a competitive advantage over those simply monitoring news and data services.

On April 4, 2012, President Obama signed into law a bill that raises important issues for hedge funds that retain political intelligence firms. The bill is called the Stop Trading on Congressional Knowledge Act, commonly referred to as the STOCK Act. Although the primary purpose of the bill is to affirm that the insider trading laws apply to Members of Congress and other public officials, the legislation makes clear that hedge funds and their employees who trade on information obtained from a political intelligence firm can be exposed to potential liability. The STOCK Act has also drawn significant attention to political intelligence firms and those who retain their services. An early version of the bill contained a controversial provision which required the firms to register with the government and disclose their activities as well as the identity of their clients. While that provision was ultimately struck from the final version of the bill, Congress ordered that a study on the activities of political intelligence firms be conducted.

Given these developments, a heightened level of government scrutiny in this area is expected. Federal prosecutors and regulators will likely be focused on the type of information these firms obtain, how they obtain it, who they provide it to and how it is used. Thus, while political intelligence firms can deliver a valuable service that is entirely lawful, fund managers who employ these firms or who wish to do so should be aware of the possible associated risks. This article considers those risks and offers some suggestions as to how to manage them.

Risk #1: Insider Trading Liability

Whenever an investor uses a consultant to gather information, there is a risk of insider trading. To assess the magnitude of that risk in the political intelligence context, it is useful to examine the STOCK Act and its potential impact on the scope of insider trading laws. The basic prohibition on insider trading is derived from federal securities laws that forbid a person from buying or selling a security while in possession of material nonpublic information that was obtained in breach of a fiduciary duty. There are two primary theories of insider trading liability. The first is the classical theory which involves a corporate insider who trades on information obtained by reason of his position in violation of the insider's fiduciary duty to the company and its shareholders. The second is the misappropriation theory which can involve anyone who trades on material nonpublic information misappropriated from a party to whom the person owes a fiduciary duty, such as the duty owed by a lawyer to a client.

Federal securities laws clearly prohibit trading based on inside information obtained through corporate channels, but until recently there was some uncertainty as to whether those laws apply to information obtained through government channels. While federal regulators had taken the position that they do, there was an ongoing debate as to whether a government official has a fiduciary duty not to act on confidential information obtained by reason of his position, similar to a corporate insider's duty to his company and its shareholders. The STOCK Act, however, put an end to that debate as it explicitly imposes such a duty and thus makes clear that trading on information obtained through government channels can serve as the basis for a federal securities law violation. As a result, hedge funds that obtain material nonpublic information from lawmakers or other public officials can be exposed to potential liability.

This is true even if the fund obtains the information indirectly from a political intelligence firm. An investor need not deal with an insider directly to violate the prohibition on insider trading. Under both the classical and misappropriation theories, the law prohibits "tipping," that is, when an individual who obtains material nonpublic information in violation of a fiduciary duty (tipper) provides the information to an individual who trades on it (tippee). The tipper and tippee can both be liable for insider trading. Tippee liability can also extend beyond the first-generation recipient and apply to other recipients further down the information distribution chain. There are many cases in which the tippee is two or more levels removed from the source of the inside information. Thus, where a public official passes prohibited information to a political intelligence firm who, in turn, passes the information to a hedge fund that trades on it, the fund and its employees can be held liable assuming the government can prove that they were aware the information was material and nonpublic and that it came from someone who obtained it in breach of a fiduciary duty.

As demonstrated by the recent wave of prosecutions involving the use of expert network firms by hedge funds, the government has aggressively pursued insider trading cases based on this theory of liability. Expert network firms, similar to political intelligence firms, facilitate the sharing of information. They serve as matchmakers connecting clients with individuals who can provide market intelligence based on specialized expertise in a particular area of interest. These experts, who can provide unique perspectives and insights into a particular company or industry, can include professors, scientists, engineers, suppliers and former executives. Over the last few years, based on a theory of tippee liability, the Department of Justice and the Securities and Exchange

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Commission have charged hedge fund principals with insider trading in connection with their use of information obtained from expert network consultants.

As illustrated by the expert network cases, the question of what constitutes material nonpublic information is a fact-intensive analysis and often leaves room for interpretation. Thus, it is difficult sometimes to draw the line between objective research and analysis and illegal insider tips. These recent enforcement actions, however, make clear that while expert network and political intelligence firms can offer a valuable service that does not run afoul of insider trading laws, there is also a valid concern that these consultants can provide prohibited inside information, and thus, subject their clients to liability. Hedge funds that employ political intelligence firms and similar consultants should be mindful of this risk as federal prosecutors and regulators have made the prosecution of insider trading a top priority and have given every indication that they will continue to do so in the future.

Risk #2: Anti-Corruption Liability

In addition to insider trading, federal authorities are continuing to aggressively pursue public corruption violations. As demonstrated by the Jack Abramoff lobbying scandal, which resulted in the conviction of 20 individuals for fraud and corruption-related offenses, the Department of Justice is closely examining the relationship between public officials and those who have access to them. Given the information provided by political intelligence firms is often derived from public officials, hedge funds that retain these consultants should be cognizant of the applicable anti-corruption laws.

Among the powerful tools the government has to pursue public corruption violations are the federal bribery and anti-gratuity statutes, which prohibit giving or offering a payment to a public official in connection with his official duties. The key distinction between these two statutes, which were often used to charge individuals in the Jack Abramoff investigation, is the element of intent. Whereas bribery requires an intent to "influence an official act," an illegal gratuity requires only that the gift be given "for or because of" an official act. In other words, for bribery there must be a *quid pro quo* – a specific intent to give or offer something of value in exchange for an official act. An illegal gratuity, on the other hand, may constitute merely a payment as a reward for an official act that would have been performed irrespective of the payment.

Hedge funds that use political intelligence firms can be exposed to potential liability for violating these statutes. The individuals covered by the bribery and anti-gratuity provisions are not limited to public officials and those who bribe them. An individual or entity who indirectly engages in such conduct can be equally liable. Corporate executives, for example, have been charged with paying bribes or illegal gratuities through intermediaries. Based on a theory of aiding and abetting or conspiratorial liability, the government does not need to prove that the executive personally made an illegal offer or payment. Rather, the question is whether the executive was complicit in a scheme to do so, which is typically answered, at least in the first instance, by a prosecutor's evaluation of the facts.

It is also worth noting that the scope of prohibited conduct under the federal bribery and anti-gratuity statutes is extremely broad. The prohibition is not limited to payments made to high-level government officials but rather applies to federal public employees at all levels and in each branch.

In addition, bribes and illegal gratuities can take many forms. The statute covers "anything of value" which, as we saw in the Jack Abramoff-related cases, can include money, entertainment, hospitality, kickbacks and political or charitable contributions. There is also no dollar threshold for liability. Thus, giving or offering any of these things – no matter how small – is prohibited and could lead to prosecution.

Of course, in order to impose liability, the government must prove a link between the thing of value conferred upon a federal official and a specific official act. While the Jack Abramoff cases often involved a quid pro quo for votes or support of legislation, an "official act" for these purposes has been interpreted broadly by the courts and can include preliminary actions, such as when a public official gives advice or a recommendation. Thus, if the official's job is to serve as a public liaison – which requires him to interact with government agencies on behalf of the public or vice-versa – his response to a request for information from a political intelligence firm could potentially implicate his job duties and qualify as an "official act." Liability may also be imposed even if the official does not have the necessary authority to perform the act in question. The bribery statute, for example, prohibits paying a public official to defraud the government or violate his official duties.

Suggested Practices to Prevent or Mitigate Liability

There is nothing wrong with hedge funds using political intelligence firms, or other consultants, to help guide investment decisions. However, given the concerns described above, fund managers who wish to use such firms should implement reasonable policies to avoid or minimize the legal risks in this area. Below are a few suggestions.

Conduct Specialized Training

Before engaging a political intelligence firm, fund employees at all levels should be trained on the applicable laws, including insider trading and anti-corruption laws. This training, which should be given periodically, should teach employees about the permissible limits of political intelligence gathering and how to identify and avoid problems in this area.

Perform Due Diligence

Political intelligence firms typically maintain compliance policies, which are sometimes described on their websites. At a minimum, a fund manager should review the firm's compliance policies before retaining it to assess how the firm addresses the above-described risks, and find out how the firm enforces those policies.

Implement Contractual Conditions

When negotiating an engagement with a political intelligence firm, a fund manager should seek certain contractual provisions, such as express prohibitions against any form of bribery or corruption as well as the disclosure of prohibited inside information in connection with any dealings with the fund or its employees. The fund manager should also request that the political intelligence firm agree to indemnify the fund in the event of any inquiry concerning such contractual provisions.

Establish and Enforce Appropriate Controls

A fund that plans to use a political intelligence firm should be sure that its own compliance policies and controls address the gathering of political intelligence. To identify and prevent problems, funds can use a variety of methods, from documenting conversations with a political intelligence firm in which the fund employee verifies that the firm is complying with applicable laws to ensuring that appropriate trading restrictions are put in place if it is suspected that a political intelligence firm has provided prohibited inside information.

These precautions can mitigate the likelihood of issues arising and can be critical in defending the fund against an enforcement inquiry. While the government has already stepped up its enforcement efforts in the areas of securities fraud and public corruption, as a result of the spotlight the STOCK Act has put on political intelligence firms, hedge funds that retain these firms can expect increased scrutiny. A potential misstep can result in a fund or its employees facing significant civil penalties and possible criminal prosecution or, at a minimum, having to respond to requests or subpoenas in a highly-publicized congressional or grand jury investigation, thus resulting in the unnecessary expenditure of time and money and the attraction of unwanted attention. By taking reasonable measures, however, hedge funds can continue to benefit from the use of political intelligence firms while managing these risks.

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