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### When Government Information Can Be “Inside Information” Under The Federal Securities and Commodities Laws <sup>1</sup>

In the past few years, the Securities and Exchange Commission (“SEC”) seems to have made cracking down on insider trading in the financial industry one of its priorities. Most recently there has been an increased focus on the improper use of governmental information in securities trading. If information is improperly obtained from government officials and used to trade in securities, it is likely that such conduct would constitute a violation of the federal securities laws which prohibit trading on insider information (assuming that such information is material and nonpublic). Government officials themselves who either convey such information to others or trade while in possession of it would be liable as well. This GlobalNote<sup>®</sup> is an overview of the insider trading landscape and the potential changes in the industry relating to the improper use of confidential government-obtained information.

#### **Insider Trading and Government Information Overview**

The prohibition against insider trading is embodied in the anti-fraud provisions of the federal securities laws.<sup>2</sup> “Traditional” insider trading involves purchasing or selling securities of a particular company while in possession of material nonpublic information concerning that company where the party who traded was either an officer or employee (*i.e.*, an “insider”) of the company or obtained the information from such an insider. Courts also have imposed liability where an accused party who improperly traded in a company’s stock was not an “insider” of the company, or where the source of the information that was traded upon was not obtained from a company “insider.” One such case involved an employee of a financial printer who worked for a company (the “acquiror”) that was planning to acquire another company (the “target”). The employee traded in the stock of the target on the basis that the acquiror was planning to acquire the target (*i.e.*, material nonpublic information). The employee had not obtained the information directly from the target company but rather became privy to the information during the course of his employment at the financial printer. The employee was still held liable for insider trading because he “misappropriated” the information from his employer (the printing company) as well as the acquiror, and such misappropriation was a fraud “in connection with the purchase or sale of a security.”<sup>3</sup> The U.S. Supreme Court eventually upheld this misappropriation theory of liability several years later in a separate case.<sup>4</sup>

It would seem to follow from the “misappropriation” line of cases that if a government employee learns material nonpublic information in the course of his government employment which would affect the market price of a publicly-held security and uses that information, or conveys it to someone else who uses it, to purchase or sell such securities, that government employee would be deemed to have misappropriated the information from his employer (*i.e.*, the government) and such conduct would constitute a violation of the federal securities laws relating to insider trading.

#### **SEC Enforcement Actions**

Several recent enforcement actions highlight the SEC trend of bringing cases against those improperly trading in confidential government information. For example, in early 2011, the SEC filed an action asserting a misappropriation claim against Cheng Yi Liang (“Liang”), a chemist employed with the U.S. Food and Drug

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<sup>1</sup> This memorandum provides general information on the subject matter described, should not be relied on for legal advice in any jurisdiction and may constitute attorney advertising.

<sup>2</sup> See, e.g., Section 17(a) of the Securities Act of 1933, as amended (the “Securities Act”), Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) and Rules 10b-5, 10b5-1 and 10b5-2 promulgated under Exchange Act Section 10(b).

<sup>3</sup> See, e.g., *SEC v. Materia*, 1983 WL 1396 (U.S.D.C., S.D.N.Y.).

<sup>4</sup> See *U.S. v. O’Hagan*; 521 U.S. 642, 652 (1997).

Administration (“FDA”), and others<sup>5</sup> (“Liang Action”). In the Liang Action, the SEC alleged that Liang misappropriated confidential information regarding upcoming FDA drug approval decisions obtained during the course of his employment and traded in securities based on that information.<sup>6</sup> The SEC further alleged that Liang breached his duty as an FDA employee by violating specific FDA rules prohibiting the use of official information for private financial interests, and he also breached his general duty as a U.S. government employee “not to engage in financial transactions using nonpublic government information and not to use such information for his personal benefit.”<sup>7</sup> The SEC alleged that Liang’s actions violated Exchange Act Section 10(b), Rule 10b-5 promulgated thereunder, and Securities Act Section 17(a). The SEC filed an amended complaint on June 2, 2011, alleging that Liang also traded in the securities of an additional company based on confidential information.<sup>8</sup>

Similarly, a couple of years prior to the Liang case, the SEC brought an action against Steven E. Nothern (“Nothern”), a mutual fund manager, who traded on confidential information obtained from the U.S. Department of the Treasury (the “Nothern Action”).<sup>9</sup> The action alleged that Nothern traded on information he received from Peter J. Davis, Jr., a consultant to Goldman Sachs who obtained confidential information during quarterly meetings of the Treasury Department. In order to be allowed to attend these meetings as a nongovernment employee, Davis signed an agreement with the Treasury Department not to disclose any confidential information. It was alleged that Davis improperly released the information to Nothern who traded on the information. A jury found Nothern liable under the misappropriation theory of insider trading for violating Exchange Act Section 10(b) and Rule 10b-5 promulgated thereunder.<sup>10</sup>

These cases demonstrate that the SEC will not hesitate to bring actions against a government employee or his tippees who traded on the basis of information learned by the employee in the course of his employment.

### **Proposed Insider Trading Legislation – Members of Congress**

There has been much recent publicity about the purported absence of statutes prohibiting Members of the U.S. Congress from trading in securities based on material nonpublic information learned through their official duties.<sup>11</sup> While the issue is not free from doubt, it may very well be that Members of Congress are not exempt from the general principles discussed above which prohibit trading on the basis of misappropriated information. If a Member of Congress, or his staff, learn material nonpublic information during the course of their duties and use that information to purchase or sell the securities of a public company, the Member or his staff – or their tippees – may in fact be subject to liability under the existing anti-fraud provisions of the federal securities laws.

Legislation has been proposed in Congress which would expressly impose liability for trading by federal employees, including Members of Congress, on the basis of material nonpublic information regarding pending or prospective legislative action which was misappropriated during the course of their employment. One of the proposed laws is entitled the “Stop Trading on Congressional Knowledge” (“STOCK”) Act and was introduced in Congress on March 17, 2011. It would amend the Exchange Act and the Commodity Exchange Act (“CEA”):

to prohibit [the] purchase or sale of either securities, security-based swaps or commodities for future delivery or swap by a person in possession of material nonpublic information regarding pending or prospective legislative action if the information was obtained: (1) knowingly from a Member or employee of Congress, (2) by reason of being a Member or employee of Congress, and (3) other federal employees.<sup>12</sup>

<sup>5</sup> See *SEC v. Cheng Yi Liang, et al.*, Civil Action No. 8:11-cv-00819-RWT (D. Md.).

<sup>6</sup> SEC Litigation Release No. 21907 (Mar. 29, 2011).

<sup>7</sup> The *Standards of Ethical Conduct for Employees of the Executive Branch* [of the U.S. government] provides that “[a]n employee shall not engage in a financial transaction using nonpublic information, nor allow the improper use of nonpublic information to further his own private interest or that of another, whether through advice or recommendation, or by knowing unauthorized disclosure.” 5 C.F.R. § 2635.703(a).

<sup>8</sup> SEC Litigation Release No. 21987 (June 2, 2011).

<sup>9</sup> See *SEC v. Steven E. Nothern*, Civil Action No. 05-cv-10983-NMG (D. Ma.).

<sup>10</sup> SEC Litigation Release No. 21099 (June 22, 2009).

<sup>11</sup> See <http://www.csmonitor.com/USA/Politics/2011/1206/Why-Congress-is-warming-up-to-ban-on-insider-trading>

<sup>12</sup> H.R. 1148, 112th Cong. (2011).

This legislation also would explicitly prohibit any investors from trading in securities based on information received from any federal employee if the person in receipt of the information knows or has reason to know that the information was obtained from any of the aforementioned classes of persons.<sup>13</sup>

As noted above, the absence of such legislation does not mean that Members of Congress (or their staff) would not be liable for trading on the basis of material nonpublic information.<sup>14</sup>

### **New Provisions Under the Dodd-Frank Act Relating to Commodities Trading**

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) in 2010, the Commodity Exchange Act prohibited employees of the Commodity Futures Trading Commission (“CFTC”) and self-regulatory authorities which oversee commodity futures trading from trading on the basis of, or conveying, material nonpublic information obtained in course of their employment.<sup>15</sup> The Commodity Exchange Act also prohibited any person from acquiring nonpublic information from CFTC employees and using such information to engage in certain transactions involving commodities.<sup>16</sup>

The Dodd-Frank Act added provisions which expanded the categories of government employees who were covered by the earlier statute to employees of “any department or agency of the Federal Government” (emphasis added) who have information which may “affect the price of any commodity in interstate commerce, or for future delivery, or any swap.”<sup>17</sup> The Dodd-Frank Act also added provisions which prohibit any person who receives such information from such employees from trading in “(i) a contract of sale of a commodity for future delivery (or option on such a contract); (ii) an option (other than those traded on a national securities exchange . . . ) or a swap.”<sup>18</sup> There are no provisions under the Dodd-Frank Act which expressly proscribe trading in *securities* or conveyance of information about securities by employees of the SEC or other government agencies. Such conduct would be governed by the anti-fraud provisions of the securities laws described above.

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Liability for trading while in possession of material nonpublic information improperly obtained or disclosed by government officials will depend upon the nature of the asset traded. Trading in *securities* on the basis of such information is likely to constitute a violation of the anti-fraud provisions of the federal securities laws.<sup>19</sup>

We continue to monitor new legislation and regulations regarding government information and insider trading. Should you have any questions regarding the above issues, please feel free to contact Michael G. Tannenbaum (212.508.6701), Ralph A. Siciliano (212.508.6718) or Richard E. Strohmenger (212.508.7520) for further information or to be placed on our distribution list.<sup>20</sup>

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<sup>13</sup> *Id.*

<sup>14</sup> The United States Foreign Corrupt Practices Act (“FCPA”), 15 U.S.C. §§ 78dd-1, *et seq.*, imposes liability on any “issuer,” “domestic concern” or agent of either of the aforementioned which provides money or anything of value to officials of foreign governments or foreign political parties with the intent to obtain or retain business, 15 U.S.C. § 78dd-2(a). “Domestic concerns” include any U.S. citizen, national or resident, or any business entity organized under the laws of any U.S. state or that has a principal place of business in the U.S., 15 U.S.C. § 78dd-2(h)(1). Based on the language of the statute, the FCPA appears to cover payments to *foreign* officials in an attempt to obtain or retain business within the countries whom the foreign officials represent. It does not appear to cover the use of information obtained from a foreign official to trade in securities (or any other asset) even if the official was paid for such information.

<sup>15</sup> See 7 U.S.C. §§13(c) and (d).

<sup>16</sup> 7 U.S.C. §13(d).

<sup>17</sup> 7 U.S.C. § 6c(a)(4)(A). Since the term, “any department or agency of the Federal Government,” is not defined in the statute, it is not clear whether it covers Members or employees of Congress.

<sup>18</sup> 7 U.S.C. §6c(a)(4)(B).

<sup>19</sup> The information contained in this memorandum is based on our interpretation of applicable statutes, regulations and case law. There can be no assurance that a court or regulatory authority would agree with such interpretations.

<sup>20</sup> Michael G. Tannenbaum is co-founder of the law firm and chair of the firm’s Financial Services, Private Funds and Capital Markets Practice. Ralph A. Siciliano is head of our firm’s Government and Regulatory Investigations practice and represents investment advisers, investment funds and securities broker-dealers on regulatory issues. Richard E. Strohmenger is an associate in our Financial Services, Private Funds and Capital Markets Practice.