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SEC Steps Up Investigations of Political Intelligence Firms for Insider Trading

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In the last few years, ***Congress***, the U.S. ***Securities and Exchange Commission (SEC)***, and the courts have significantly increased their efforts to grapple with insider trading in the realm of political intelligence. In 2012, Congress enacted the ***Stop Trading on Congressional Knowledge Act (STOCK Act)***, which explicitly applies federal insider trading laws to legislative branch employees. In the wake of the passage of the STOCK Act, the SEC has initiated at least one high-profile investigation involving the distribution of political intelligence about an unexpected increase in Medicare reimbursements to institutional fund clients (the Sutter Investigation). We have previously reported on that investigation[1].This week, the SEC announced the culmination of another, similar investigation of Marwood Group Research LLC (Marwood). The breadth of the Sutter and the Marwood Investigations, combined with the passage of the STOCK Act, suggests a concerted effort by Congress and the SEC to prosecute insider trading in political intelligence on a much broader scale than had previously been pursued. Political intelligence firms and institutional funds that obtain political intelligence as part of their trading strategies should be aware of this focus, and review their compliance policies accordingly.

The SEC's Marwood Investigation

Marwood is a registered broker-dealer and investment adviser, which provides regulatory and government intelligence updates (called "research notes") to clients, including hedge funds. According to the SEC, in two separate instances in 2010 Marwood analysts learned from federal employees about potential non-public developments in health care regulations and then shared this intelligence with clients without ensuring that it did not qualify as material non-public information (MNPI).[2] Even though Marwood had written compliance policies and procedures requiring employees to verify that any intelligence was not based on MNPI, in both cases, the firm's employees failed to identify the potential MNPI and failed to consult with the compliance department.

In the first incident, a Marwood employee who had previously worked at the Centers for Medicare and Medicaid Services (CMS) allegedly learned from former colleagues that the CMS had commenced an investigation into Medicare coverage of the immunotherapy drug Provenge (to determine whether it was "reasonable and necessary" for the diagnosis or treatment of a specific illness or injury) because of concerns about unapproved use of the drug. The Marwood employee was told that the intelligence was "good color," but he was also warned that if he leaked the information he would get "locked out of any conversations going forward." Despite the warning, no one at Marwood consulted with the compliance department, and analysts disseminated research notes speculating that the CMS would continue covering Provenge for on-label uses.

In the second incident, a Marwood consultant who was formerly with the U.S. Food and Drug Administration (FDA) allegedly learned from his former colleagues that the agency was concerned about safety issues with a potential new diabetes drug called Bydureon. Again, without consulting compliance, the firm told various clients that the FDA might deny the drug's application.

Marwood was charged with violations under Section 15(g) of the Exchange Act of 1934 (Exchange Act) and Section 204A of the Investment Advisers Act of 1940 (Investment Advisers Act). Marwood agreed to settle the charges, and, as part of the settlement, consented to a cease and desist order, agreed to pay a fine of $375,000, and admitted wrong doing – i.e., that the firm failed to establish, maintain, and enforce written policies and procedures requiring employees to verify that the health care intelligence was not MNPI. The firm also agreed to hire an independent consultant to improve its compliance protocols.

The Marwood Investigation also follows on the heels of — but is different than — other SEC investigations of insider trading based on confidential information held by the FDA about the status of particular drug approvals or the results of clinical trials. Previous cases involving FDA-confidential information, such as the SEC's widely publicized enforcement action against FDA chemist Cheng Yi Liang and his son, involved more traditional fact patterns where clearly confidential FDA information was misappropriated in order to conduct unlawful trading.[3] By contrast, in the Marwood investigation, the information from the CMS and the FDA was much more akin to the type of information frequently gathered by political information firms on background and then disseminated to their institutional fund clientele. Clearly, the SEC is stepping up its enforcement efforts against trading on "political" information, even when it does not directly bring charges of insider trading.

Lessons From the SEC's Political Intelligence Enforcement Efforts

There are a number of lessons from the SEC's recent investigations involving political intelligence firms:

1. Insider Trading Charges Involving Political Intelligence are Hard to Prosecute

The SEC did not charge Marwood with an actual violation of the insider trading laws under Section 10(b) of the Exchange Act. The SEC Order carefully refers to the health care intelligence as "potential" MNPI, but never alleges that the intelligence in question actually was MNPI. The application of insider trading concepts to the legislative and executive agency sphere raises a number of important issues unique to that realm:

What, exactly, is "non-public" information taken "in breach of a duty of trust or confidence," in the inherently public (as opposed to private) sphere of elected or appointed officials?

What type of "benefit," exactly, does the recent decision in *United States v. Newman* require be shown when the currency of trade in the public sector differs so markedly from that in the private sector?

Even before *Newman*, the potential prosecution of insider trading charges involving political information was problematic; in the wake of *Newman*, the challenges become even more pointed.

2. In the Absence of Insider Trading Charges, the SEC Will Prosecute Compliance Process Failures

In 2010, Marwood already had written policies and procedures that most firms would likely consider sufficient, including a requirement that a supervisor review all regulatory and legislative research notes and a requirement that, if there is "any doubt" as to whether the information was MNPI, the employee must refrain from disseminating the information and contact compliance. According to the SEC, however, Marwood's policies were inadequate because 1) They "did not expressly require the compliance department to be advised as to the source of the information included in the research note or about communications with government sources, if any," and 2) Marwood's managers failed reasonably to enforce the existing policy because they should have quarantined potential MNPI and sought guidance from compliance. The SEC also confirmed what it had previously determined in similar situations, that where a broker-dealer or investment adviser has employees who might come into possession of MNPI on a regular basis, a general policy requiring the employees to self-evaluate the information, without more protocols, is insufficient to comply with Section 15(g) of the Exchange Act and Section 204A of the Investment Advisers Act.

In the wake of Marwood, political intelligence firms should again take a close look at their written policies and procedures concerning MNPI, perhaps even requiring compliance to review all political intelligence prior to dissemination and requiring supervisors to become more active in terms of quarantining potential MNPI. Again, perhaps in light of the difficulties in prosecuting exchanges of potential MNPI in the political intelligence realm the SEC's current solution is not to provide more guidance about what constitutes MNPI but to emphasize the necessity of adopting internal policies which require employees in political intelligence firms to defer more to the compliance departments.

3. Political Intelligence Firms May Be Prosecuted Under Rules Specific to Broker-Dealers and Investment Advisers

Some political intelligence firms do not register as broker-dealers or investment advisers; Marwood did. While the SEC could use a variety of tools (including the insider trading laws) to prosecute unlawful "tipping" by political intelligence firms and their sources, in Marwood's case the agency ultimately decided to rest its action — as it frequently does — on violations of the compliance and supervision requirements for broker-dealers and investment advisers.

4. The SEC Has Robust Discovery Tools in Its Toolbox to Prosecute Political Intelligence Firms

As with any investigation, the SEC enjoys a broad range of discovery tools when investigating political intelligence firms — including electronic market surveillance, document subpoenas, and the ability to take testimony under oath — which are not available to the firms being investigated.

Recently, at least one court has held that such subpoenas can include documents prepared or received by the legislative branch. In the Sutter Investigation, the Committee on Ways and Means of

the U.S. House of Representatives and Brian Sutter refused to respond to the SEC's investigative subpoenas, arguing that the information was protected from disclosure in discovery under the doctrine of sovereign immunity and under the Constitution's Speech and Debate Clause. The court rejected these defenses; and in particular found that Congress had waived its sovereign immunity by passing the STOCK Act. See supra n.1.

With these latest investigative salvos, the SEC not only continues to make inroads into a new realm of MNPI within the world of political intelligence, but also continues to carry a number of enforcement tools in its arsenal to pursue this new path.

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[1] More recently, the United States District Court for the Southern District of New York held that the SEC is not prevented from seeking information from Congressional sources. SEC v. Comm. on Ways & Means of the United States House of Representatives, 14 Misc. 193 (PGG), 2015 U.S. Dist. LEXIS 154302 (S.D.N.Y. Nov. 13, 2015).

[2] SEC Order, In the Matter of Marwood Group Research LLC, Release Nos. 34-76512, 40-4279, Adm. Proc. File No. 3-16970 (Nov. 24, 2015), https://www.sec.gov/litigation/admin/2015/34-76512.pdf.

[3] FDA Chemist and Son Charged with Trading on Inside Information, DOJ Press Release No. 11-393 (Mar. 29, 2011), http://www.justice.gov/opa/pr/fda-chemist-and-son-charged-trading-inside-information ; SEC Charges FDA Chemist With Insider Trading Ahead of Drug Approval Announcements, SEC Press Release No. 2011-76 (Mar. 29, 2011), http://www.sec.gov/news/press/2011/2011-76.htm; see also SEC Charges Two Clinical Drug Trial Doctors With Insider Trading, SEC Press Release No. 2014-100 (May 19, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541857556.

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