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INSIDER TRADING AND CONGRESSIONAL ACCOUNTABILITY

HEARING

BEFORE THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

DECEMBER 1, 2011

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INSIDER TRADING AND CONGRESSIONAL ACCOUNTABILITY

THURSDAY, DECEMBER 1, 2011

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 2:34 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Carper, McCaskill, Tester, Begich, Collins, Coburn, Brown, and Johnson.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. The hearing will come to order. Good afternoon. A recent book by Peter Schweizer and a story based on it on "60 Minutes" have raised the very serious question of whether Members of Congress have been using "insider information" to make investments that enable them to make money they could not have made if they were not Members of Congress.

The Members of Congress who have been specifically accused have denied the allegations. Our purpose here this afternoon is not to determine the guilt or innocence of individual cases. Our purpose is to determine whether the existing law is sufficient to prevent and punish congressional insider trading.

Perceptions are very important in public service. That means that if the law seems to allow Members of Congress to take advantage of their public position for personal gain, the trust that needs to exist between the American people and our government will be further eroded than it already is.

So what is the state of the law governing insider trading by Members of Congress?

It will surprise most people to learn that there is no explicit prohibition in our laws against insider trading by anyone, including Members of Congress. That is to say, the term "insider trading" is not mentioned or defined in statute. All the investigations and prosecutions of insider trading over the years by the U.S. Securities and Exchange Commission (SEC) or the Department of Justice (DOJ) have been carried out pursuant to the broad anti-fraud provisions of the Securities Exchange Act of 1934, which makes it unlawful, in Section 10(b), to "use or employ, in connection with the purchase or sale of any security—any manipulative or deceptive device or contrivance in contravention of such rules"—this sounds like it was written not in 1934 but in 1734—"and regulations as

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the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

The specific rules making insider trading illegal are found in a large body of SEC regulatory activities pursuant to Section 10(b), that broad anti-fraud statute I just read, and court decisions interpreting those activities. The rules against insider trading now clearly encompass not just corporate "insiders" but others who have bought and sold securities based on material, nonpublic information they obtained and used in violation of a duty of trust.

Now, I gather that some have said that Congress has exempted itself from these insider trading rules, but that is not true. In fact, in a statement submitted to our Committee for the record for this hearing, Robert Khuzami,[1] Director of the Division of Enforcement at the U.S. Securities and Exchange Commission, makes clear that the Commission has authority to prosecute such wrongful conduct, declaring that "trading by congressional Members or their staffs is not exempt from the Federal securities laws, including the insider trading prohibitions."

This afternoon, we are going to hear testimony that a Member of Congress or a congressional staffer who buys or sells stock based on inside information they obtain as a result of their job not only violates congressional ethics rules, but violates the securities laws as well.

On the other hand, we are going to hear testimony that the law is not as clear as it needs to be and that Congress should specifically proscribe congressional insider trading.

I am with the second school of thought. In my opinion, whether or not there is currently clear and conclusive evidence that Members of Congress or staff members have benefited financially from insider information and whether or not the SEC believes it can act against Members of Congress for insider trading under its existing authority, there ought to be a law that explicitly deters such unethical, illegal behavior by Members of Congress and punishes it when it happens.

Our goal today is to sort out the facts and determine precisely what legal reforms are needed to ensure that regulators and law enforcers have the tools they need to bring to justice Members of Congress and our staffs who defy the public trust by using insider information for personal gain.

Our first witnesses today, who we will call on in a short while, will be Senator Kirsten Gillibrand of New York and Senator Scott Brown of Massachusetts, a valued Member of this Committee, both of whom have taken the lead in the Senate in introducing legislation to deal with this problem, and that legislation has been referred to our Committee, which is why we are convening this hearing today.

The point that we are focused on today is narrow, but it touches on much broader values and realities. The fact is that the American people's faith in their elected representatives is the cornerstone around which our democratic republic was built. When that faith ebbs, as it now has, to historic lows, we must increase our efforts to ensure that the people who did us the honor of sending us

[1] The prepared statement of Mr. Khuzami appears in the Appendix on page 164.

to Washington to represent them are confident that our only business is their business.

I have been reading a lot about George Washington lately, and as is so often the case, he said something long ago—in fact, on the first day of our new government—that seems relevant to our hearing today, "The foundations of our national policy will be laid in the pure and immutable principles of private morality, and the preeminence of free government [will] be exemplified by all the attributes which can win the affections of its citizens and command the respect of the world."

Adopting a new law that explicitly makes insider trading by Members of Congress illegal would strengthen the "foundations of our national policy," in Washington's words, and I hope in a small way will help to repair the breach that exists today between our government and our people.

Senator Collins.

OPENING STATEMENT OF SENATOR COLLINS

Senator COLLINS. Thank you, Mr. Chairman. Unfortunately, I do not have an eloquent quote to begin my statement to take up where you left off today, but I do want to thank you for holding this hearing to examine whether or not current laws are adequate to prevent Members of Congress from engaging in insider trading. I very much appreciate your inviting our two colleagues Senator Brown and Senator Gillibrand to describe the bills that they have proposed to address this concern. I am a cosponsor of Senator Brown's bill, which is known as the Stop Trading on Congressional Knowledge (STOCK) Act, and I look forward to learning more about Senator Gillibrand's bill today. This hearing is an important step in our efforts to ensure that Members of Congress are not profiting from trading on insider information.

Recent press reports on "60 Minutes" and elsewhere demonstrate why this Committee must explore the application of existing laws to Congress and identify what actions may need to be taken to close possible loopholes that undermine the public's confidence in this institution.

Elected office is a place for public service, not private gain. As demonstrated by recent press stories, however, there are questions about whether lawmakers have been exempt—either legally or practically—from the reach of our laws prohibiting insider trading.

The recent allegations come at a time when the public's faith in Congress is already extremely low. A recent Gallup poll shows that 69 percent of the American public has little or no confidence in Congress. Other polls show that Americans rate Members of Congress at or near the bottom of the list when it comes to perceived honesty and ethical standards.

This erosion of public trust is not confined to Congress, but taints the public's entire view of our Federal system. Why does this matter? Well, with so many critical challenges facing our country, if the American public does not believe that the decisions that we are making are in their interests rather than our interests, it will be next to impossible to tackle the truly significant problems that we face. And we must address the concerns that underpin the

public's skepticism. We need to assure the American people that we are putting their interests above our own.

Seven years ago, economist Alan Ziobrowski published a study that showed that the stock portfolios held by U.S. Senators in the mid-1990s outperformed the market by nearly 12 percent per year. Mr. Ziobrowski concluded from his data that Senators have "a definite informational advantage over other investors," though he also was careful to point out that his results "should not be used to infer illegal activity." In his words, "Current law does not prohibit Senators from trading stock on the basis of information acquired in the course of performing their normal senatorial functions."

A more recent study by the professor showed similar, albeit less dramatic, investment returns for stock portfolios held by Members of the House between 1985 and 2001. At the same time, however, not all experts who have examined these data share the professor's conclusions or his legal interpretations.

So the purpose of today's hearing is to analyze the need for greater clarity in the scope of the insider trading laws. I am eager to hear the views and recommendations of the witnesses on the legislation presented by our colleagues to close any loopholes and also to explore whether this is simply a matter of insufficient enforcement under the existing fraud laws.

Whatever the problem is, one thing is certain. We should not be shielding Congress from laws that apply to other Americans.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thanks very much, Senator Collins.

Senator Gillibrand and Senator Brown, thanks for your leadership here. You really seized the moment and, as soon as this problem became evident, took real leadership. And it is because you have introduced the bills that we are here. We take your legislative proposals very seriously, and it is Senator Collins' intent and mine to move to a markup as soon as we can. So we welcome you here today.

It is always a difficult question when you have two Senators who you call on first. We have researched this matter, and it turns out that Senator Gillibrand, by a small amount, has more seniority, although it is clear that Senator Brown is much older. [Laughter.]

Senator COLLINS. And he is a Member of our Committee. [Laughter.]

Chairman LIEBERMAN. Touche. Senator Gillibrand, go ahead.

TESTIMONY OF HON. KIRSTEN E. GILLIBRAND,[1] A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator GILLIBRAND. Thank you, Mr. Chairman. I am very grateful for your leadership. Senator Collins, thank you for your leadership. I appreciate your holding this extremely important hearing and inviting me to offer my testimony this afternoon. Your strong leadership together is a shining example of how important it is to shine light on an issue as important as fundamental fairness, and it is a very important step forward on the path to restoring Americans' faith in our government, just as you said, Mr. Chairman.

[1] The prepared statement of Senator Gillibrand appears in the Appendix on page 43.

Like millions of Americans all across the country, I was very surprised to learn that insider trading by Members of Congress, their families, or their staff using non-public information gained through their congressional work is not clearly and expressly prohibited by law or by the rules of Congress.

The American people need to know that their elected leaders play by the exact same rules that they play by. They also deserve the right to know that their lawmakers' only interest is in what is best for the country, not what is best for their own financial interests.

Members of Congress, their families, and their staff should not be able to gain personal profits from information to which they have access that everyday middle-class American families do not. I simply believe that this is not right. Nobody should be above the rules.

I have introduced a bipartisan bill in the Senate with 15 of our colleagues. Senators Rubio, Snowe, Johanns, Tester, Stabenow, McCaskill, Klobuchar, Durbin, Blumenthal, Bill Nelson, Reed, Cardin, Kerry, Sherrod Brown, and Baucus have all offered this bill to close the loophole.

This STOCK Act legislation is very similar to the legislation that was first introduced in the House by Congresswoman Louise Slaughter and Congressman Tim Walz. So I want to thank them for their longstanding commitment to this issue and to the advocacy on it. I also want to recognize my colleague Senator Scott Brown for requesting today's hearing and for his very strong work on this issue as well.

Our bill, which has received the support of at least seven good-government groups, covers basic important principles:

First, it says that Members of Congress, their families, and their staff should be barred from buying or selling securities on the basis of knowledge gained through their congressional service or from using that knowledge to tip off anyone else. The SEC and the U.S. Commodity Futures Trading Commission must be empowered to investigate these cases. To provide additional teeth, such acts should also be a violation of Congress' own rules to make clear that the activity is not only illegal but inappropriate for Members of Congress.

Members should be required to disclose major transactions of $1,000 or more within 90 days, providing dramatically improved oversight and accountability from the current annual reporting requirements.

Last, individuals doing political intelligence work—contacting Members of Congress, their staffs, and other individuals to gain information to help with investment decisions—should have to register as lobbyists to provide additional oversight of this industry.

There are those who do not want us to succeed and pass this common-sense legislation the American people expect. Some critics will say that the bill is unnecessary or already covered under current statutes. I have spoken with experts tasked in the past with investigations of this nature, and they strongly disagree. We must make it unambiguous that this kind of behavior is illegal.

Others may say that the legislation is too weak, so let me be very clear. Our mission here is to pass a strong bill with teeth in it that

will make any and all insider trading clearly illegal and a violation of our congressional rules for all Members of Congress, their entire families, and their staff. As we move forward, there will be technical changes in the language to improve the bill and to ensure that the final product meets this goal. Anything less is unacceptable.

As my home State newspaper the *Buffalo News* recently noted, "The STOCK Act would ensure that it is the people's business being attended to." This is a step that we must take to begin to restore America's trust in this very broken Congress.

Thank you again, Senators Lieberman and Collins. I am very grateful that you held the hearing today.

Chairman LIEBERMAN. Thanks, Senator Gillibrand.

Senator Brown, in fact, as our colleague said, requested this hearing and asked us to do it as soon as we could, which is why we are here today.

Senator Brown, it is all yours.

TESTIMONY OF HON. SCOTT P. BROWN,[1] A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator BROWN. Thank you, Mr. Chairman and Senator Collins. Being new here, until the "60 Minutes" piece came out, I had no knowledge that something like this was even allowed. And as a result of that, I wanted to do something about it to try to make a difference.

There was a "60 Minutes" piece that featured a segment about Members of Congress and their alleged insider trading advantage, which garnered widespread public attention, as you referenced.

You know, it is interesting. When you even have to hear about things like this that happen apparently in Washington, there is clearly something wrong. And you referenced it, Mr. Chairman. There is a breakdown of trust. We need to re-establish that connection and let people know that we are subjected to the same laws and rules that they are. We should not pass laws and then not have to adhere to them. And the American people's trust in Congress is at an all-time low, and that is disturbing.

It is more important than ever to have Members of Congress affirm that we live by those very same laws that we pass for everyone else in our country. We should be held to the same and, quite frankly, I think a higher standard than the members of the general public and should not be able to profit based on nonpublic information.

That is why I introduced the STOCK Act of 2011, and I greatly appreciate your jumping on it. It does not surprise me at all that both of you would move quickly to address something that affects our body in such a dramatic way. This obviously affects Members and employees of Congress as well as the Executive Branch employees from using nonpublic information obtained through their public service for the purposes of investing or otherwise making a personal financial gain.

Consider this: A Member of Congress hears during a meeting that a program will be cut or something dramatic is going to hap-

[1] The prepared statement of Senator Brown appears in the Appendix on page 45.

pen, and then he either buys or sells his stock to score a profit or avoid losses when the news breaks. And under current law, the Congressman would likely walk away with a fatter investment account. For everyone else, it would mean jail time, and that is not right.

Some scholars argue that the current law already applies to Members of Congress, as you referenced in your opening statement, and that we do not need it, but I disagree. If it is in effect, then why have they not done something about these sorts of things? There has not been one prosecution. If the SEC has all this power, why have they not used it?

The mere existence of this debate is enough to show that we must clearly define the blanket affirmative duty that we have as Members of Congress to the American people pertaining to confidential nonpublic information. Not defining this duty will leave an absolute gap—and it is clear that it has left a gap—of uncertainty that invites abuse, intentional or otherwise, and contributes to a breakdown of trust among the American people. And that is just not right.

This legislation is directly aimed at correcting this problem that academics such as Professors Alan Ziobrowski and Stephen Bainbridge have identified. In his work, Professor Ziobrowski found that Members of Congress' investments may have benefited from an informational advantage over members of the general public. And in his recent book, "Throw Them All Out," author Peter Schweizer, a fellow at the Hoover Institute, reports that Members of Congress are making a killing in real estate by approving the use of Federal funds for projects that will enhance the value of buildings or lands that they actually own. And that is not right.

As Members of Congress, we all know we have access to information that the public does not—through classified briefings, closed conference reports, and personal conversations with government officials. All of these sources can give us nonpublic information that we could find of significant value and trade accordingly. Not only do we have that access, we create information and policy as well, and we can influence things that way.

When we act on legislation or negotiate legislative language, frequently that legislation has real financial consequences to many different industries in this country. And because we have that access and we create information, we absolutely must not betray the public's trust in everything that we do for our own personal gain.

I believe—and I know you two do, and everybody on this Committee does—that diminishing public trust is why you called the hearing today. I suspect we will hear from witnesses today who say that the existing laws and rules are sufficient—Senator Gillibrand referenced it; you did, Mr. Chairman—and I respectfully disagree. I say, "Like really?" Then, once again, why are we here? Why was the piece run? Why has something not been done? Basic questions. There has been no successful prosecutions of Members or their staff, and I believe the uncertainty that exists around the legal framework provides an excuse for enforcement officials and agencies to avoid the politically difficult task of policing Congress, especially when we control the purse strings of many of those agencies. We must absolutely close this loophole.

I believe that the vast majority of the Members and staff of Congress are here to serve their constituents' best interests. They are people of good will, and they are not here to line their pockets. But by explicitly prohibiting the use of material nonpublic information for personal gain, we will vastly increase the transparency that everyone always talks about here, but sometimes it just does not get done.

The legislation I have introduced is similar to the bipartisan legislation that has been introduced in the House for many years now. Back in the 109th Congress, I know that Congresswoman Slaughter and Chairman Brian Baird actually filed the STOCK Act, and now Congresswoman Slaughter and Congressman Walz have continued their effort in this regard, and it is getting more and more support. So I want to thank them for their efforts.

The media attention has obviously brought a good eye to this, and the American people are watching what we do. They watch more than ever, especially with all the new media opportunities out there.

I am not afraid of acting in the public's interest, and that is why I introduced this legislation. It is critically needed. And there are differences between our two bills. Mine does not amend the ethics rules. It does not need a 67-vote threshold. It needs 51 votes. It makes it a lot easier to get it through. We can do the Senate resolution side by side.

I would suggest and request that you take the best of both bills, put them together, have us all join together in a clearly bipartisan, bicameral manner, and get this thing done. The American people deserve it. We will see if politics will play a role in it or not. And it is up to us.

So I look forward to sitting in that Committee chair on the dais and asking some questions. Thank you.

Chairman LIEBERMAN. Thanks very much, Senator Brown, and thanks for your closing comments about the process. I will note for the record that Senator Gillibrand was nodding her head affirmatively, which is that there are some differences between your two bills, but there are many more similarities. And I hope that the two of you will be able to work with Senator Collins and me to come up with a joint bill. We may want to separate them. As you said, we will probably want to have a separate resolution on the Senate rules so that it will be separate from the legislative proposal. I am going to set a standard that may be hard to meet, but if we work intensely, it would be great if we could bring this before a markup of the full Committee in December before we break for the holidays. We tentatively have scheduled a markup for December 14, so let us set that as the goal and, informed by the second panel, see if we can put this together.

Thank you both very much.

Senator GILLIBRAND. Thank you, Mr. Chairman.

Chairman LIEBERMAN. We will now call the second panel: Melanie Sloan, Executive Director of Citizens for Responsibility and Ethics in Washington; Donna M. Nagy, Professor of Law at Indiana University Maurer School of Law; Donald G. Langevoort, Professor of Law at Georgetown University Law Center; John Coffee, Professor of Law at Columbia Law School. I am having flash-

backs to those terrible days at law school. But, remember, here I am the one who asks the questions. [Laughter.]

It was not that way in law school.

And, finally, Robert Walker, Counsel at Wiley Rein and former Chief Counsel and Staff Director of both the Senate and House Ethics Committees.

Thanks to all of you for being here on relatively short notice. You bring in various ways a wealth of experience and information.

Ms. Sloan, we will begin with you. Your organization has one of the best acronyms in Washington—CREW, Citizens for Responsibility and Ethics in Washington. I know you have worked together with a number of other public interest groups that advocate legislation to deal with this insider trading problem. Please proceed.

TESTIMONY OF MELANIE SLOAN,[1] EXECUTIVE DIRECTOR, CITIZENS FOR RESPONSIBILITY AND ETHICS IN WASHINGTON

Ms. SLOAN. Chairman Lieberman, Senator Collins, and other Members of the Committee, thank you for inviting me here today to join such a distinguished panel.

No disrespect to any of you intended personally, but the fact is America does not trust you. A full 46 percent of Americans believe Congress is corrupt. Stories like the one on "60 Minutes" a few weeks ago become such big news because they confirm what so many people already believe: That many of your colleagues use their positions not for the public good but to feather their own nests.

My organization, CREW, has focused on misconduct of Members of Congress for many years. We have seen and complained of numerous legislators abusing their positions to earmark projects to increase the value of their personal real estate holdings, buying into companies that soon thereafter surged in value, urging agencies to take actions to financially benefit themselves or family members, pushing through legislation in apparent exchange for campaign contributions, and, finally, even trading on inside information.

As others have said, at no time in history has the public's view of Congress been quite so dismal. The jobless rate is sky high, and a wide swath of the country is suffering severe economic hardship, but Members of Congress have never been richer. Sixty-six percent of Senators and 41 percent of House Members are millionaires. Members have significant stock portfolios, but only some maintain their assets in blind trusts. Whether or not it is accurate, there is a widespread public perception that Members of Congress are abusing their positions to enhance their personal wealth.

Members are also willing to accept benefits, like generous pensions and health care coverage, that most Americans only dream about, while at the same time Congress exempts itself from laws like those governing whistleblower protections, workplace safety, and perhaps insider trading that are applied to everybody else.

Notably, presidential appointees requiring Senate confirmation often have been required by the Senate to divest themselves of interests in companies they will oversee as part of the Executive

[1] The prepared statement of Ms. Sloan appears in the Appendix on page 48.

Branch. But Senators are under no such restrictions. For example, the *Washington Post* found between 2004 and 2009, 19 of the 28 Senators on the Armed Services Committee held assets in companies that did business with the Pentagon. The Senate has refused to require Senators to file campaign finance reports electronically, all the better to stop the media and watchdogs from comparing campaign contributions with legislative actions. And Congress, particularly the House counsel's office, has been advancing a very aggressive interpretation of the Speech or Debate Clause that allows Members who have engaged in serious crimes like bribery to go unpunished.

Congress frequently refuses to enforce even its own limited ethics rules, failing to police the conduct of Members except when it is so egregious it becomes fodder for sensational, wall-to-wall, 24-hour news coverage.

I am not an expert on securities law, so I will leave it to all these other esteemed panelists who are leaders in this field to discuss whether and to what extent insider trading laws already on the books apply to you. But given that there has been no prosecution of a Member of Congress for insider trading and only one Member of the House way back in 1976 has ever been disciplined for any even remotely related conduct, it is imperative that Congress pass a STOCK Act soon. Members of Congress need to demonstrate to America that you take our concerns about your ethics seriously.

Undoubtedly, there are cases in which the Speech or Debate Clause of the Constitution might prevent a prosecution such as where a Member traded on confidential information received pursuant to a committee inquiry. As a result, not only should the STOCK Act provide a role for the SEC and the Department of Justice in addressing such conduct, but the House and Senate should also amend their standing rules to make clear that such conduct is prohibited and subject to specific disciplinary action, perhaps including a financial penalty of three times the amount of a profit obtained or a loss avoided.

Disclosures of trades also must be a key component of any legislation. The 90 days permitted under the bills that we have seen is far too long and should be cut back dramatically. After all, electronic confirmations of trades are often instantaneous, making such significant time delays unnecessary.

Members of Congress should post information about trades in an electronic searchable database. Further, as with personal financial disclosure reports, the willful failure to disclose such information should be punishable under the False Statements Act.

The bottom line is that Americans are becoming increasingly frustrated with a Congress viewed as part of the 1 percent and more concerned with preserving that status than in working to improve the standard of living of the remaining 99 percent. Passing a STOCK Act would be a good first step toward changing that image.

Thank you.

Chairman LIEBERMAN. Thank you, Ms. Sloan. And now Professor Nagy from Indiana University Maurer School of Law.

TESTIMONY OF DONNA M. NAGY,[1] C. BEN DUTTON PROFESSOR OF LAW, INDIANA UNIVERSITY MAURER SCHOOL OF LAW

Ms. NAGY. Chairman Lieberman, Senator Collins, and Members of the Committee, I am honored with the invitation to testify. My name is Donna Nagy, and I am the C. Ben Dutton Professor of Law at Indiana University Maurer School of Law. In my 17 years as a professor, I have co-authored a treatise on insider trading, and I have written many articles, including one published last May, on the precise topic of today's hearing.

The articles sought to debunk what at the time was becoming an urban myth: That Congress had exempted itself or was somehow immune from the existing law that prohibits insider trading. Congress in no way has sought to immunize or exempt itself. Beyond that, the article concludes that congressional insider trading is already illegal under existing law.

Based on my research, I would expect a court to hold a Member of Congress liable for any securities trading that is based on material nonpublic information obtained through congressional service if the SEC or DOJ successfully proved the facts alleged. I acknowledge, however, that many distinguished securities law scholars see shades of gray, and some believe a court would rule likely the other way.

The controversy surrounding the application of existing law to Congress stems from the fact that Congress has never enacted a securities statute that explicitly prohibits anyone from insider trading. A STOCK Act would only address one manifestation of this much larger malady.

In the absence of an express statutory prohibition, the offense of insider trading has been prosecuted as a violation of Section 10(b) of the Exchange Act and Rule 10b–5. These provisions prohibit fraud "in connection with the purchase or sale of any security." The Department of Justice also prosecutes insider trading as a criminal violation of either Rule 10b–5 or the Federal mail and wire fraud statutes. Thus, in the vast majority of instances, insider trading is illegal only insofar as it can be deemed an act of fraud.

Because the term "fraud" is not defined in these statutes, the formidable task of determining illegal insider trading has defaulted to the Supreme Court and lower Federal courts. And in literally hundreds of cases, courts have imposed liability where the traders were decidedly not insiders of the issuer whose securities were traded.

For example, courts routinely impose liability in so-called outsider trading cases involving family members who trade on information entrusted to them by spouses or relatives.

Other outsider cases would include Federal and State officials who trade on information obtained through government service, including a Food and Drug Administration chemist who pled guilty last month and now awaits a likely prison sentence.

In misappropriation cases such as these, as in all insider trading cases, the liability linchpin is a securities trader who has breached a fiduciary-like duty of trust and confidence by secretly profiting

[1] The prepared statement of Ms. Nagy with an attachment appears in the Appendix on page 54.

from the use of material nonpublic information that rightfully belongs to somebody else.

The Constitution refers repeatedly to public offices being "of trust." Members also take an oath of office to faithfully discharge their duties. So there should be little doubt that Members' undisclosed, self-serving use of congressional knowledge constitutes a misappropriation that would defraud the United States and the general public, among others.

For a court to conclude otherwise, it essentially would have to view nonpublic congressional knowledge as a perk of office belonging to an individual Member to do with as he or she wished. Such a view would be strikingly inconsistent with the tenets of representative democracy.

I recognize that a Member of Congress has never been prosecuted for insider trading based on nonpublic congressional knowledge. But the DOJ has used the Federal mail and wire fraud statutes to successfully prosecute congressional officials for defrauding the United States and the public through the undisclosed misappropriation of congressional funds and tangible property. And the Supreme Court has dictated that material nonpublic information constitutes intangible property.

In sum, congressional insider trading violates the broad antifraud provisions in Rule 10b–5 and the mail and wire statutes.

My final point relates to one possible consequence of a STOCK Act. I applaud and endorse the motivation behind the proposed legislation, but I am concerned that in the absence of a modification to its wording, a STOCK Act could be viewed as the only insider trading law that applies to Congress. This risk is troubling because the proposed legislation fails to reach a host of possible insider trading scenarios that would almost certainly fall within existing law.

Thank you very much for giving me this opportunity to share my thoughts.

Chairman LIEBERMAN. Thanks very much, Professor. That was very helpful, and we will come back with some questions.

Next, Professor Donald Langevoort, Professor of Law at Georgetown University Law Center. Thanks very much for being here.

TESTIMONY OF DONALD C. LANGEVOORT,[1] THOMAS AQUINAS REYNOLDS PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LANGEVOORT. Thank you, Chairman Lieberman, Senator Collins, and Members of the Committee. My testimony today strongly supports legislative efforts to explicitly proscribe insider trading by Members of Congress and their staffs, as intended by the various STOCK Act bills recently introduced in the House and Senate.

There is no current exemption from the main thrust of U.S. insider trading law for either Members or staff, and many forms of trading or tipping by such persons are adequately proscribed under existing legal authority. Indeed, as Professor Nagy has just told you, it is possible that courts would rule that current insider trading law adequately proscribes all abusive trading in securities on

[1] The prepared statement of Mr. Langevoort appears in the Appendix on page 126.

Capitol Hill. I hope they would. But there is sufficient doubt, especially in light of how courts recently have been reading Section 10(b) and Rule 10b–5.

The primary weapon against insider trading cases like this—the misappropriation theory—requires a showing that the trader was in a fiduciary-like relationship to the true owner of the information and deceptively stole information entrusted to them. As applied to legislative activities on Capitol Hill, this theft of someone else's secrets concept does not fit neatly.

Yet the idea that Members of Congress or their staffs can freely step ahead of ordinary investors to profit from information acquired as a result of their legislative roles is disturbing, to say the least. Congress should, therefore, act to eliminate any doubt and state clearly that both trading and tipping apply to Members and staff.

An insider trading case against a Member or even a powerful staff person will always be a matter of great political sensitivity, likely to be brought only to the extent that the case factually and legally is very strong. The external pressures to bring such cases, or not bring them, will inevitably be great when any suspicions arise. Leaving any ambiguity as to the question of whether, and to what extent, insider trading on Capitol Hill is unlawful is hardly an encouragement to those matters that deserve to be courageously investigated and pursued.

It would be extremely unfortunate were the SEC or prosecutors to bring an action and have the Member or staff person raise the defense, which they surely would, that service in Congress carries with it no fiduciary-like duty with respect to government confidences. That would be the last headline Congress should want to see.

While I fully support the intent behind the STOCK Act bills, the legislative language must be carefully crafted to assure that legislation does not create the very problem it seeks to address: The perception that Congress has exempted itself from insider trading law. If read as an exclusive statement of Congress' insider trading restrictions, it is at times too narrow, at times overbroad.

I am more than happy to work with the Committee and its staff to resolve these problems, which I do not believe at all reflects the true intent of the drafters. Thank you.

Chairman LIEBERMAN. Thank you, Professor. Let me immediately accept your offer of assistance.

We have a purpose, I think, most of us on the Committee, but this is a field of law with a lot of precedent and a lot of complications. So in trying to fix this problem, we do not want to create other problems or create other appearances, as you said. So I look forward to the question-and-answer period.

Next, John C. Coffee Jr., is a Professor of Law at Columbia Law School. We have quite a distinguished panel here. Thank you for being here.

TESTIMONY OF JOHN C. COFFEE JR.,[1] ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. Thank you, Chairman Lieberman, Senator Collins, and other Members of the Committee. I am delighted to be here because I agree almost completely with my predecessor, Professor Langevoort. I am going to edit out much of what I was going to say in support of what he was saying and make just four points.

Point one, I believe Congress should act, but narrowly, and I want to underline the words "but narrowly." While reasonable people and reasonable professors can disagree—and reasonable professors almost always do disagree—I think there are clearly enough ambiguities in this field that you need legislative action.

Senator Brown asked this point earlier: Why has there not been enforcement? I think even very responsible U.S. Attorneys would not prosecute criminally, would not indict, if there is any uncertainty in the law. You do not indict in a case where the law is 50/50, so that is a reason they may have restrained their hands in cases where they could have gone forward. So that is point one, that there is ambiguity, and I think you should act, and Professor Langevoort already said that.

Point two, which he alluded to, but I want to say it a little bit more fully, the proposed legislation has language that does not quite work. I want to say this respectfully, but one of the key concepts in both the proposed bills is that the information that you receive has to relate to pending or proposed legislation before there is liability. Unfortunately, that is not the most common case that we are likely to see. I can imagine a Department of Defense official calling a congressman and saying, "You know that bill you have been pushing us for 2 years to pass to give that defense contract to that contractor in your district? That defense contract will be announced tomorrow for $5 billion." There is no legislation there. There is nothing that under the existing language would make that criminal. Frankly, congressmen spend much of their time exercising oversight, and that oversight function does not fall within the pending or proposed legislation. That is flaw one.

Flaw two, there is a reference that you cannot trade in securities of an issuer. Well, frankly, the most likely trading that you are likely to see would be in options or futures or stock index products, which are not securities of an issuer. They are issued by financial dealers in the market. They are not particular companies you are buying into. You have to play with that language.

I think there is a difference in the two bills with regard to whether tipping—as opposed to yourself receiving information—by the congressman is covered. I think that should be reconciled.

There are several places where you need to talk a little bit about directly or indirectly because there could be a chain of four or five people, and there could be a distance between the congressman and the tippee. I think you want to cover those situations. These are all small points that I will not go further into.

Let me go to my third point. Doing less is more. Rather than attempting to write a detailed code that would codify terms that have well-recognized judicial meanings, like "material" and "nonpublic,"

[1] The prepared statement of Mr. Coffee appears in the Appendix on page 139.

it might be better to write a very simple one-sentence statute. For example, such a one-sentence statute could say, "A Member of Congress is a fiduciary with respect to all material nonpublic information that such person acquires in the performance of such person's duties or that such person receives because of his or her status as a Member of Congress."

That one sentence does it, and it does not require you to define terms like "material" or "nonpublic." You would just say that in interpreting this statute, the courts should use the existing meaning under the Federal securities laws of these terms.

If you attempt to do more, ambitious as it is, and have a universal legislative statute, Congress has tried that before and it has proven to be a disaster. I testified in this field 30 years ago, in the 1970s and 1980s, and Congress wisely backed off from writing a universal statute and just changed the penalties and insider trading sanctions. I think that is wiser because if you adopt legislation with new terms, the Federal courts will spend 10 to 15 years resolving what those new terms mean. There will be conflicts in the circuit. None of us needs that confusion.

Also, if you try to adopt comprehensive legislation, I am afraid that every special interest group in the United States will want a safe harbor for what they do, and you will find that the statute will go from short to page after page of proposed safe harbors. You do not need to do any of that to deal with the real problem that concerns you, which is Members of Congress. So I think you should keep it short and simple.

Last point: Members of Congress will face some illiquidity if such a statute is adopted. That is a necessary cost. But I want to advise you that I do not think the problem of illiquidity is as great as you might think. There are some special rules that the SEC already has, most notably Rule 10b5–1, that permits anyone, including Members of Congress, to adopt what is called a Rule 10b5–1 trading plan. This is different than a blind trust. You can give very detailed instructions to a fiduciary, a broker or a bank, advising the broker or bank exactly what you want done if stock prices fall, if different things happen. I think that would solve most of these problems. In addition, you could even instruct the SEC to give no-action letters to you. And, finally, I think that you can rely on the advice of counsel that if you get an opinion from a lawyer with experience in the securities laws that you are not engaged in using material nonpublic information, I believe that no enforcer will proceed against you where you have a reliable defense-of-counsel defense. Thank you.

Chairman LIEBERMAN. Well, thank you. Again, very helpful. We are not accustomed to drafting legislation as brief as you suggest, but it is a very constructive recommendation.

Robert Walker, as I mentioned at the outset, comes to us with the unusual and very helpful experience of having been Chief Counsel and Staff Director of both the Senate and House Ethics Committees. Thanks for being here.

TESTIMONY OF ROBERT L. WALKER,[1] COUNSEL, WILEY REIN LLP

Mr. WALKER. Thank you, Chairman Lieberman, and thank you, Senator Collins and Members of the Committee. Thanks for the opportunity to address the important issue of insider trading and congressional accountability.

I am not here to advocate against or for any version of the STOCK Act. I will say, however, that in my view current Federal insider trading prohibitions do apply fully to Members and employees of Congress under the misappropriation theory. And I will also say in my view as a former Federal prosecutor, the law is more than 50/50 on that.

There are substantial proof problems in making out an insider trading case in the congressional context, however; in particular, proof that information traded upon was truly nonpublic may be an obstacle, probably would be an obstacle, given the continual swirl of information in and around the Capitol.

There is also a unique complicating factor to prosecuting insider trading cases, at least some insider trading cases, in the congressional context. As already alluded to, under the Speech or Debate Clause of the Constitution, certain congressional actions and activities cannot be cited or used as proof in legal actions against Members brought outside of Congress. But even the most sweeping conceivable legislation against congressional insider trading could not trump constitutional speech or debate privilege.

Within Congress itself, existing standards of conduct do capture and do provide the basis for sanctioning a congressional individual for profiting from securities trades based on material nonpublic information gained through his or her official position. Most directly, paragraph 8 of the Code of Ethics for Government Service states that a person in Federal Government service should "never use any information coming to him confidentially in the performance of governmental duties as a means for making private profit."

Insider trading based on confidential congressional information would be a clear violation of this provision, and the mechanism for enforcement would be the congressional ethics process. Having said this, it cannot be said as clearly exactly what information would be considered confidential within Congress for purposes of enforcement of this code provision.

Under the rules of the House and Senate, there is no blanket duty of confidentiality on the part of Members and staff. Senate rules, for example, basically leave it to each committee and office to determine what information before them is confidential. But relatively few committees of the Senate or of the House actually have specific rules imposing duties of confidentiality on their Members and staffs. So paragraph 8 of the Code of Ethics does not provide a systematic tool for addressing allegations of congressional insider trading. Use of this provision for pursuing insider trading allegations within Congress requires a case-by-case analysis.

The current focus on insider trading in Congress does provide the opportunity for the Senate and the House and each of the commit-

[1] The prepared statement of Mr. Walker appears in the Appendix on page 155.

tees to take a hard look at their rules with respect to the definition, scope, and duties relating to confidential information.

Apart from paragraph 8 of the Code of Ethics, allegations of insider trading in Congress may be addressed under the fail-safe standard of conduct, which enjoins Members and staff never to engage in conduct that may reflect discredit on the House or Senate. If credible allegations of securities trading by a Member or employee based on material nonpublic information were to come before the Senate Ethics Committee, the House Ethics Committee, or the House Office of Congressional Ethics, and these allegations were more than mere insinuation, the allegations would be pursued by the Ethics Committee as potentially conduct reflecting discredit on the institution, and they would be so pursued and investigated, regardless of whether any other specific law or rule were applicable.

Finally, let me turn to the issue of whether Members of Congress may trade in or hold securities of companies or industries that fall within the jurisdiction of their committee assignments. As you know, recusal and divestment are viewed in Congress as extraordinary and disfavored remedies to potential conflicts of interest. The preferred approach to monitoring and policing potential conflicts in the Legislative Branch is through public financial disclosure. The provisions of the proposed STOCK Acts that would require public disclosure of securities transactions within 90 days are consistent with and would extend this approach. There would, of course, be a compliance burden on Members and staff, but there would also be a substantial increase in the accessible pool of information based upon which a Member's constituents could form their own ultimately conclusive and unappealable judgments as to the appropriateness of the Member's financial transactions and as to the propriety overall of the Member's conduct. Thank you.

Chairman LIEBERMAN. Thank you, Mr. Walker.

We will go forward with questioning now, and we will have 7-minute rounds for each Senator.

Based on the research that I did before I came into the hearing today, I reached a tentative conclusion, informed by the SEC testimony filed with the Committee today, that under existing law the SEC would have the authority to pursue and prosecute Members of Congress or staff for insider trading.

Based on the testimony that the witnesses have given, I think now I come to a different kind of conclusion, which is that there is genuine ambiguity in the law. My original feeling was that we should legislate to make clear that Members of Congress are included within laws against insider trading because, obviously, as we have said earlier, insider trading is not mentioned or defined in the existing state of the law. You have to take a two- or three-step jump to get there.

But now you convinced me that there is ambiguity that has to be resolved, and if I am hearing you correctly, particularly Professor Langevoort and Professor Coffee, it goes particularly to this question of fiduciary duty. And as I understand it, as you mentioned, Professor Nagy, the Supreme Court really has set the law here because it has required the interpretation on up, a person can be found to have committed insider trading if the person trades on

the basis of material nonpublic information, but only if the person is breaching a fiduciary duty, which, as I understand it, normally is to shareholders or the source of the nonpublic information.

So the normal reaction—but the normal reaction does not necessarily prevail in courts of law, in other words, there is a separate vocabulary—would be, "Well of course, Members of Congress have a fiduciary duty." We have a duty to our constituents and to the law. But your testimony leads me to now feel that is ambiguous because Members of Congress and our staffs are in such a different relationship to this nonpublic material information.

So I want to ask Professors Langevoort and Coffee, and Professor Nagy, too, to weigh in on the nature of the duty that must be established. Is it a fiduciary duty? If so, how do we define it? Or is it a broader duty of trust and confidence, which is the kind of language that we normally would use or that we think we have. Professor Langevoort, please go first.

Mr. LANGEVOORT. The courts are still working out the answer to that question. The Supreme Court established the misappropriation theory in the context of a case involving a partner in a law firm who misappropriated information belonging to the law firm and the firm's client. That is a quintessential fiduciary relationship. A firm has a clear-cut right to sue a partner for breach of fiduciary duties, such as duties of loyalty and care.

As you move away from settings in which there is an employer, a boss, a principal who would be able to file a breach of fiduciary duty action against the person in question, the ability to make the argument that the misappropriation theory clearly applies grows weaker.

As I said, I would hope that a court would make that leap, but I am not confident.

Chairman LIEBERMAN. Yes. Professor Coffee.

Mr. COFFEE. Let me just add a word on that same line. In an en banc decision of the Second Circuit—and "en banc" means every judge on that circuit participated—they ruled that husbands and wives are not fiduciaries to each other. That will really surprise you. What more sensitive relationship is there than husband and wife? But they were not fiduciaries because the Second Circuit ruled that to be a fiduciary, there has to be a relationship with discretionary authority on one side and dependency on the other, and the more it was equal, it was not a relationship that was fiduciary in character.

Now, the SEC partially overruled that with respect to husbands and wives, but that definition that a fiduciary relationship only exists when there is discretionary authority on one side and dependency on the other is a very high standard that neither Professor Langevoort nor I want to see applied. No one wants to see it applied. But that is why there is this ambiguity, and we think that because there is ambiguity, there is no downside in passing this legislation and considerable upside.

Chairman LIEBERMAN. Right. So if I remember your one-sentence proposal, it dealt exclusively with this question. Am I right?

Mr. COFFEE. Simply, you are a fiduciary with information you receive in the course of your work or your status in Congress. The advantage of that is only that if you start defining in legislation

what "material" and "nonpublic" means, there are going to be efforts by defense counsel to say that is different and it was not satisfied in this case.

Chairman LIEBERMAN. Yes. So it would not be enough, for instance, if we avoided the issue of fiduciary duty altogether, for whatever reason, and simply declared in law that Members of Congress may not trade on the basis of material nonpublic information, which they obtained only because they were Members of Congress?

Mr. COFFEE. You could possibly do it that way, but what you just said would not cover the tipping problem. You want to cover both the tipper and the tippee who is a Member of Congress.

Chairman LIEBERMAN. Professor Nagy, do you want to get into this?

Ms. NAGY. Yes, I do. Thank you, Mr. Chairman.

With respect to the *Chestman* decision that Professor Coffee just mentioned, the Securities and Exchange Commission has made perfectly clear its view that the Second Circuit unduly narrowed what the Supreme Court had set out in its *Chiarella, Dirks,* and *O'Hagan* decisions as the requisite relationship of trust and confidence. And in direct response to the *Chestman* decision, the Securities and Exchange Commission promulgated Rule 10(b)5–2. Professor Coffee mentioned one aspect of that rule: It creates a rebuttable presumption that family members—parents, children, siblings, and spouses—owe duties of trust and confidence to each other. But the rule has two other provisions, and one references "histories, patterns, and practices of exchanging confidences" that create the requisite duty of trust and confidence.

One other point: If courts routinely were applying the now-discredited *Chestman* analysis to the insider trading prosecutions brought by the Securities and Exchange Commission or the Department of Justice, we would see far fewer government victories and far fewer settlements. There have been outsider cases including one involving a nonmartial relationship where one partner misappropriated information from the other. Although clearly not a spousal relationship, the result was a criminal sentence for the boyfriend who had misappropriated from his attorney girlfriend.

Certainly the *Chestman* standard—a very high standard for a fiduciary relationship—would not have supported a criminal sentence in that case. According to the SEC, a relationship of trust and confidence is what triggers the requisite disclosure duty.

I would ask you to imagine a situation where a district court is faced with this a case involving a Senator or Representative. If a district court were to conclude that a Member of Congress does not owe a duty of trust and confidence to the United States and to the American people, I would be mightily surprised. We could all anticipate what the headlines the next morning would be on that ruling. To avoid all that, a district judge would likely find the requisite duty of trust and confidence under existing law.

Chairman LIEBERMAN. Very interesting. Obviously this is important because we want to get this done, but we are not, if I can use a metaphor from a different area of activity, painting on a blank canvas. There is a lot on the canvas in existing law and Supreme Court rulings.

The other conclusion I have, Senator Collins, is more personal. I have actually understood what the three law professors have said today, which says to me that I am more prepared to go to law school now than I was when I went. [Laughter.]

Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman.

Professor Coffee, you made a very important point that Members of Congress do more than just legislate. We act as advocates for our constituents. We endorse public funding for them through grants or contracts. We seek expert advice on public policy in order to reach the right decisions. I am thinking of how many of us during the financial crisis in the fall of 2008 reached out to financial experts for advice.

So I think this is a more complicated issue than it first appears to make sure that when we do act, we are not having a chilling impact on the responsibilities of Members of Congress to their constituents.

So with that preface in mind, let me suggest a completely different way of looking at this issue, and you actually started to touch on it in your testimony, Professor Coffee. Instead of trying to put into law a ban that works to prevent what we would all think was improper and should-be-illegal behavior, what if we said that Members of Congress cannot trade in individual stocks themselves but must either limit their investments to mutual funds or do as you suggest and adopt a mechanism approved by the SEC to allow trading pursuant to a written plan that gives detailed instructions to a person overseeing the investments, but the Member does not make the trades, or set up a blind trust if they have enough assets to have blind trusts? What if we got at it from that perspective? What would be your opinion of that? I am going to ask the whole panel this question.

Mr. COFFEE. Well, I think that kind of Rule 10b–5 plan is a means of protection. I think many Congressmen would find it an imposition if they were told that they had to use blind trusts or Rule 10b–5 plans, even when they had no information at all. They might in some cases do this as a matter of pure precaution, but I think they would find it an unnecessary bit of overbroad regulation to say you cannot trade at all because you are a Congressman.

I think if you recognize that you are going to regularly come in contact with material information, you would be well advised to use a Rule 10b–5 plan, but the reason you are using it really is that it might be criminal if you traded in your own name based on your own decisions. So I think these two things fit together. You have the prohibition, and then you have safe harbors. The safe harbor would be a Rule 10b–5 plan or an opinion of counsel, which I think can often be obtained in many situations quite quickly. So I think you need both of them together.

Senator COLLINS. Does anyone disagree with the professor or want to add anything to that issue? Professor Langevoort.

Mr. LANGEVOORT. Let me add something besides the reference to Rule 10b5–1. You mentioned at the outset of your question the possibility of moving Members of Congress away from single stocks to other forms of financial instruments. That is very difficult because we have discovered that insider trading is possible with respect to

nearly every form of financial instrument, including mutual funds, of which we are aware.

With respect to Rule 10b5–1, it is important to know that is simply a rule—and Congress would have to face up to this if it were to go that route—that says as long as you execute those instructions at a time when you did not possess material nonpublic information, then the fact that the trade was executed after you came into possession of such information does not make you liable. It simply moves the time where we are looking at what did the person know, when did they know it, and that does not make all that many hard issues go away.

Senator COLLINS. Professor Nagy, I would like your comment, but I want to get to a different issue for you, so if you could answer that quickly so that I have time for a second issue for you.

Ms. NAGY. I think blind trusts might well be an effective response to much of the difficulty here. I will leave it at that.

Senator COLLINS. Mr. Walker.

Mr. WALKER. You are right, Senator Collins. Blind trusts are really a mechanism basically only for people who have substantial assets because there are administrative costs, and they are not blind as to what you put into them initially. They are only blind really if you put in cash or after a period of time if the assets have been sold down to a particular level, you are notified that you do not have those anymore. But they are really not blind as to what you put into them.

And as to limiting investment opportunities for Members and staff, I would be concerned that you would be perhaps making it harder to attract the best and the brightest or really even the pretty good and the fairly smart into government service. [Laughter.]

Senator COLLINS. Well, I will try not to be offended by that as a person with no assets and who could never qualify for a blind trust.

Mr. WALKER. I do not mean the blind trust aspect. I mean limiting stock trades.

Senator COLLINS. No. I understand.

Professor Nagy, you testified that you feel confident that congressional insider trading is already illegal under existing law. Even if you are correct, is there an advantage to Congress making it crystal clear by passing such a law? I mean, I realize we have to be careful how we draft it.

Ms. NAGY. One potential disadvantage, though I concede this could be cured by careful drafting, is that by legislating directly, some courts could infer a congressional intent that the STOCK Act is the only insider trading law that applies to Members of Congress. As Professor Langevoort testified, that can be cured by a simple statement that the STOCK Act builds on top of existing law. Rule 10b–5 and the Federal mail and wire fraud statutes would be there then as the floor, and the STOCK Act would come on top. So I think that potential risk could be eliminated, and I would be happy to help in that effort.

There is, though, another risk that I think we should think through relating to public perception. As I mentioned, the controversy surrounding the application of the Federal securities laws to Members of Congress stems from the fact that Congress has

never enacted an express statutory prohibition of insider trading for anybody. And so everybody now must navigate through what has often been described as "a maze" of court decisions.

The boyfriend has to decide whether he can trade on information or whether he would be breaching a duty of trust and confidence owed to his girlfriend. Sometimes that analysis is hopelessly confusing. If an express statutory prohibition applies to Congress and Federal employees, when all the dust settles from all of this, everyday, ordinary people might well begin saying, "Why do they get an express prohibition and we have to suffer through the maze of what it means to defraud in connection with the purchase or sale of securities?" I think that is a troubling risk that might not be all that apparent now.

Senator COLLINS. A valid point, and in the next round or for the record, a question that I want you to be thinking of is whether we should have a law, if we are going to venture into this area, that applies explicitly to the Executive Branch officials as well since, frankly, I think a Treasury Secretary has access to far more confidential nonpublic information than any Member of Congress.

Chairman LIEBERMAN. Thanks, Senator Collins.

In order of appearance, we will go to Senator Brown, Senator Begich, and then Senator Tester. Senator Brown.

OPENING STATEMENT OF SENATOR BROWN

Senator BROWN. Thank you, Mr. Chairman.

I appreciate all the examples about boyfriends, girlfriends, and relationships. We are not talking about that. We are talking very specifically about Members of Congress. If I am in a top-secret meeting and I find that we are going to drop a weapons system and by doing that the company stock is going to go down dramatically, and I walk outside and I pick up the phone and I say, "Hey, sell XYZ Company's stock," that is what we are talking about. We are not talking about all the classroom examples that you are using. We are talking very specifically about real-time, real-world situations that have been brought to our attention.

I went to law school, too, and it reminds me of a law school class. And, quite frankly, I want to start to do something because you indicated that the courts still have not decided what to do. Well, if not now, when? I mean, that is why we are here. That is why the Chairman and the Ranking Member asked for this very important hearing.

I want to go to Ms. Sloan first since you have been kind of left out of all the fun. If you are looking at this type of situation, would you think it would be a good idea in our ethics disclosures to just be more specific in maybe a more periodic update as to the stocks we own, the stocks we trade, when we bought them, when we sold them, and the exact amount of monies we purchased and sold them for? That way, anybody who is in the media or the government agencies looking at it will say, oh, well, Senator So-and-so is on the Armed Services Committee, and he or she bought X amount of military arms stock when he or she found out that the contract was going to be terminated. That is, I think, certainly the initial information that would be used to establish that prima facie case poten-

tially on saying that there is an issue we need to look into. Do you think that is a good suggestion?

Ms. SLOAN. I do think that disclosure is a great way to go because I think there would be a lot of repercussions if you have quick disclosure. Again, I think 90 days is far too long, but I think there are people who will be looking at these kinds of trades very frequently, especially if they are searchable on an electronic database.

I do want to point out that in the example that you gave where you learned something in a committee and you immediately went out and made a call, that is exactly the kind of conduct that the Speech or Debate Clause would make very difficult to prosecute because it is something that you learned in a legislative committee. So no grand jury and no prosecutor would be able to use that information that you had obtained in a committee either to obtain an indictment or at trial. So it is a tricky situation.

Senator BROWN. That is why we are here. I mean, the bottom line is I think the fiduciary responsibility is to the American people. I mean, that is the relationship that we have.

Professor Langevoort, the Supreme Court has articulated a severely restrained approach to applying the insider trading laws, saying it is within Congress' power, not the courts, to expand Rule 10b–5, as I think you have touched upon. If we choose to do nothing today or in the very near future, would Congress be sending a pretty strong message to the Supreme Court that we do not want to clearly articulate the rule to hold Members of Congress liable for trading on this material nonpublic information?

Mr. LANGEVOORT. You are absolutely right, Senator. The Supreme Court in a number of cases, admitted largely involving private securities litigation, has said repeatedly it is Congress' job to push on the statute, to expand it—not the Court's job—in the absence of clarity. That is the language that worries me the most in terms of a court coming out the other way.

I think you can accomplish a lot by that explicit statement.

Senator BROWN. Thank you.

Ms. Sloan, back to you. As you are aware, no Members of Congress have been successfully prosecuted for insider trading. Would strengthening the Senate ethics rules be a sufficient deterrent? And would this reform help rebuild the confidence that Members are, in fact, held to the same standard and face the same consequences as everyone else?

Ms. SLOAN. No. I think people have very little confidence in the Ethics Committees in the House and Senate. They have done a pretty lousy job over the past years. They very rarely hold Members' feet to the fire except in particularly egregious cases that have received a lot of press attention. CREW has filed many complaints for which we have not even received responses 3 years later. So that is not a solution. I think you need a dual solution: Going to the Ethics Committee if the Speech or Debate Clause is going to kill your prosecution, but also having a very clear prohibition and ability of prosecutors to go after you.

Senator BROWN. Professor Coffee, in its written testimony, the SEC indicates that it has all the tools it needs, but yet we have never seen any prosecution, as we referenced, of any Members of

Congress or staff for insider trading. And given that the SEC recently lost a string of insider trading cases, as you state in your written testimony, why would the SEC not want a legal standard that creates without a doubt a crystal clear framework for the SEC to prosecute Members and staff who trade on material nonpublic information?

Mr. COFFEE. They should want that, and I think both Professor Langevoort and I are clearly saying, we agree with you, that Congress should legislate. We are just talking about little tweaks in what the language should be.

Senator BROWN. Mr. Walker, if the existing Senate ethics rules provide a framework, as I think maybe you have indicated, for prosecuting Members who trade on material nonpublic information, why have we not seen any prosecutions then?

Mr. WALKER. Well, first of all, I do want to say that there is the Ziobrowski study that suggests that this practice of insider trading is somehow endemic in Congress. There is the Eggers and Hainmueller study that I think says otherwise and says that, in fact, Members' portfolios perform below the market, and particularly when you look at the average Member's portfolio, they do not exceed the market, and they do not meet market performance. And so I think the question of why have there not been prosecutions is based on the premise that somehow this is happening everywhere.

Another aspect of the answer is that the Ethics Committees do not have an audit function. They do not go from office to office to investigate what people are doing that has not otherwise been reported either to them either through a complaint or through the media. And so it is not a matter of complaints and allegations coming before the committees that they are not paying attention to. It just is not that.

Senator BROWN. Thank you. I have one more question for Professor Langevoort and Professor Coffee. Some scholars have suggested that clearly defining a duty for Members of Congress would be an easy solution that could be done through a Senate resolution. Do you agree with that?

Mr. COFFEE. I think that passing a statute along the lines you have suggested, with possible tweaks in the language, would be an effective solution.

Senator BROWN. A Senate resolution?

Mr. COFFEE. Oh, no. I meant legislation. I misunderstood you.

Senator BROWN. No. Just a Senate resolution.

Mr. COFFEE. That is like a motherhood salute. I do not think it accomplishes that much.

Senator BROWN. I agree. Thank you.

Mr. LANGEVOORT. It takes you one step forward, but only one small step.

Senator BROWN. Well, listen, I appreciate all of your testimony.

Mr. Chairman, I appreciate you and Senator Collins for bringing this forward, and I and my staff will make ourselves available to meet that deadline of December 14.

Chairman LIEBERMAN. Thanks, Senator Brown. Thanks very much for your work, and we look forward to working with you to move this quickly.

Senator Begich.

OPENING STATEMENT OF SENATOR BEGICH

Senator BEGICH. Thank you very much, Mr. Chairman and Senator Collins, for having this hearing.

I remember when I was on the Anchorage Assembly, we had to write the ethics code, and at the end of the day, I really came to the conclusion that you are ethical or you are not. You can provide all the rules you want, but if you are going to cheat, you are going to cheat. And so keeping that in mind, one of the views that I have is disclosure, disclosure, disclosure.

For example, you can go on my Web site and find every single disclosure form I have ever filled out since 1988 in any office, any public facility that I have participated in.

Mr. Coffee, I know it is hard for us to do simple things around here, but actually sometimes simpler is better. And I like your approach, and so I am going to ask some questions and get some comments from people. In the Senate, if I ask a constituent of mine in Alaska to get a copy of my disclosure form, thank God I have it online because they would have to come to Washington, DC, or have someone here come down to the clerk's office and get a copy of it, copy it, and then get it to them in Alaska.

Neither one of these bills requires an electronic searchable database. I agree with you that you can file these things very quickly, and I have done trades, that is all public disclosure, and that is why I disclose it. So I want your comment on either both of these bills or any legislation. Should it be required that any trade, any action be electronically available to anyone at any time via the Internet and searchable? I will just go down the list here. Then I have a different question for you, Mr. Coffee and Mr. Walker.

Mr. WALKER. Well, in this day and age, other than perhaps a shortage of resources in the Office of Public Records that would be needed to manage it, it is not clear to me why there would not be and should not be online availability.

Senator BEGICH. It actually costs us more to do what is going on now by hand processing when people send in their forms. Some of these people around here who are very wealthy—I am not one of them—have big, thick disclosure forms.

Mr. WALKER. The fact of the matter is that there are nonprofit and outside groups that have put them online already, so the question is: Why should the Senate not put them online?

Senator BEGICH. Correct. So you are a yes?

Mr. WALKER. Yes.

Mr. COFFEE. I am definitely a yes, and what you have just proposed is on page 14 of my testimony.

Senator BEGICH. That is right.

Mr. COFFEE. That it should go on a Web site so a journalist could immediately find this——

Senator BEGICH. Or a constituent.

Mr. COFFEE. Constituents, too, but journalists would be——

Senator BEGICH. Because they are the best enforcers.

Mr. COFFEE. Well, I think journalists are effective, too.

Senator BEGICH. I have seen a lot of people lose offices because of ethical issues, but you are right, journalists add to it.

Mr. LANGEVOORT. Agreed, and if you are a high-ranking executive of a public corporation, today you have 48 hours electronically to file your trades.

Senator BEGICH. That is right, which we require them to do.

Mr. LANGEVOORT. Exactly. That is right. And that immediately becomes accessible.

Senator BEGICH. You are making my point.

Ms. NAGY. I am a yes as well.

Ms. SLOAN. Yes, I agree.

Senator BEGICH. That was a soft ball question, but the reason I asked this is because we—when I say "we," I mean collectively here—are so resistant to this for some reason. So I am looking to the two Members here who are going to do the markup with the other Members sitting here, this is going to be an insistent theme on my part, and I will actually ask for an expansion not only of these forms but our disclosure forms because they have the annual reports of stock trades. And if someone wanted to search through that now, you cannot. It is the most ridiculous system I have ever seen.

So, Mr. Chairman and Senator Collins, I am just putting that on the record here that if we do not do that, we will pass another law that will go off somewhere, and we will fill out forms that will be handwritten and sent in, and then the good-government groups, a constituent who is mad at you, and your opposition will be the searchable database people. So I appreciate that.

Second, to Mr. Coffee, I like your idea about a one-liner, so I am going to turn to the rest of the four to ask them to comment on your idea. I am not an attorney. I did not go to law school. So no disrespect to all the folks here, but simple is better. The more detail, the more out clauses people have, in my view. I will not say what my brother says about the bigger the bill, the more times you will get—I will fill in the blank later. That is a little concern.

So let me ask what people think of Mr. Coffee's idea.

Mr. WALKER. Well, if the idea you are talking about is a one-liner that says Members of Congress are fiduciaries with respect to information they learn in committees——

Mr. COFFEE. Not committees. Anyplace.

Senator BEGICH. Anyplace.

Mr. WALKER. Anyplace. I think you need to be careful, and you need to think about the potential consequences to what you do as Senators beyond financial transactions.

For example, the Privacy Act does not apply to the Congress, and you are, therefore, able to do certain things with information that you receive from constituents and others that may not be consonant with the Privacy Act at any rate. So you have more freedom to use information than the Executive Branch. If you create a blanket fiduciary obligation with respect to congressional information, I think you do want to be concerned about how it could affect your representative functions and your oversight function and your function of communicating with others beyond the financial transaction area.

Senator BEGICH. Fair enough.

Mr. LANGEVOORT. I have not seen Professor Coffee's precise language. I think I could do it in two sentences. But apropos of what

was just said, I think it has to relate specifically to what insider trading is, which is profiting from——

Senator BEGICH. Information.

Mr. LANGEVOORT [continuing]. The existence of that information, without talking about all the other fiduciary possibilities that could be associated with that information.

Senator BEGICH. That is good. I see Mr. Walker kind of nodding but not yet acknowledged, but good.

Ms. NAGY. I would support one sentence. [Laughter.]

Senator BEGICH. It is amazing how lawyers get down to one and two sentences. I am very excited right now.

Ms. NAGY. I wholeheartedly agree that simple is better, and I would encourage avoiding the "fiduciary" concept altogether such that the sentence would be: "For purposes of Rule 10b–5's misappropriation theory, a duty of trust and confidence exists whenever a person is a Member of Congress or a congressional employee and has learned that information through government service."

Congress could possibly authorize the Securities and Exchange Commission to add that subsection to existing Rule 10b5–2.

Senator BEGICH. To existing rules, that is right.

Ms. NAGY. Rule 10b5–2 now sets out three nonexclusive situations in which a trader is presumed to be in a relationship of trust and confidence with the source of the information. There is the family member prong; the "history, pattern, or practice" prong; and the "has promised to maintain information in confidence" prong. If Congress were to authorize the Securities and Exchange Commission to add a fourth sub-section, that would appropriately clarify existing law. But going back to my point to Senator Collins, it would also apply the same law to everybody else. I think that is a very important principle that should come out of any legislative action Congress takes in this matter.

Ms. SLOAN. I have to defer to the law professors on the material about insider trading, but I would caution you that would not really solve your problem of the Speech or Debate Clause, which would not allow prosecution in an awful lot of these cases, so I still would go back to—as much as I do not love the Ethics Committees, sometimes they are really the only option left.

Senator BEGICH. Very good. Thank you, Mr. Chairman and Senator Collins, for having this hearing. I am a big supporter of the concepts of this legislation. Again, disclosure to me is really critical, but also ease of use and accessibility are how we create more enforcement because the public and media become the enforcers in a lot of ways, so thank you very much.

Chairman LIEBERMAN. Thank you, Senator Begich. Senator Tester.

OPENING STATEMENT OF SENATOR TESTER

Senator TESTER. Yes, thank you, Mr. Chairman. I assume, Senator Begich, you are on my bill to make sure that campaign disclosures are filed electronically?

Senator BEGICH. I believe I am, and if I am not, I will be, I will tell you that.

Senator TESTER. That sounds good.

Senator BEGICH. I like it.

Senator TESTER. That is good.

I, first of all, want to welcome all the panel members. I appreciate your perceptions and your comments. I can tell you that I am not as good as the Chairman. I did not understand everything you said. But that is OK.

Chairman LIEBERMAN. I was not under oath. [Laughter.]

Senator TESTER. That is good. And it is ironic because about 3 or 4 hours ago, Mr. Coffee was in front of the Banking Committee, and if it was not you, it was your brother because you look a lot alike. And so this is a day of your testimony, and we appreciate all your testimony today.

You know, what I did hear, as people talked about the STOCK Act, is that we need to be careful because there are potentially some unintended consequences whatever we do. And those unintended consequences may be something that really limit our ability to legislate and create policy and do the things that we need to do as Senators or House Members.

So I want to approach it from a way similar to what was talked about earlier here today, and that is, from a transparency standpoint, if we did things like make financial disclosures transparent, if we did things like make our schedules transparent and online in searchable databases—all this stuff has to be done that way—if we required ethics audits of Senate and House offices. And then I got to thinking maybe there are some unintended consequences there.

Can you think of anything that we do that should not be transparent? I believe in transparency. I believe in sunlight. I think that we should do the maximum to let everybody know what we are doing, which cleanses all the problems. I believe the forefathers were right when they said we need to have a citizen legislature.

Is there any area that you can think of where transparency might be inappropriate? We will start with you, Ms. Sloan.

Ms. SLOAN. No, I cannot see anywhere where transparency would be inappropriate. I think more transparency is required, and I also think the Ethics Committee needs to have the ability to audit Members routinely. They get all these financial disclosure forms, but all they do is make sure that they are filled out. There is no auditing to compare them with perhaps a tax return to see if they are, in fact, jibing together. And if we saw more of that, I think we might find some problems.

I know that there was a situation in the House Ethics Committee, for example, where a Member had filled out a financial disclosure form in one way and a tax return indicated a far different scenario, and that Member resigned rather than face the consequences of that situation.

Senator TESTER. Ms. Nagy.

Ms. NAGY. I cannot think of a downside to transparency that would be specific enough to articulate at this time, so I would say I am in favor of transparency.

Senator TESTER. Mr. Langevoort.

Mr. LANGEVOORT. I agree also. If somebody is bent on acting unethically, they are going to violate the disclosure rules as well as the substantive rules.

Senator TESTER. Fair point.

Mr. LANGEVOORT. Insider trading often takes the form not of transacting securities in your own account because it really is so transparent already, but establishing a friendship in a foreign country with a foreign bank account, laundering money, laundering ideas——

Senator TESTER. But if that was ever found out about one of us, we would be noodled.

Mr. LANGEVOORT. I have seen clever enough insider trading schemes that very successfully avoid detection for a long period of time. All I am saying—I am trying to be responsive to your question—is if you try to expand transparency not simply to trades but to the communication of information to others, which is the route by which profit often comes, you will run into difficulties with respect to the work you do on the Hill.

Senator TESTER. Fair point. Thanks.

Mr. COFFEE. I think that some law professors smarter than me probably can think of some problem with transparency. The way to deal with that is to give the SEC exemptive authority. You could say, "We have this obligation, and if we find out there are problems, the SEC is given exemptive rulemaking authority to carve out safe harbors and exemptions."

Senator TESTER. Super. Mr. Walker.

Mr. WALKER. Well, I want to put it on record that I am not smarter than Professor Coffee, but I do see some concerns with across-the-board transparency in everything that the Senate and Congress does, if that is what you are asking.

Senator TESTER. That is what I am asking.

Mr. WALKER. I mean, certainly there would be many executive closed sessions that could not be transparent. There would be many deliberations of Committee Members behind the scenes that probably ought not to be transparent.

I think there is even less room today for negotiation and for tradeoffs between Members of different parties than there has been in the past, and there would be perhaps even less room if everything were transparent and if everything were televised.

As far as an audit function for the Ethics Committee, I think it is a good idea in principle, but obviously it would require a vast increase in resources for the Ethics Committee, and whether or not in these days of tight budgets that would be possible is a real question.

And, also, I would be concerned if all congressional communications with whomever were to be transparent, I do think there would be some serious chilling effects.

Senator TESTER. Fair point by all.

I do not think either one of these bills deals with personal real estate, which you brought up, Ms. Sloan, where a person would increase the value of their own personal real estate by advocating for policies that would help them in that, regardless of what that would be.

It seems to me that is much easier to track down than insider trading. Is that a fair statement? I do not deal with insider trading so I have very little knowledge of it. I wish I had enough money to even buy stock, but I do not, but go ahead.

Ms. NAGY. Senator, one possible variation on that example would be insider trading in real estate: Taking material nonpublic information and using it in a real property purchase as opposed to a securities purchase.

Senator TESTER. Or purchasing property and enhancing it with policies that you pass, whether it is——

Ms. NAGY. That is different—although that would be a conflict of interest problem. But it is not the same problem as using material nonpublic information that one learns in government service to actually purchase physical real estate. The use of information for a real estate purchase could be prosecuted under the Federal mail and wire fraud statutes much like insider trading in securities. There is precedent where a government official, actually a Chicago politician, used material nonpublic information that he came upon in connection with his alderman service, and he was prosecuted under the Federal mail and wire fraud statutes by the Department of Justice.

Senator TESTER. And he used that information to buy land?

Ms. NAGY. To buy, I believe, an interest in an apartment building that was going to receive a tax abatement.

Senator TESTER. What about if you owned land and you advocated for an appropriation to build a highway over it or something along those lines that would add value to that property?

Ms. NAGY. Well, and one could imagine a similar situation on the securities side where one takes a favorable legislative action to a company whose stock you own. And so, again, that could be a conflict of interest problem.

Senator TESTER. But this bill would not cover that.

Ms. NAGY. Not that I see.

Senator TESTER. Very good. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Do you have more questions?

Senator TESTER. Well, I have some more questions, but I think I hammered out what I needed to hammer out.

I appreciate the panelists' perspectives and thoughtfulness, and as we look forward—if I might just say something, Mr. Chairman.

Chairman LIEBERMAN. Please.

Senator TESTER. I think that it is very difficult to take a look at ourselves and say, "You know what? People think we are crooked," when you do not think you are doing anything wrong and there is no intent, whether that is dealing with a policy with the farm program and talking to one of your neighbors about what you are working on, which may actually impact the price of wheat or futures, or something like that.

On the other side of the coin, I think that it is critically important that we operate in a way that is totally clean—and if there is any way we can do that, we should make those policies, quite honestly, mandatory. And transparency is important, and I get your point, Mr. Walker. I do get your point. But as far as the forms we fill out, they ought to all be online, they ought to be in searchable databases. Our schedules ought to be online. We should be letting people know everything that they should reasonably know online in a way that they can access, not just online but all searchable.

So I think that we need to be aware of this. What do we have—an 8- or 9-percent rating? That is probably due to much more than this, but I do not think this helps a lick. And, by the way, if somebody in the Senate or somebody in the House does something crooked, it reflects on everybody, whether they are honest or not. And that is just the way it is.

So I think we need to address it, but we need to address it in a common-sense way that really gets to the problem and does not create more problems than it fixes.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you very much, Senator Tester.

Senator McCaskill, welcome.

OPENING STATEMENT OF SENATOR MCCASKILL

Senator MCCASKILL. Thank you. I apologize. I have been presiding over the Senate, so I have not been able to be here.

I think it is pretty important that we clarify that this law applies to Congress. I know that there is one of those good old-fashioned legal arguments that is great for hypotheticals in a law school classroom, but for purposes of clarifying to the public, regardless of what the SEC says, I think it would be very helpful for us to pass this legislation to make it crystal clear that the rules that apply in companies and to CEOs apply just as much to Members of Congress in terms of their ability to have and use information not available to the public. And you all may have covered this, and if you have, do not answer the question because I can move on to another one.

Have you all characterized why you think it might be a challenge to prosecute these cases in Congress? Has that been covered?

Ms. SLOAN. Senator, I think I talked a fair amount about the problems with the Speech or Debate Clause that will lead to some prosecutions being difficult, which is why I think in addition to Federal law you also need to make it clear that the Ethics Committee has enforcement over that, too.

Mr. WALKER. And I think we addressed certain other practical problems as well in enforcement in the congressional context.

Senator MCCASKILL. Well, as a former prosecutor, it seems to me that one of the things that makes it easier to prosecute these cases in Congress is that it is much clearer what is a public record and what is not. I think it is more murky in private companies what is in the public domain and what is not. Here we have hearings and the record is available to the public. We pass laws and the dates they are passed are available to the public, and then it is publicly available. There is a great deal of information that prosecutors could easily see whether or not this is something that someone who looked into it could find with some great deal of ease, or whether it would be more difficult.

Would anybody disagree that these cases might be easier to prosecute because it is very hard to have inside information in Congress. I mean, this place is pretty open in terms of what gets out to the public. But even in a formal context, a great deal of our work is publicly done.

Mr. WALKER. I would not disagree, Senator McCaskill, but I do think because so much is open in Congress that the issue of some-

thing being material nonpublic information would be an obstacle to overcome. And if that were alleged in any given case, I think you would find some pretty rigorous defenses and attempts to proof and probably successful proof that ultimately the information in question was public.

Senator MCCASKILL. Right. I have five things that I have been told we need to do better in the legislation, and probably some of them have been mentioned, but I want to determine if there are disagreements on any of them. First, we need to expand the covered information because we need to also talk about regulatory action, grants——

Mr. COFFEE. Contracts.

Senator MCCASKILL. Earmarks, contracts obviously. Second, shorten the time frame of disclosure, clearly that is important. I think 90 days is obviously way too long, and we do have a measure of transparency now that allowed some of the things to be written even though a lot of the things that were written were inaccurate. Certainly the fact that purchases were made and so forth was available to the public because of the rules we currently have. Third, expand the types of securities that are covered; fourth, explicitly state that the Members owe a duty; and finally, specifically lay out in the legislation that Members cannot give insider tips.

Well, those are the five things that I think we need to put in the legislation, and I think we have a significant amount of problems out there with the public right now. I think, Mr. Chairman, the more quickly we can pass this legislation and demonstrate to the public that none of us has gone into this line of work because he thought he was going to receive a great deal of money for it. I am not arguing that there may have been some people who have used their positions inappropriately. Certainly there have been people who have gone to jail in Congress, but I think all of us want to make sure that the public knows that we are not using this position in any way to gain personally from it. And the more we can do to reassure them in that regard, the better. And I think we need to write this legislation in a way that does that.

The last thing I would ask is about earmarks. Earmarks are a tricky area. We have a current moratorium on earmarks, and I am cosponsoring legislation for a permanent moratorium on earmarks. But I think that knowing that a Member would have the ability singlehandedly to put public money in a project certainly could lead to the kind of information that would allow someone to benefit from that knowledge since in a pure earmark, there is nobody that has any say as to whether it is good, bad, or indifferent, other than that individual member.

Have any of you discussed how earmarks might also lend themselves to this kind of activity that the public would obviously disapprove of?

Mr. COFFEE. I do not think we have discussed it, but I think, as I understand what you are saying, it would be a kind of material nonpublic information. If you know that you are going to earmark resources for a particular project and it is going to benefit particular companies and you buy that stock, that falls easily within the category of misusing material nonpublic information.

Senator MCCASKILL. There have been thousands of earmarks done for research and development into certain types of technology, and a great deal of that technology has worked itself into the marketplace. So I think that is one area that we need to make sure that we cover because that is the essence of insider information, since somebody singlehandedly can provide the resources to a company to make that research and development a reality.

Ms. NAGY. I would certainly agree with respect to earmarks. As you listed the five fixes, I would encourage you to think of a sixth or add a sixth to the list: A clear statement that the legislation builds on the floor of existing law, so that it would not be read to displace Rule 10b–5 of the Federal securities laws and the mail and wire fraud statutes in connection with securities trading by government employees, congressional officials, and Members of Congress.

Senator MCCASKILL. Because at the root of all this, these are good old-fashioned fraud cases, right?

Ms. NAGY. Exactly.

Senator MCCASKILL. Right. I think that would be important because we do not want to start a whole new book of precedent. Not that we do not want all the lawyers to stay busy, but——

Mr. COFFEE. In that light, it is rather important that you not try to redefine established terms like "material" or "nonpublic."

Senator MCCASKILL. Right.

Mr. COFFEE. They are redefined in this legislation, and that would raise questions about whether for Congress it is a different kind of information than it is in ordinary cases. So if you say you are adopting the existing case law with respect to all of the terms that go into the prosecution and you have done that before, I think that gives greater certainty to the courts.

Senator MCCASKILL. I think that is a great idea, and I will share that with the other cosponsors of the legislation because I think there are three or four of us who are working on this, and we will look for your input as we get it drafted and try to improve it and make it as strong as possible. We appreciate all of you being here today and helping us with this. We want to do this right.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator McCaskill. I mentioned before you could be here that ideally we will get something drafted for which we can get a majority of the Committee before we depart in December.

I have a couple more questions. I think we have gone over pretty well, and very helpfully to the Committee, what we should do in response to this problem in making clear in law unambiguously, if I may say so, that Members of Congress and our staffs are covered by insider trading laws.

There are two other responses that are possible here. One deals with Senate ethics. I want to come back to that in a minute. But first I want to talk about disclosure, which you have also talked about, and this is more in the way of prevention, or of course, it may accelerate discovery of a problem.

So I wanted to start with you, Ms. Sloan. Ideally, how would you alter the requirements in the Ethics in Government Act for disclosure? Senator Begich focused on electronic filing, and I think that is a very good idea. You talked a little bit about requiring that we

file more than once a year, presumably after transactions, so I wanted to invite you to spend a little more time on how you would ideally have us change the Ethics in Government Act with regard to filing.

Ms. SLOAN. Well, the personal financial disclosure forms have very broad ranges of assets.

Chairman LIEBERMAN. Right.

Ms. SLOAN. And I think that they could be narrowed substantially. You would not actually have to, if you did not want to, change the Ethics in Government Act, which would, therefore, change the form for everybody. You could do that by House and Senate rules, if you chose to, so you would not have to go through that.

Chairman LIEBERMAN. Right.

Ms. SLOAN. But the ranges are so wide that it is often impossible to tell what a person's assets really are and how much income they have had from those assets. In addition to that, I understand that they are burdensome, but they are filed once a year, and they are filed even then 6 months after the previous year ended. So they are pretty far down the line.

Those forms, too, are not in a form that are searchable. I spoke with a reporter, for example, who wanted to see if Members had any specific asset, and you cannot search them for that kind of thing. And in this day and age, with the technology that is available, there is really no reason that these forms are not put on the Web quickly and in searchable form so that the information is easily accessible, so that if there is wrongdoing, it can be ferreted out quickly, and often just the court of public opinion will be helpful here.

Chairman LIEBERMAN. I agree. So one alternative here, I presume—and let me ask you to respond to it—is that in addition to having us file the whole form more than once a year, there could be some requirement to file amendments after stock trades of a certain amount. Is that a possibility?

Ms. SLOAN. I think you should probably have something separate for stocks so that you do that form once a year, but file something about the stocks. And I would say rather than this 90-day period that is included right now, I would get it down to something like 10 days because, again, I do not think it needs to be so burdensome. Since this information comes in an electronic form as it is, there could easily be set up a database so that somebody only had to hit a button to transfer it into this bigger database that the Senate, for example, could maintain of all such information. So it does not really need to be burdensome once it is set up. And then also, as I said, I would make clear that lying on those kinds of forms or willfully failing to disclose that information would be a false statement, and those kinds of false statements are, by the way, much more easily prosecuted than anything else we have been talking about.

Chairman LIEBERMAN. Before I move on to the ethics rules of the Senate, which would have to be changed by the Senate in this regard, do any of you have any other ideas on the panel about how we might alter the existing Senate and House disclosure rules to

prevent insider trading or at least to make it more discoverable more quickly if it occurs?

Mr. WALKER. Well, I do agree that the provisions in the STOCK Act that would call for public disclosure of stock transactions within a specific period of time would go a long way to deterring insider trading where it may be occurring. I am not sure I agree with the 10-day period for doing that, simply for the reason Ms. Sloan mentioned. Failure to provide full information could be prosecuted under the False Statements Act. I think 10 days is a very short window. Maybe 90 days is too long, but I do think that kind of more frequent periodic disclosure does make sense.

Chairman LIEBERMAN. Let us just spend a moment—and it will be my last series of questions—about our ethics rules of the Senate and your concern, Ms. Sloan, about the impact of the Speech or Debate Clause of the Constitution on prosecution of Members of Congress for using insider information. How would you change our rules to deal with this problem?

Mr. SLOAN. The Speech or Debate Clause only applies if a Member is being prosecuted, so it does not have any implications at all for the Ethics Committee, which is why that works better in some ways.

Chairman LIEBERMAN. Right, for the Ethics Committee and for Congress itself, pursuant to the Constitution, in fact.

Ms. SLOAN. Right, so while a prosecutor would not easily be able to obtain and sift through, for example, committee files to see if somebody really had inside information, the Ethics Committee absolutely could review that material.

Chairman LIEBERMAN. Right.

Ms. SLOAN. And so that is why it would be so significant to make sure that the Ethics Committee does have jurisdiction. But I think that the ethics rules are not clear enough, and the House Ethics Committee just 2 days ago issued guidance, but again, I think it is imperative to make it crystal clear and lay it out.

And the other problem that we have seen is that the Ethics Committees are very soft, frankly, on Members of Congress. If somebody is only going to get a mild reprimand or a letter of admonition for having done something like this, really that does not hurt very much, and there is not a lot of disincentive. But if you included something specific, which you could, like some kind of financial penalty, such that money would have to be turned over to the Treasury in some significant amount—like three times the amount of the profit or loss—that, too, would be a disincentive.

Chairman LIEBERMAN. So what you would do here is make clear in our rules that insider trading is a violation of the rules? Is it as simple as that?

Ms. SLOAN. Yes, and that there are certain penalties that will attach.

Chairman LIEBERMAN. Yes, understood.

Ms. SLOAN. Right.

Chairman LIEBERMAN. Mr. Walker, based on your experience, what do you think of this idea?

Mr. WALKER. Well, as I said in my statement, I do think there are rules that address this. I think a big problem here in the Senate and in the House with respect to use of paragraph 8 of the

Code of Ethics of Government Service is that there just is not across the board from committee to committee and office to office specific obligations and rules and policies regarding what information is confidential. And I think getting at it at that level is important. I think there are rules in place. I think if there was a rule crafted that mentioned insider trading specifically as part of Rule 37 on conflicts of interest, that would not be harmful, provided it was crafted in a way, as you are very carefully considering, that would not have other chilling effects.

Let me just say that as to the notion of the Ethics Committees' actions perhaps not having sufficient force, I would perhaps want to ask certain Members whose careers were ended by receiving letters of admonition whether they think that is a soft action. The Ethics Committees do pursue allegations that come before them. They are not criminal enforcement agencies, but I do think if you chose to strengthen the rules regarding insider trading within Congress, that would be a reasonable approach.

Chairman LIEBERMAN. Good. A final question, bringing two parts of this together, if I may. Ms. Sloan just mentioned this fact. Two days ago, as you may know, the House Ethics Committee released a memo to all House Members and staff, stating in part, and I will quote here: "House rules prohibit Members and employees from entering into personal financial transactions to take advantage of any confidential information obtained through performing their official government duties."

I wonder to what extent, if any extent, that kind of statement by the House Ethics Committee establishes the necessary fiduciary duty that we have talked about as a condition of a successful insider trading case against a Member of Congress.

Mr. COFFEE. I think you are going to get different responses from the three of us here because a fiduciary duty is a kind of property right. It is a relationship between the director and the company or the employee, master, principal, etc. An ethical duty is far more general reaching, ineffable. Look at it this way: The Boy Scout oath is an ethical duty. I do not think it gives rise to the kind of relationship that can support a criminal prosecution. There will be different views.

Mr. LANGEVOORT. I share much of that view. I think to a judge predisposed to find a fiduciary duty on Capitol Hill, that simply adds to the case.

Chairman LIEBERMAN. Yes.

Mr. LANGEVOORT. To a judge not inclined, there are all the ways in the world to avoid it.

Chairman LIEBERMAN. Not enough, so that disinclined judge would want to see the concept of fiduciary duty spelled out in law.

Mr. LANGEVOORT. A clear statement, yes.

Chairman LIEBERMAN. Yes. Professor Nagy.

Ms. NAGY. Again, I would encourage the use of the term "trust and confidence" rather than "fiduciary duty" because the Supreme Court has made clear that one does not have to stand in an explicit fiduciary relationship in order to fall under the classical or misappropriation theory.

I think that Professor Langevoort's response is correct. A statement would put one more brick on the scale in terms of whether there is indicia of a duty of trust and confidence.

I should say, though, that many Securities and Exchange Commission and Justice Department prosecutions are based on such indicia. Everyday, ordinary individuals are prosecuted, even though they are not in explicit fiduciary relationships. The SEC's complaint or the Justice Department's indictment typically includes ethical language from codes, much like the Boy Scout code. And that code is put in as a paragraph in the indictment or in the complaint.

An official statement could be another paragraph in a complaint, if it came to that.

Chairman LIEBERMAN. Right. Thank you. You have been very helpful.

Senator McCaskill, do you have other questions?

Senator MCCASKILL. I just have one question. How do we address in terms of disclosure purchases and sales within a managed fund? In other words, if a Member of Congress has a fund that he buys—whether it is an index fund or whether it is some other kind of fund—would we be creating a new duty for the manager of that fund to have to let this particular Member know when he is buying and selling stocks within the fund? Or would there only be a duty in your mind to report the purchase and sale of the overall fund? Do you understand the question I am asking?

Mr. COFFEE. The fund manager has the discretion——

Senator MCCASKILL. Correct.

Mr. COFFEE. It is not a decision made by the Member who owns shares.

Senator MCCASKILL. Correct.

Mr. COFFEE. I assume the Member has no control or no ability to influence the decision of the fund manager. It would be different if he tipped the fund manager.

Senator MCCASKILL. Right. So, obviously, there could be no information going from the Member of Congress to the manager, but whatever decisions the manager had the legal authority to make internally that the Member had no control over would not have to be reportable every 10 days or every 90 days. I was just curious about that.

Thank you.

Chairman LIEBERMAN. Thanks, Senator McCaskill. Thanks very much to the five of you. You have been an extraordinarily helpful panel. In some sense, this is like we have been sitting around the table and saying we have a problem, which I think all of us acknowledge, and now how can we best solve this problem legislatively? And I think you have helped the Committee very substantially in doing that, and you have also made the mistake of offering to continue to be available to review the work that we do, so we will take advantage of that.

I said earlier that I hoped we could do something on this before we leave. December 14 is 2 weeks from today. But we can do that, and I think we have to find a balance here to make sure—because this is important and complicated—that we do as much as we are confident that we have got right on December 14, and if we hold

parts of this over until January when we come back, that is not terrible either.

We will leave the record of this hearing open for 10 days for any additional questions and statements. I thank the witnesses again very much, and with that the hearing is adjourned.

[Whereupon, at 4:36 p.m., the Committee was adjourned.]

APPENDIX

United States Senate
Committee on Homeland Security and Governmental Affairs
Chairman Joseph I. Lieberman, ID-Conn.

Opening Statement of Chairman Joseph Lieberman
Homeland Security and Governmental Affairs Committee
Insider Trading and Congressional Accountability
Washington, DC
December 1, 2011

The hearing will come to order; good afternoon. A recent book by Peter Schweizer and a story based on it on "60 Minutes" have raised the very serious question of whether members of Congress have been using "insider information" to make investments that enable them to make money they could not have made if they were not members of Congress.

The members of Congress who have been specifically accused have denied the allegations. Our purpose here this afternoon is not to determine the guilt or innocence of individual cases. Our purpose is to determine whether the existing law is sufficient to prevent and punish Congressional insider trading.

Perceptions are very important in public service. That means if the law seems to allow members of Congress to take advantage of their public position for personal gain, the trust that needs to exist between the American people and our government will be further eroded than it already is.

So what is the state of the law governing insider trading by members of Congress?

It will surprise most people to learn that there is no explicit prohibition in our laws against insider trading by anyone including members of Congress. That is to say, the term "insider trading" is not defined in statute. All the investigations and prosecutions of insider trading over the years by the Securities and Exchange Commission and the Department of Justice have been carried out pursuant to the broad anti-fraud provisions of the Securities Exchange Act of 1934, which makes it unlawful, in section 10b, to "use or employ, in connection with the purchase or sale of any security – any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

The specific rules making insider trading illegal are found in a large body of SEC regulatory activities pursuant to section 10b, that broad anti-fraud statute and court decisions interpreting those activities. The rules against insider trading now clearly encompass not just corporate "insiders" but others who have bought and sold securities based on material, nonpublic information they obtained and used in violation of a duty of trust. Now I gather that some have said that Congress has exempted itself from these insider trading rules but that is not true. In fact, in a statement submitted to our Committee for the record for this hearing, the Director of Enforcement at the SEC itself makes clear that it has authority to prosecute such wrongful conduct, declaring that "trading by

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Congressional Members or their staffs is not exempt from the federal securities laws, including the insider trading prohibitions."

This afternoon, we are going to hear testimony that a member of Congress or a Congressional staffer who buys or sells stock based on inside information they obtain as a result of their job not only violates Congressional ethics rules, but violates the securities laws as well.

On the other hand, we're going to hear testimony that the law is not as clear as it needs to be and that Congress should specifically proscribe Congressional insider trading.

I'm with the second school of thought. In my opinion, whether or not there is clear and conclusive evidence that members of Congress or our staffs have benefitted financially from insider information and whether or not the SEC believes it can act against members of Congress under its existing authority, there ought to be a law that explicitly deters such unethical, illegal behavior by members of Congress and punishes it when it happens.

Our goal today is to sort out the facts and determine precisely what legal reforms are needed to ensure that regulators and law enforcers have the tools they need to bring to justice members of Congress and our staffs who defy the public trust by using insider information for personal gain.

Our first witnesses today, who we will call on in a short while, will be Senators Kirsten Gillibrand and Scott Brown, a valued member of this Committee, who have taken the lead in the Senate in introducing legislation on this problem and that has been referred to our committee, which is why we're convening this hearing here today.

The point we're focused on today is narrow, but touches on much broader realities. The fact is the American people's faith in their elected representatives is the cornerstone around which our democratic republic was built. When that faith ebbs, as it now has to historic lows, we must increase our efforts to ensure that the people who did us the honor of sending us to Washington to represent them are confident that our only business is their business. I've been reading a lot about George Washington lately and he said it well long ago on the first day of our new government, "The foundations of our national policy will be laid in the pure and immutable principals of private morality, and the preeminence of free government [will] be exemplified by all the attributes which can win the affections of its citizens and command the respect of the world." Adopting a new law that explicitly makes insider trading by members of Congress illegal would strengthen the "foundations of our national policy" and I hope, in a small way, help repair the breach that exists today between our government and our people.

Senator Collins.

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Statement of
Senator Susan M. Collins

"Insider Trading And Congressional Accountability"

U. S. Senate Committee on Homeland Security and Governmental Affairs
December 1, 2011

Mr. Chairman, thank you for holding this hearing to examine whether or not current laws are adequate to prevent Members of Congress from engaging in insider trading. I appreciate your inviting Senator Brown and Senator Gillibrand to describe the legislation they have proposed to address this concern. I am a cosponsor of Senator Brown's bill known as the "STOCK Act." This hearing is an important step in our efforts to ensure that Members of Congress do not profit from trading on insider information.

Recent press reports on "60 Minutes" and elsewhere demonstrate why we must explore the application of existing laws to Congress, and what actions may need to be taken to close possible loopholes that undermine the public's confidence in this institution.

Elected office is a place for public service, not personal gain. As demonstrated by the recent press stories, however, there are questions about whether lawmakers have been exempt - legally or practically - from the reach of our laws prohibiting insider trading.

The recent allegations come at a time when the public's faith in Congress is already extremely low. A recent Gallup poll shows that 69 percent of the American public has little or no confidence in Congress. Other polls show that Americans rate Members of Congress at or near the bottom of the list in terms of perceived honesty and ethical standards.

This erosion of public trust is not confined to Congress, but taints the public's view of our entire federal system. With the many challenges our nation faces, we must act to restore - and to deserve - the trust of the American people.

And we must address the concerns that underpin the public's skepticism. We need to assure the American people that we put their interests above our own.

Seven years ago, economist Alan Ziobrowski [pronounced "*Zeh-brow-ski*"] published a study showing that stock portfolios held by U.S. Senators in the mid-1990s outperformed the market by nearly 12 percent per year. Mr.

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Ziobrowski concluded from his data that Senators have "a definite informational advantage over other investors," though he also pointed out that his results "should not be used to infer illegal activity." In his words, "Current law does not prohibit Senators from trading stock on the basis of information acquired in the course of performing their normal Senatorial functions."

A more recent study by Professor Ziobrowski showed similar, though less dramatic, investment returns for stock portfolios held by Members of the House between 1985 and 2001. At the same time, however, not all experts who have examined the data share his conclusions or his legal interpretations.

In today's hearing, we will analyze the need for greater clarity in the scope of the insider trading laws. I am also eager to hear the views of the witnesses on the legislation presented by our colleagues to close any loopholes or to remedy a lack of enforcement that may shield Congress from the insider trading laws that apply to other Americans.

SENATOR GILLIBRAND TESTIMONY
U.S. Senate Committee on Homeland Security and Governmental Affairs Hearing on "Insider Trading and Congressional Accountability:"

Thank you, Chairman Lieberman, and Ranking Member Collins, for holding this important hearing, and for inviting me to offer testimony this afternoon. Your strong leadership today in shining a light on this issue of fundamental fairness is a step forward on the path to restoring American's faith in their government.

Like millions of American's all across the country, I was surprised to learn that insider trading by members of Congress, their families, or their staff, using non-public information gained through their Congressional work is not clearly and expressly prohibited by law and the rules of Congress.

The American people need to know that their elected leaders play by the exact same rules that they play by. They also deserve the right to know their lawmakers' only interest is what's best for the country, not their own financial interests.

Members of Congress, their families and staff shouldn't be able to gain personal profits from information they have access to that everyday middle class families don't. It's simply not right -- nobody should be above the rules.

I have introduced a bipartisan bill in the Senate with fourteen of our colleagues -- Senators Rubio, Snowe, Tester, Stabenow, McCaskill, Klobuchar, Durbin, Blumenthal, Bill Nelson, Reed, Cardin, Kerry, Sherrod Brown, and Baucus -- to close this loophole.

This STOCK Act legislation is very similar to the legislation introduced by my friends in the House of Representatives, Louise Slaughter and Tim Walz. I want to thank them for their longstanding and dedicated leadership. I also want to recognize Senator Scott Brown for requesting today's hearing and his work on this issue.

Our bill, which has received the support of at least seven good government advocacy groups, covers several important principles:

- Members of Congress, their families and their staff should be barred from buying or selling securities on the basis of knowledge gained through their Congressional service – or from using that knowledge to tip off anyone else. The SEC and CFTC must be empowered to investigate these cases. To provide additional teeth -- such acts should also be a violation of Congress's own rules, to make clear that this activity is inappropriate.

- Members should be required to disclose major transactions – of $1,000 or more – within 90 days, providing dramatically improved oversight and accountability from the current annual reporting requirements.

- Lastly, individuals doing political intelligence work – contacting members of Congress, their staffs, and other individuals to gain information on investment decisions – should have to register as lobbyists to provide oversight of this industry.

There are those who don't want us to succeed and pass this common sense legislation the American people expect. Some critics will say this bill is unnecessary and already covered under current statutes. I have spoken with experts tasked in the past with investigations of this nature who strongly disagree. We must make it unambiguous that this kind of behavior is illegal.

Others may say this bill will be too weak. Let me be clear – our mission is to pass a strong bill with teeth that will make any and all insider trading clearly illegal and a violation of Congressional rules for all members of Congress, their families and their staff. As we move forward, there will be technical changes in the language to improve the bill and ensure the final product meets this goal. Anything less is unacceptable.

As my home state newspaper the Buffalo News recently noted, "... the STOCK Act would ensure that it's the people's business being attended to." This is a step we must take to begin restoring trust to this broken Congress.

Thank you again, Senator Lieberman and Senator Collins, for inviting me today to share my testimony on this important issue.

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Statement by Senator Scott P. Brown

December 1st, 2011

Before the

U.S. Senate Homeland Security & Governmental Affairs Committee Hearing

"INSIDER TRADING

AND CONGRESSIONAL ACCOUNTABILITY"

A few weeks ago, "60 Minutes" featured a segment about Members of Congress' insider trading advantage, which garnered widespread public attention. The recent "60 minutes" investigation revealed something we already know: there is something wrong in Washington that needs to be fixed so that we can regain the trust of the American people. At a time when the American people's trust in Congress is close to an all time low, it is more important than ever that members' of Congress affirm that we live by the same rules as everyone else. Serving the public is a privilege and an honor, and should not be used as an opportunity for personal gain. Simply put, members of Congress should be held to the same standard as the general public and should not be able to profit based on nonpublic information.

That is why I have introduced in the Senate the Stop Trading on Congressional Knowledge (STOCK) Act of 2011 and the accompanying Senate Resolution, which would prohibit members or employees of Congress, as well as Executive Branch employees, from using nonpublic information obtained through their public service for the purposes of investing or otherwise making a personal financial gain.

Consider this: A Member of Congress hears during a meeting that a program is going to be cut the next day. That member could then sell

his or her stock in that sector and score a profit - or avoid losses - when the news breaks. Under current law, the congressman would likely walk away with a fatter investment account. For everyone else, it could mean you go to jail.

Arguing that current laws already apply to members of Congress and staff, some scholars see no need for the STOCK Act. Other scholars argue that members of Congress have no fiduciary duty to prevent members from trading on material nonpublic information. The mere existence of this debate is enough to show that we must clearly define a blanket affirmative duty on members of Congress to the American public pertaining to confidential nonpublic information. Not defining this duty will leave a "gap" of uncertainty that invites abuse and contributes to a breakdown of trust among the American people.

This legislation is directly aimed at correcting this problem that academics such as Professors Ziobrowski and Bainbridge have identified. Professor Ziobrowski's work found that some members of Congress' investments may have benefited from an informational advantage over members of the general public. In his recently published book, "Throw Them All Out," author Peter Schweizer, a fellow at the Hoover Institute, reports that members of Congress are making a killing in real estate by approving the use of federal funds for projects that enhance the value of buildings and land that they own.

As members of Congress, we have access to information that the public does not; classified briefings, closed conference reports and personal conversations with government officials. All of these sources can give us nonpublic information that may have a significant value if traded upon. But not only do we access information, we create information and policy. When we act on legislation or negotiate legislative language, frequently that legislation has real financial consequences to an industry or company. Because we have access to and we create information, we must not betray the public's trust by using it for our own personal gain.

Doing so diminishes public trust and that is why I called for this hearing here today. I suspect we will hear from some witnesses at today's hearing that existing laws and rules are sufficient. Yet, there have been no successful prosecutions of members or their staff and I believe the uncertainty surrounding the existing legal framework provides an excuse for enforcement agencies to avoid the politically difficult task of policing Congress. We must close this loophole.

I believe that the vast majority of Members and staff of Congress are here to serve their constituents best interests, not to line their pockets. But by explicitly prohibiting the use of material nonpublic information for personal gain, we will vastly increase transparency while restoring some public faith in Congress.

The legislation I have introduced is similar to the bipartisan legislation that has been introduced in the House of Representatives over the past few years but has languished as Congress has lacked the will to affirm that we live by the same rules as everyone else. I would also like to recognize the leadership on this issue of retired Congressman Baird and Congresswoman Slaughter who introduced the Stock Act back in the 109th Congress. Congresswoman Slaughter and Congressman Walz have continued the effort to close this loophole.

The recent media attention means that the American people are watching to see if we are serious about regaining their trust.

I am not afraid of acting in the public's interest, and that is why I introduced this legislation to improve Washington. The Stock Act is critically needed and should not be a partisan issue. I strongly encourage my colleagues to listen to the American people and take an important step towards regaining their trust -that is why action is needed now.

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Testimony of Melanie Sloan
Executive Director, Citizens for Responsibility and Ethics in Washington
Senate Committee on Homeland Security and Governmental Affairs
December 1, 2011

Chairman Lieberman, Ranking Member Collins and other members of the committee, thank you for inviting me here today to join such a distinguished panel. You will be hearing from some of the foremost experts on securities regulation and they are far better equipped than I to discuss whether insider trading laws already on the books apply to members of Congress and congressional staff. Further, others may debate whether and to what extent members of Congress really have unduly high rates of return on investments compared to average investors. I, on the other hand, am here as the executive director of Citizens for Responsibility and Ethics in Washington (CREW), a government watchdog group focused on congressional ethics. Since its founding in 2003, CREW has filed a significant number of complaints against members of Congress for a range of self-dealing and self-interested conduct.

From CREW's perspective, while discussions of the breadth and application of insider trading laws are interesting, the most compelling reason this committee should consider and move legislation to prohibit members and congressional staff from trading based on information received in the course of their employment is the incredibly low regard in which Congress is held.

At no time in history has the public's view of Congress been quite so dismal. While the jobless rate remains a dizzying 9% with nearly 14 million unemployed, and a wide swath of America is suffering severe economic hardship, members of Congress have never been richer. 66% of senators and 41% of House members are millionaires. Many members have significant stock portfolios, but only some maintain their assets in blind trusts. Whether or not it is accurate, there

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is a widespread public belief that members of Congress are using their positions to feather their own nests. They come in middle income, and walk out rich.

As Alaska Governor Sarah Palin recently wrote in an op-ed appearing in the *Wall Street Journal*, "the money-making opportunities for politicians are myriad and sickening." In the past few years, CREW and others have noted with alarm members of Congress who have earmarked projects that increased the value of their personal real estate holdings, pushed through legislation in apparent exchange for campaign contributions, bought into companies that soon thereafter surged in value, urged agencies to take actions that financially benefitted themselves or family members, and made fortuitous stock trades shortly after meetings with federal regulators.

Some argue most members of Congress play by the rules so legislation banning self-dealing is unnecessary. But a July poll found a whopping 46% of Americans believe most members of Congress are corrupt. So at the very least, those few bad apples are ruining the reputations of honest legislators. In any event, we don't write laws for the majority. After all, not many people rob banks, burn down buildings, or commit murder, but we nevertheless have laws banning such conduct as well as cops on the beat to catch those who do. Specific, clear prohibitions both deter undesirable behavior and allow us to punish violators.

Some also might suggest the House and Senate Ethics Committees already have authority to discipline members and staff who trade on information acquired through dint of their positions. Both the House and Senate ethics manuals incorporate the Code of Government Service, which provides that all government employees, including officers, should "never use information received confidentially in the performance of governmental duties for making private profit." Nevertheless, the only time a member of Congress appears to have been disciplined based on this

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prohibition is in the only somewhat relevant case of Florida Congressman Robert L. F. Sikes. There, the House Ethics Committee found Rep. Sikes had failed to disclose investments in bank stock while engaged in official actions on behalf of the bank. As a result on July 29, 1976, he was reprimanded by the full House in a 381-3 vote.

According to the Senate Ethics Manual, up to the date the manual was published in 2003, the Code of Government Service had not been cited by the Senate Ethics Committee as a basis for recommending discipline of a Senate member, officer or employee. I do not believe the committee has cited the code in any other matter since that time.

Aside from whether the ethics committees have the jurisdiction to discipline this sort of conduct, the question is who would trust them to do so? Certainly not CREW. The fact is the public – and good government groups like mine – have remarkably, and deservedly, little confidence in the congressional ethics committees. A few recent instances aside, it often appears as if the committees are more interested in covering up the misconduct of members than in aggressively enforcing the ethics rules. One example from my own work is that CREW filed an ethics complaint against a senator in 2005, only to receive a letter two years later in 2007 informing us that because the senator had retired, the committee no longer had jurisdiction over him. In another instance, CREW filed a complaint against a senator in the fall of 2008 alleging he had filed inadequate financial disclosure reports, but over three years later we have yet to receive a response.

In the House of Representatives, the situation is even worse. The House Ethics Committee is currently itself the subject of an ethics investigation for misconduct by committee members and

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staff in pursuing an investigation of another member for violating House conflict of interest rules.

Therefore, while the House and Senate should amend their codes of conduct to make clear that trading securities based on information obtained through the course of their employment is prohibited and will result in severe disciplinary proceedings -- perhaps including a requirement that the offender pay a fine of three times the amount of profit obtained or loss avoided -- this alone would not be sufficient. Rather, to help instill confidence that Congress takes the misconduct of its own members as seriously as it takes the misconduct of others, it is important to pass legislation specifically making trading on confidential information a crime. Further, given the ever increasing evidence that the Securities and Exchange Commission's enforcement division is overwhelmed and ineffective, it is also imperative the Department of Justice have jurisdiction to prosecute offenders.

This brings me to my one note of caution. The Speech or Debate Clause of the Constitution will have a bearing on the ability of prosecutors to bring charges against members of Congress who trade on information obtained through their positions as legislators. The clause protects members from inquiry into their legislative acts or their motivation for performing legislative acts. A "legislative act," however, does not include all activity in any way related to the legislative process. Rather, it is an act generally done in Congress in relation to the business before it. Hypothetically, imagine after some version of the STOCK Act became law, a senator received documents as a result of a request made pursuant to a committee investigation and then, based on confidential information contained in those documents, bought stock that soon thereafter increased in value. The Speech or Debate Clause would prevent a prosecutor investigating the senator from obtaining or introducing before a grand jury or at trial any of the

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records obtained by the committee. That said, courts have held that not everything a member of Congress does is protected by the Clause. Meetings with constituents and business people, assistance in procuring government contracts and contacting agency officials have been considered by courts to be "political matters" not protected. The Supreme Court has been clear that the purpose of the Clause is not "to make members of Congress super-citizens, immune from responsibility." In any event, the Speech or Debate Clause issue is no reason to avoid legislating. After all, the criminal code includes a statute prohibiting bribery of and by public officials and even though there have been instances where the Clause has prevented prosecution despite strong evidence of wrongdoing, there are other instances where cases have been brought successfully.

Reviewing both versions of the STOCK Act that have been introduced in the Senate, S. 1871 and S. 1903, I think S. 1871 is the better bill. For reasons unclear to me, while much of the language of the two bills is nearly identical, S. 1903 includes several additional sections perhaps intended to strengthen the intent requirement, but which in my view, undermine the bill's purpose. Further, while I strongly support requiring disclosure of the purchase and sale of securities, I believe such reports should be made much more quickly than the 90 days provided in both bills.

Finally, I would also suggest two additional provisions. First, the personal financial disclosure report forms should be revised. Currently, these forms allow members to provide fairly vague valuations of their unearned assets: at the high end from $1,000,0001-$5,000,000, $5,000,0001-$25,000,000, $25,000,0001-$50,000,000; and to list similarly vague valuations of the income received from those assets. I'd recommend narrowing those ranges to allow readers to more accurately assess members' holdings.

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Finally, while some members of Congress maintain their assets in blind trusts, there is some question as to exactly how blind those trusts really are. Do members know what securities are held in the trusts? Are they informed of purchases and sales? I'd recommend members with blind trusts be required to submit statements from their financial managers certifying that they are not providing such information to the member or the members' close family members.

The bottom line is the public is growing increasingly frustrated with a Congress viewed as part of the 1% and as more concerned with preserving that status than in working to improve the plight of all Americans. Legislation clearly prohibiting members and congressional staff from buying and selling securities based on material non-public information should cause no concern among rule-abiding members of Congress and staff, but likely will deter such conduct and ensure consequences for those who do engage in such self-dealing practices. While passing a STOCK Act is not a cure-all, it would be a good first step as part of a sustained effort to demonstrate Congress hears and understands our concerns, and is here to serve the public interest and not your own personal financial interests.

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Hearing on Insider Trading and Congressional Accountability before the United States Senate Committee on Homeland Security and Governmental Affairs

Testimony of Donna M. Nagy, C. Ben Dutton Professor of Law
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Bloomington, Indiana

December 1, 2011

Chairman Lieberman, Ranking Member Collins, and Members of the Committee on Homeland Security and Governmental Affairs: Thank you for inviting me to submit written testimony as part of your hearing on "Insider Trading and Congressional Accountability." My name is Donna M. Nagy and I am the C. Ben Dutton Professor of Law at Indiana University Maurer School of Law in Bloomington, Indiana. I began my academic career 17 years ago at the University of Cincinnati College of Law. Before that, I practiced securities litigation as an associate at Debevoise & Plimpton in Washington, D.C. I am the co-author of two books: a treatise on the law of insider trading (with Ralph C. Ferrara and Herbert Thomas) and a casebook on Securities Litigation and Enforcement (with Professors Richard W. Painter and Margaret V. Sachs). I have also published several law review articles on insider trading, including a 58 page article on the precise topic of today's hearing. That article, which appeared in the May 2011 issue of the Boston University Law Review, is entitled "Insider Trading, Congressional Officials, and Duties of Entrustment."[1] I have attached it to this testimony.

The article sought to debunk what at the time was bordering on urban myth: that Congress had somehow exempted itself from a federal statute that outlaws insider trading by all those outside of the Capitol. Indeed, while the current catalyst is *60 Minutes*' recent claim that congressional insider trading is "perfectly legal," a similar hullabaloo occurred more than a year ago after the *Wall Street Journal* asserted that legislative staffers could legally profit from the use of congressional knowledge because Congress was purportedly "immune from insider-trading laws."

Congress in no way has sought to immunize or exempt itself. Beyond that, my article concluded then, and I continue to say with confidence now, that congressional insider trading in securities violates the broad anti-fraud provisions in federal securities law as well as the federal mail and wire fraud statutes. Thus, congressional insider trading is already illegal under existing law. I acknowledge, however, that many distinguished securities law scholars see shades of gray in existing law,[2] and at least one

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[1] Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 BOSTON UNIV. L. REV. 1105 (2011).

[2] See, e.g., DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION § 3.09 (2011) (observing that the issue "raises difficult constitutional and political questions"); Jonathan R.

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such scholar has concluded that "the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted."[3]

With my testimony, I hope to accomplish three things. The first is to provide a brief snapshot of existing insider trading law and where Members of Congress stand in relation to that law. As I hope to show, sometimes applying that law to Senators and Representatives is reasonably straightforward, while other times it is less so. The second is to analyze both versions of the STOCK Act (S. 1871 and S. 1903) and to highlight some significant – but readily fixable – problems with their present formulation. The third is to show why fixing those problems, although crucial to do, does not go far enough. What we need, in my opinion, is legislation that offers a definition of insider trading that is applicable to everyone, or at a minimum ensures that the same anti-fraud prohibition will be applied to everyone. Congress has already done work on this issue that brings us almost to the finish line. I will show the feasibility of crossing the finish line and the vital importance of doing so.

A Brief Snapshot of Existing Insider Trading Law

The controversy surrounding the application of existing law to Members of Congress and their staff stems largely from the fact that Congress has never enacted a federal securities statute that explicitly prohibits *anyone* from insider trading. Rather, since the 1960s, when the Securities and Exchange Commission (SEC) first began to initiate enforcement actions for securities trading on the basis of material nonpublic information, the offense of insider trading has typically been prosecuted as a violation of Rule 10b-5, a general antifraud rule which the SEC promulgated nearly seventy years ago pursuant to the congressional grant of rulemaking authority in Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act). Rule 10b-5 broadly prohibits fraud "in connection with the purchase or sale of any security." The Department of Justice also prosecutes insider trading as a criminal violation of either Rule 10b-5 or the federal statutes prohibiting mail fraud and wire fraud, 18 U.S.C. §§ 1341 and 1343. Thus, in the vast majority of instances, insider trading is illegal only insofar as it can be deemed a fraudulent act or practice.[4] The explicit statutory ban on insider trading, which operates

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Macey & Maureen O'Hara, *Regulation and Scholarship Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 107 (2009) (maintaining that although a plausible theory exists that would render insider trading by members of Congress illegal, a narrower view of the current law might be more likely to prevail).

[3] Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011).

[4] When insider trading involves material nonpublic information pertaining to a tender offer, a special insider trading rule applies. Once "a substantial step" toward a tender offer has been taken, Rule 14e-3(a) prohibits trading by any person in possession of material nonpublic information relating to that tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (2010). Accordingly, the government can establish liability for insider trading under Rule 14e-3(a), even if it cannot prove the breach of a fiduciary-like duty of disclosure.

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in nearly every other country with a developed securities market, is entirely absent in U.S. securities law.

Consequently, our federal courts, through their interpretation of Exchange Act Section 10(b) and Rule 10b-5, have largely shaped the contours of the federal prohibition of insider trading. To be sure, in 1984 and then again in 1988, Congress amended the Exchange Act to authorize stiff monetary penalties and long prison terms when a civil or criminal prosecution establishes a Rule 10b-5 violation by a person who has traded securities based on material nonpublic information. But Congress has left the formidable task of defining fraudulent insider trading to the SEC and federal courts, with the U.S. Supreme Court as the final arbiter, subject to a legislative override by Congress. The end result takes the form of two complementary theories of insider trading liability: a classical theory and a misappropriation theory. Although these theories can be set out and described in a few sentences, they have resulted in an insider trading jurisprudence that is extraordinarily complex and frequently criticized for its ambiguity and indeterminacy.[5]

The classical theory, which the Supreme Court established in 1980 and reaffirmed three years later, regards insider trading as a fraud on the parties to a securities transaction, when those parties trade with a person who remains silent about material nonpublic information in breach of a fiduciary-like disclosure duty. *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983). Pursuant to this theory, persons who owe fiduciary-like duties of trust and confidence to an issuer's shareholders must either disclose all material nonpublic information in their possession or abstain from trading in the issuer's shares. The failure to "disclose or abstain" in such transactions constitutes a violation of Rule 10b-5.

More than a decade later, in *United States v. O'Hagan*, 521 U.S. 642 (1997), the Court endorsed an alternative approach for determining whether insider trading constitutes a fraud in violation of Rule 10b-5. Under the "misappropriation theory," a fraud occurs when a person owing a fiduciary-like duty to the source of material nonpublic information misappropriates that information by secretly using it to reap personal profits. The misappropriation theory thus focuses on the relationship of trust and confidence that exists between the securities trader and the source of the material

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[5] See, e.g., Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883 (2010) (observing that there are "hundreds of decisions grappling with the issue" of whether an insider trading defendant engaged in fraud within the meaning of Rule 10b-5, and that "[m]any of these decisions are confusing and inconsistent with one another"); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1498 (1999) ("[T]he SEC's dysfunctional regulatory strategy brings to mind unpleasant images of Cinderella's stepsisters who each chopped off portions of a foot in order to stuff the foot into Cinderella's shoe."); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that "the legal restrictions on trading securities while in possession of material nonpublic information are confused and confusing," and emphasizing that the "case law contains logical as well as interpretive flaws").

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nonpublic information and regards the source as the person who is defrauded in connection with the securities transaction.

The Supreme Court has also ruled unanimously on two occasions that insider trading can constitute a criminal violation of the federal mail fraud or wire fraud statutes. As the Court in *Carpenter v. United States*, 484 U.S. 19 (1987) explained, "[t]he concept of fraud includes the act of embezzlement, which is the fraudulent appropriation to one's own use of [property] entrusted to one's case by another." *Id.* at 27. *Carpenter* further clarified that the "intangible nature" of material nonpublic information "does not make it any less 'property' protected by the mail and wire fraud statutes." *Id.* at 24. The Court therefore affirmed the Second Circuit's judgment that the mail and wire fraud statutes had been violated by a reporter and those who received his tips in a trading scheme involving the pre-publication use of material nonpublic information belonging to the reporter's employer, the Wall Street Journal. Nearly a decade later, *Carpenter*'s fraud holding was reaffirmed in *O'Hagan*, when the Court concluded that an attorney's undisclosed self-serving use of material nonpublic information for securities trading purposes defrauded his law firm and its client of the exclusive use of their property within the meaning of the federal mail fraud statute.[6]

Few securities law scholars would dispute the broad and malleable nature of Rule 10b-5's misappropriation theory, which captures conduct by "outsiders" who lack any duty or connection to the issuer's shareholders.[7] Nor is there any serious question as to whether the misappropriation theory can be applied to persons who owe duties of trust and confidence to the source of misappropriated information, even if the requisite relationship fails to qualify as a "paradigmatic fiduciary relationship," such as those involving employers-employees, principals-agents, or clients-attorneys. Indeed, the Supreme Court has never implied – let alone stated – that a relationship has to be strictly a "fiduciary" one for a disclosure duty to attach under the misappropriation theory. Rather, in *Chiarella*, *Dirks*, and *O'Hagan*, the Court used the term "fiduciary duty" interchangeably with "a duty of trust and confidence."

Over the last decade, the SEC and Justice Department have cast a tremendously wide net in Rule 10b-5 investigations premised on the misappropriation theory. In such prosecutions, the government's ability to satisfy its burden was facilitated considerably after 2000, when the SEC promulgated Rule 10b5-2.[8] Rule 10b5-2(b) sets out a list of

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[6] The Court found that its ruling under Rule 10b-5 required it to vacate the circuit court's judgment reversing O'Hagan's conviction on the mail fraud count as well, because both convictions were predicated on the attorney's fraudulent misappropriation of intangible property. See *O'Hagan*, 521 U.S. at 652 (emphasizing that misappropriators "deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal").

[7] That said, such scholars engage in rigorous debate as to whether such elastic interpretations of anti-fraud provisions should be heralded or scorned.

[8] SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2. The SEC promulgated this rule in partial response to *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), a decision that adopted what the SEC regarded

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three *non-exclusive* situations in which a person shall be deemed to have a "duty of trust or confidence" for purposes of the misappropriation theory:

> (1) Whenever a person agrees to maintain [that] information in confidence;
>
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
>
> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential.[9]

Thus, when a court is confronted with a relationship that is not quintessentially fiduciary-like, most courts will look to the "reasonable and legitimate" expectations of the source of the material nonpublic information.

Based on such *ad hoc* inquiries, Rule 10b-5 liability has been imposed in misappropriation cases involving:

- family members and other persons who traded on information misappropriated from their relatives and friends (including in family relationships more remote than spousal, parent-child, and siblings);
- participants in private placements who traded securities in the public markets based on the confidential information to which they were given access;
- an electrician who traded on information that he overheard while at a company repairing its wiring;
- a member of a business roundtable who traded on information conveyed by a fellow member;
- a businessman who traded on information entrusted to him by his business partner;
- a bank that traded corporate bonds based on nonpublic information obtained through service on six bankruptcy creditors' committees;
- a juror who tipped confidential information obtained from his service on a grand jury; and
- a governmental affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department.[10]

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as an unduly narrow interpretation of the "trust and confidence duty" in the context of a spousal relationship. See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,863 (Dec. 20, 1999) ("[T]he *Chestman* majority's approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.").

[9] Id., § 240.10b5-2(b)(1)-(3).

[10] Specific cites to these examples can be found in Nagy, *supra* note 1, at 1120-21.

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In all of these instances, and in dozens of other prosecutions falling outside of ordinary fiduciary categories, the linchpin has been a securities trader (or tipper) who breached a duty of entrustment by secretly profiting from the use of material nonpublic information that rightfully belongs to somebody else. And while that linchpin might not be readily apparent from the facts of all of these cases (as I have observed in my scholarship),[11] the SEC and Justice Department have proven themselves quite adept at convincing courts to find the type of "feigning fidelity" that, under *O'Hagan*, is "essential" to liability under the misappropriation theory.[12]

Application of Existing Law to Members of Congress

Based on the foregoing summary of existing law, I will focus my analysis on its application to Members of Congress. I note that even scholars who question whether existing law applies to Senators and Representatives are quick to conclude that legislative staffers and other congressional employees are liable for insider trading based on the well-established employer-employee misappropriation theory precedents. For Members of Congress, however, their employee status is far more complicated because case law conflicts as to whether Senators and Representatives actually constitute "employees" of the federal government. Therefore, a court presented with a prosecution of a Member of Congress could not simply use the employment heuristic to find the existence of a relationship of trust and confidence for purposes of insider trading liability.

Rather, as in all other insider trading cases falling outside of paradigmatic fiduciary relationships, a court would have to decide whether the defendant – in our case an individual Member– owed a duty of trust and confidence to either the investors with whom she traded or to the source of the material nonpublic congressional knowledge. As with all other insider trading cases falling outside traditional paradigms, the analysis would necessarily be *ad hoc*. It could depend on criteria that reflect the Member's status as a Senator or Representative, or the "reasonable and legitimate expectations" of the particular persons communicating the information to the individual Member.

In view of the substantial number of cases holding the insider trading prohibition applicable to relationships that are by no means ordinary fiduciary ones, I very much

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[11] See Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV 1315 (2009) (discussing instances where federal courts have arguably stretched too far the relationship of trust and confidence parameters originally drawn by the Court in *Chiarella*, *Dirks*, and *O'Hagan*).

[12] That is not to imply that the government always emerges victorious in ligation. In addition to the Second Circuit's en banc decision in *Chestman*, *supra* note 8, see United States v. Cassese, 273 F. Supp. 2d 481 (S.D.N.Y. 2003) (emphasizing that the business competitors were "not inherent fiduciaries, but rather potential arms-length business partners . . . [who] did not have a long-standing relationship or . . . regularly shared confidences") and United States v. Kim, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (holding that a member of the Young Presidents Association, a national organization of company presidents under the age of fifty, did not owe a duty of trust and confidence to fellow club member). See also SEC v. Cuban, 634 F. Supp. 2d 713, 724 (N.D. Tex. 2009) (dismissing complaint and holding that Rule 10b5-2(b)(1) is invalid and unenforceable insofar as it predicates liability on a defendant's mere agreement to maintain information in confidence), vacated and remanded on other grounds, 620 F.3d 557 (5th Cir. 2010).

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doubt that a federal court would have the temerity to conclude as a matter of law that a Member of Congress lacks a duty of "trust and confidence" for purposes of the misappropriation theory. Given the Constitution's repeated reference to public offices being "of trust," and Members' oath of office to "faithfully discharge" their duties, I would predict that a court would be highly likely to find that Senators and Representatives owe fiduciary-like duties of trust and confidence to a host of parties who may be regarded as the source of material nonpublic congressional knowledge. Such duties of trust and confidence may be owed to, among others:

- the citizen-investors they serve;
- the United States;
- the general public;
- Congress, as well as the Senate or the House;
- other Members of Congress; and
- federal officials outside of Congress who rely on a Member's loyalty and integrity.

Moreover, precedent tells us that such duties of trust and confidence are both bona fide and enforceable through each Chamber's own constitutionally specified authority to punish its Members, as well as through prosecutions by the Executive Branch under criminal and civil statutes. For example, in connection with conduct involving kickbacks or bribes, the Justice Department has prosecuted congressional officials for mail or wire frauds that deprive the United States and the public of its right to honest services, and these prosecutions are premised on a Member's breach of a fiduciary duty of loyalty.[13] Thus, while Members of Congress may constitute a class that is *sui generis*, that class has been found to owe the public the same duties of trust and loyalty that the public expects from other government officials.

As with all insider trading cases, when the person prosecuted is a Member of Congress, one can envision both reasonably straightforward cases as well as cases that are more factually complex. In my view, a relatively straightforward case falling well within the misappropriation theory of Rule 10b-5 and the federal mail and wire fraud

[13] See HEARING ON RESTORING KEY TOOLS TO COMBAT FRAUD AND CORRUPTION AFTER THE SUPREME COURT'S *SKILLING* DECISION BEFORE THE SENATE JUDICIARY COMMITTEE, September 28, 2010 (written statement by Lanny A. Breuer, Assistant Attorney General, Criminal Division, Department of Justice) (stating that for decades, federal prosecutors have used the mail and wire fraud statutes to reach "schemes designed to *deprive citizens* of the honest services of public and private officials who owe them *a fiduciary duty of loyalty*" and observing that some of these prosecutions and convictions have involved members of Congress) (emphasis added). See also *United States v Jefferson*, 562 F. Supp. 2d 719, 721 (2008) (denying motion to dismiss counts of indictment charging then-Congressman William Jefferson with "a scheme to defraud and deprive American citizens of their right to [his] honest services by taking bribes . . .in return for [his] performance of various official acts" and concluding that these "honest-services fraud" counts were not unconstitutionally vague). Although the Supreme Court recently held that the Due Process Clause requires 18 U.S.C. § 1346's prohibition of honest-services fraud to be read narrowly, the Court made clear that bribe and kickback cases continue to fall within the statute's constitutional scope. Skilling v. United States, 130 S. Ct. 2896 (2010).

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statutes involves a Senator who learns from a Committee Chair that an aircraft manufacturer will be receiving a multi-million dollar defense contract in an Appropriations bill. If that Senator were to buy shares of stock in the aircraft manufacturer based on that material nonpublic information, that Senator would be misappropriating that information for his own personal benefit, and in the absence of disclosure about his intent to trade, he would be deceiving and defrauding multiple sources of that information, including: the United States and the public, Congress and the Senate, and/or the fellow Member (the Chairman of the Committee) who conveyed that information with a reasonable and legitimate expectation of confidentiality.[14] Likewise, if the Senator had learned similar defense contract type information from a federal official outside of Congress, for example, the Secretary of Defense, the prosecution should also be relatively straightforward. Here, the Senator's stock purchases would still constitute a fraud and deceit on the United States and the public, and/or on Congress and the Senate, but instead of a fellow Member, the Senator's undisclosed securities trading based on his nonpublic knowledge would likely deceive and defraud the Secretary of Defense who entrusted him with the information.

For a court to conclude otherwise and foreclose misappropriation theory liability, it essentially would have to view the nonpublic congressional knowledge pertaining to the defense contract award as a perk of office belonging to the individual Senator to do with as he wished. Such a view would be strikingly inconsistent with the tenets of a representative democracy. It would be at odds with the high ethical conduct Americans expect. It also would contradict a provision in the Code of Ethics for Government Service, which specifies that all Government employees, including officeholders, should "never use any information coming to him confidentially in the performance of government duties as a means for making personal profit."[15]

A more factually complex case could involve a Senator who realizes that with her own vote, sufficient support exists to pass legislation that would result in an aircraft manufacturer's receipt of a multi-million dollar defense contract. Here the congressional knowledge that motivates the purchase of an issuer's stock would have been gleaned from the Senator's own legislative activity. But even then, the material nonpublic information pertaining to how her vote is likely to affect a legislative outcome should not be viewed as "belonging" individually to her, just as a corporate board member's knowledge of her own vote in an upcoming board meeting would not allow that board member to trade securities based on the meeting's anticipated outcome. Both the Senator

[14] There is also a compelling argument that could be made for this Senator's liability under Rule 10b-5's classical theory: as a person who owes duties of trust and confidence to the general public (including at least some of the aircraft manufacturer's shareholders on the other side of his trades), the Senator would violate Rule 10b-5 were he to purchase stock while remaining silent about material nonpublic facts pertaining to the imminent award of a multi-million dollar defense contract.

[15] Code of Ethics for U.S. Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

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and the board member would be, in the words of the Supreme Court, "tak[ing] advantage of information intended to be available only for an [institutional] purpose and not for the personal benefit of anyone." *Dirks*, 463 U.S. at 654.

Although a member of Congress has never been prosecuted for insider trading based on nonpublic congressional knowledge, the Justice Department has used the federal mail and wire fraud statutes to successfully prosecute congressional officials for deceiving and defrauding the United States and the public through the undisclosed misappropriation of congressional funds and tangible property. For example, in affirming former Congressman Charles Diggs's conviction under the mail fraud statute, the D.C. Circuit concluded that the Congressman's conduct "amounted to no less than a scheme to take illicit kick-backs" and that this scheme "defrauded the public of not only substantial sums of money but of his faithful and honest services." *United States v. Diggs*, 613 F.2d 988, 998 (1979). The Justice Department also used the federal mail and wire fraud statutes to prosecute former Congressman Daniel Rostenkowski for "a scheme to defraud the United States of its money, its property, and its right to [his] fair and honest services" in connection with alleged staff salary kickbacks, misappropriation of goods worth over $40,000, and misappropriation of funds by exchanging stamp vouchers for cash.[16]

Given that congressional funds and tangible property are deemed to "belong" to the United States and the public, and given the Supreme Court's clear dictate that that the "intangible nature" of material nonpublic information does not render it "any less property," it is difficult to see how a court could reject the SEC or Justice Department's claim that Rule 10b-5 is violated by a Member's undisclosed self-serving use of material nonpublic congressional knowledge.[17] To be sure, this analysis assumes that the government would be able to prove that the information was material, nonpublic, and, in fact, was used with scienter by the Member in deciding to trade securities -- and many practical and constitutional obstacles could stand in the way of prosecutors as they attempt to gather evidence to make this showing. But such practical and constitutional obstacles would be present in any criminal or civil prosecution involving a Member of Congress, even prosecutions brought pursuant to an express statutory insider trading prohibition such as the one proposed in S. 1871 and S. 1903's STOCK Act, to which I shall now turn.

The Legislative Response

The STOCK Act seeks to explicitly proscribe insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and other federal

[16] See United States v. Rostenkowski, 59 F.3d 1291, 1294 (D.C. Cir. 1995) (rejecting arguments that the Speech or Debate Clause and the Rulemaking Clause stood as an absolute bar to the 17 count indictment).

[17] Moreover, if pressed to speculate, I would go so far as to predict the SEC or Justice Department's ultimate success at the Supreme Court. Although the Court can be expected to read Rule 10b-5 quite narrowly in the context of private securities litigation (particularly in fraud-on-the-market lawsuits), the Court has embraced a decidedly broader interpretation in circumstances where the government has urged it to preserve the SEC or Justice Department's Rule 10b-5 enforcement authority.

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employees. I applaud and endorse the motivation behind this proposed legislation. At the same time, I believe that there are a number of immediate changes to the text of the bills that would vastly improve their efficacy.

First and foremost, the language in the bills should clarify that the Act does not constitute the exclusive insider trading prohibition applying to Members of Congress and legislative staffers. Without such clarification, there is a very real risk that the STOCK Act could be read to displace the application of Rule 10b-5 and the mail and wire fraud statutes regarding instances of congressional insider trading. This risk is particularly troubling because, as I read S. 1871 and S. 1903,, the bills fail to reach a host of hypothetical situations involving congressional insider trading that would almost certainly fall within this existing law.

Much of the under-inclusiveness stems from the STOCK Act's language authorizing the SEC to proscribe congressional insider trading only when the material nonpublic information pertains to "pending or prospective legislative action" relating to "such issuer" – that is, the issuer of the particular securities which were traded. But Members of Congress and legislative staffers routinely possess all sorts of material nonpublic information that do not relate to any "pending or prospective legislative action," such as information conveyed in confidential briefings by federal officials outside of Congress, including those conducted by Cabinet and sub-cabinet officials and those conducted by independent regulatory agencies. Thus, while SEC rules promulgated under S. 1871 or S. 1903 would reach a Senator who buys stock in an aircraft manufacturer based on information pertaining to a not-yet publicly announced multi-million defense contract in an Appropriations bill, those rules would likely fail to reach that same Senator if he learned of a multi-million dollar defense contract through a confidential informational briefing by the Secretary of Defense.

Likewise, S. 1871 or S. 1903 would not seem to prohibit a Senator, in possession of information pertaining to a "pending or prospective legislative action" that related to one issuer, from using that information to purchase securities in an altogether different issuer whose business could be affected by a positive or negative legislative development. For example, the bills likely would not reach a Senator who learned that Boeing would be receiving a multi-million dollar defense appropriation, but then shorted Lockheed Martin stock based on that material nonpublic congressional knowledge.

A third example of under-inclusiveness concerns the STOCK Act's failure to explicitly prohibit Members of Congress and legislative staffers from tipping others about material nonpublic information. Under existing law, to establish Rule 10b-5 liability on the part of a congressional official for tipping material nonpublic information (as opposed to trading on that information herself), the government would have to show that the official breached a duty of loyalty for some "direct or indirect personal benefit . . . such as a pecuniary gain or a reputational benefit" or that the official intended to make "a gift of confidential information to a trading relative or a friend." *Dirks v. SEC*, 463 U.S. 646,

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659 (1983). The STOCK Act, however, only authorizes the SEC to prohibit tippee trading. Thus, any liability on the part of a Member of Congress or legislative staffer for self-interested tipping would have to be inferred from the statutory ban on tippee trading (a ban that, as it is currently drafted, extends far beyond the tippee-trading prohibition under existing law).

In short, STOCK Act provisions such as these would actually create gaps that do not exist under current law. And if these express statutory provisions were interpreted to displace application of Rule 10b-5 and the federal mail and wire fraud statutes, then congressional enactment of a STOCK Act would constitute an unfortunate step backward. In the name of Congressional accountability, it would actually demand less of Members and legislative staffers than existing law requires.

But a mere fix to those drafting problems, although crucial to do, would not go far enough. S. 1871 and S. 1903 strive to send the public an important message: that Senators, Representatives, and legislative staffers should not operate under a different set of rules, but should instead be treated the same as all other investors who trade securities in the capital markets. Unfortunately, the statutory prohibition in those bills risks sending an alternative message that is antithetical to the principle of uniform application: Such an explicit statutory prohibition could imply that Rule 10b-5's fiduciary-focused anti-fraud prohibition is hopelessly vague and uncertain as it applies to Congress and federal employees, and hence must be corrected, but that such vagaries and uncertainties are acceptable for all others who trade in the capital markets.

There is, however, an alternative approach that would accomplish S. 1871 and S. 1903's worthy goal – and more – without creating the anomalous and potentially harmful situation of an explicit statutory definition of insider trading for Congress and federal employees, but none for anyone else. On several past occasions, Congress has sought to bring greater coherence, legitimacy, and predictability to the law of insider trading through the enactment of an express statutory definition and prohibition that would apply to all securities traders. The most promising attempts at legislation were untaken in the period preceding the enactment of the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Congress, however, ultimately decided against any explicit statutory prohibition because, in its view, "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."[18]

Yet, these "court-drawn parameters of insider trading" have not proven to be particularly effective when applied to some *nontraditional* insider trading cases. Such cases include those involving trading by non-fiduciary thieves (such as computer hackers

[18] H.R. REP. NO. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048.

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who manage to gain access to confidential information), brazen fiduciaries (who make full disclosure before trading on information misappropriated from their principal and thereby obviate a finding of fraud), and persons who are not in any sense fiduciaries, but who nonetheless may fall within Rule 10b5-1(1)'s prohibition because they are alleged to have breached an arm's-length promise to maintain information in confidence (such as the case involving the governmental affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department, or the case against Mark Cuban, referenced *supra* at footnotes 10 and 12). Moreover, these "court-drawn parameters of insider trading" may not be applied uniformly in cases where there is reason to doubt the fiduciary-like bona fides in a particular relationship (such as in many misappropriation cases involving business associates, family members, and friends, or in the case involving the electrician, discussed *supra*). Indeed, as Professor Thomas Hazen reminds us, without explicit legislation, courts will have no choice but to continue muddling through "the tortuous path of Rule 10b-5 liability for insider trading."[19]

Thus, rather than addressing one manifestation of the problem through legislative efforts such as S. 1871 or S. 1903, Congress could use this current controversy to diagnose and treat the entire malady through the enactment of an express statutory definition and prohibition of insider trading. For example, the proposed Insider Trading Proscription Act of 1987 would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a "person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."[20] Much could be gained from dusting off that proposal and reconsidering it in light of the insider trading jurisprudence that has developed over the last 25 years. Then, as part of this general statutory overhaul, Congress should consider addressing the particular issue of congressional insider trading by including a separate provision in the new statute that would expressly prohibit securities trading based on material nonpublic information learned in the course of congressional service.

Even if Congress is not prepared to take on the task of a general statutory overhaul, there are several legislative responses that would be vastly superior to the lengthy and complicated provisions in S. 1871 and S. 1903. For example, Professor John Coffee has suggested a single sentence statutory prohibition declaring in essence "that a Member of Congress is a fiduciary for purposes of insider trading liability, and that no

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[19] Hazen, *supra* note 5, at 889.

[20] The Insider Trading Proscription Act of 1987, S. 1380, 100th Cong. (1987), reprinted in *SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep (BNA) 1817 (Nov. 27, 1987). The statutory definition of "wrongful" extended to information that "has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship." *Id*

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personal benefit or deceptive act is required to establish liability." Professor Donald Langevoort has proposed an alternative route to an effective congressional insider trading prohibition that would conform with the anti-fraud prohibition applied to the rest of the investing public. My own suggestion is a variation on that route: Congress could instruct the SEC to add a new fourth subsection to the three nonexclusive situations already set out in existing Rule 10b5-2(b) – a new fourth subsection specifying that for purposes of the misappropriation theory, a duty of trust and confidence exists whenever a person is a Member of Congress, federal official, or federal employee and that person has learned material nonpublic information in the course of his or her governmental service. All three of these alternatives would allow Congress to rely substantially on existing case law, but would make unmistakably clear that congressional insider trading constitutes a violation of federal law.

Conclusion

S. 1871 and S. 1903 would explicitly ban some instances of insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and other federal employees. But neither of these bills would do anything to clarify the uncertainty for the millions of other investors who must continue to look to the vicissitudes of a fiduciary-focused anti-fraud prohibition to determine the legality – or illegality – of securities trading based on material nonpublic information.

The record must be made clear that Rule 10b-5 and the federal mail and wire fraud statutes do indeed apply to insider trading by Members of Congress and legislative staffers. The current controversy can then serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. Although S. 1871 and S. 1903 should receive thoughtful consideration in the weeks and months ahead, congressional attention to insider trading in securities should not end there. Instead, these hearings should initiate a serious conversation that could result in a statutory overhaul of the federal law of insider trading. A generally applicable statutory prohibition of insider trading would clarify and simplify the law for all those who trade securities in our capital markets -- from Members of Congress right on down to electricians, business associates, and friends.

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INSIDER TRADING, CONGRESSIONAL OFFICIALS, AND DUTIES OF ENTRUSTMENT

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INTRODUCTION

A few weeks prior to this Conference on Trust and Fiduciary Law in the Twenty-First Century, the *Wall Street Journal* published a front page news article with the headline *Congress Staffers Gain from Trading in Stocks.*[1] The article reported that during the last two years, "[a]t least 72 aides on both sides of the aisle traded shares of companies that their bosses help oversee."[2] One congressional spokesman told the *Journal* that "[c]ongressional staff are often privy to inside information, and an unscrupulous person could profit off that knowledge."[3]

The article was, in many respects, a sequel to a *Journal* article published six years earlier with the headline *U.S. Senators' Stock Picks Outperform the Pros*.[4] That article reported on an academic study finding that, during the 1990s, the stock portfolios of U.S. Senators beat the market by an average of twelve percentage points.[5] The study's authors concluded that the "senators' uncanny ability to know when to buy or sell their shares seems to stem from having access to information that other investors wouldn't have."[6]

The *Journal*'s more recent article on congressional staffers, however, interspersed legal analysis with its factual reporting. That is, the article acknowledged that "[t]he aides identified . . . say they didn't profit by making trades based on any information gathered in the halls of Congress."[7] But the

[1] Brody Mullins et al., *Congress Staffers Gain from Trading in Stocks*, WALL ST. J., Oct. 11, 2010, at A1.

[2] *Id.* (highlighting the *Journal*'s "analysis of more than 3,000 disclosure forms covering trading activity by Capitol Hill staffers for 2008 and 2009").

[3] *Id.* (quoting Vincent Morris, spokesman for Rep. Louise Slaughter (D-N.Y.)) (internal quotation marks omitted).

[4] Jane J. Kim, *U.S. Senators' Stock Picks Outperform the Pros*, WALL ST. J., Oct. 26, 2004, at D2.

[5] *Id.* ("The study's authors, relying on financial-disclosure forms from 1993 to 1998, looked at about 6,000 common-stock transactions of about a third of the senators each year."). The cited study is Alan J. Ziobrowski et al., *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661 (2004).

[6] Kim, *supra* note 4 ("I don't think you need much of an imagination to realize that they're in the know." (quoting Professor Ziobrowski, one of the study's co-authors) (internal quotation marks omitted)).

[7] Mullins et al., *supra* note 1.

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Journal then advanced the claim that "[e]ven if they had done so, it would be legal, because insider-trading laws don't apply to Congress."[8] The *Journal* published a follow-up article the next day highlighting the proposed STOCK Act, an acronym for the Stop Trading on Congressional Knowledge Act.[9] That article noted that the proposed legislation, which had been pending in the U.S. House of Representatives for more than four years, sought to "outlaw insider trading by Capitol Hill members and their staffs."[10] Again, though, the *Journal* followed this fact with the legal conclusion that, in the absence of new legislation, "Congress is immune from insider-trading laws."[11]

The *Journal*'s conclusion about the legality of insider trading by members of Congress and legislative staffers set the blogosphere and mainstream media on fire. Several securities law scholars agreed with the *Journal*'s analysis as it pertained to members of Congress, but disagreed that the conclusion also held true for legislative staffers.[12] Then-Representative Brian Baird, the

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[8] *Id.*

[9] Tom McGinty & Brody Mullins, *Lawmaker Aims to Outlaw Insider Trading on the Hill*, WALL ST. J., Oct. 12, 2010, at A9.

[10] *Id.*

[11] *Id.*

[12] *See, e.g.*, Stephen M. Bainbridge, *More Evidence of Insider Trading Inside the Beltway*, PROFESSORBAINBRIDGE.COM (Oct 11, 2010, 7:32 AM), http://www.professorbainbridge.com/professorbainbridgecom/2010/10/more-evidence-of-insider-trading-inside-the-beltway.html ("The key point is that the staffers have no blanket immunity . . . in the way that members of Congress do."); Thom Lambert, *Does the Insider Trading Ban Apply to Congressional Staffers?*, TRUTH ON THE MARKET (Oct. 11, 2010, 6:22 PM), http://truthonthemarket.com/2010/10/11/does-the-insider-trading-ban-apply-to-congressional-staffers ("I think [the *Journal* article is] assuming that because members of Congress may trade on material, non-public information they learn in the course of their jobs, their aides may do so as well. I don't think that's right."). Professor Bainbridge has analyzed the topic of congressional insider trading in an extensive article. Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011) [hereinafter Bainbridge, *Beltway I*] ("Congressional staffers and other government officials and employees could be prosecuted successfully for insider trading under the federal securities laws, but the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted."); *see infra* notes 171, 180, 186, 312.

Other securities and business law scholars have weighed in on these issues in the past. *E.g.*, RICHARD W. PAINTER, GETTING THE GOVERNMENT AMERICA DESERVES: HOW ETHICS REFORM CAN MAKE A DIFFERENCE 163 (2009) (contending that the current law governing insider trading "may not be sufficiently rigorous to prevent abuses by government officials"); Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 107 (2009) (maintaining that while there is a plausible theory that would render insider trading by members of Congress illegal, a narrower view of the current law might be more likely to prevail); Ziobrowski et al., *supra* note 5, at 676 ("Current law does not prohibit Senators from trading stock on the basis of information acquired in the course of performing their normal Senatorial functions."); *see also* sources cited *infra* note 237. For student-written pieces, see

congressional co-author of the STOCK Act, drew no such distinction between members and staff, and opined that "[t]he public expects us to adhere to at least as high a standard as we impose on other people, and we don't in this case."[13] Former Securities and Exchange Commission (SEC) Chairman Arthur Levitt then entered the fray, lamenting in a broadcast that "members of Congress and their staffs . . . benefit from an exemption that the average investor doesn't benefit from. They're immune from insider trading laws."[14] Media outlets were soon reporting as conventional wisdom that "while insider trading is illegal in the private sector, it is totally legal for government employees to do it" because "[b]asically, Congress passed a law making insider trading illegal for the private sector and exempted itself."[15]

Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 215-17 (2009) (arguing that current law reaches neither members of Congress nor legislative staffers); Andrew George, Short Essay, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL'Y REV. 161, 163 (2008) (arguing that insider trading by members of Congress and legislative staffers is already illegal under the misappropriation theory); Bud W. Jerke, Comment, *Cashing In on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, 158 U. PA. L. REV. 1451, 1458-59 (2010) (arguing that insider trading by congressional officials is most likely not illegal under existing law, but advocating proposals for a change in the law governing congressional ethics rather than an amendment to the federal securities laws); Herbert T. Krimmel, Note, *The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine*, 47 S. CAL. L. REV. 1491, 1492 (1974) (arguing for a broad prohibition under the then-current law).

[13] McGinty & Mullins, *supra* note 9 (quoting Rep. Brian Baird (D-Wash.)).

[14] *Arthur Levitt, Board Member at Bloomberg LP, Talks About the U.S. Financial Services System on Bloomberg Surveillance* (Bloomberg radio broadcast Oct. 13, 2010) (transcript available through Analyst Wire, *available at* 2010 WLNR 20471195). Former SEC Chairman Arthur Levitt considered it "a public outrage" that Congress has yet to adopt proposed legislation that would change the law. *Id.* In his view, the failure to adopt such legislation "condones insider trading" and is "a disgrace for Congress" that "looks terrible for them" because "working on serious legislation dealing with publicly owned companies" and then trading in the shares of those companies is "just a horrible, horrible practice." *Id.* Other former SEC officials have likewise expressed the view that current law does not prohibit insider trading by members of Congress. *See, e.g.*, Brody Mullins, *Bill Seeks to Ban Insider Trading by Lawmakers and Their Aides*, WALL. ST. J., Mar. 28, 2006, at A1 ("If a congressman learns that his committee is about to do something that would affect a company, he can go trade on that because he is not obligated to keep that information confidential . . . . He is not breaching a duty of confidentiality to anybody and therefore he would not be liable for insider trading." (quoting former Associate Director of the SEC Enforcement Division Thomas Newkirk)).

[15] Veronique de Rugy, *If This Were the Private Sector, Those Congressional Staffers Would End Up in Jail*, NAT. REV. ONLINE (Oct. 12, 2010, 5:16 PM), http://www.nationalreview.com/corner/249553/if-were-private-sector-those-congressional-staffers-would-end-jail-veronique-de-rugy. For additional outrage, see, for example, *Insider Trading on Capitol Hill?*, THE WEEK (Oct. 13, 2010, 6:00 AM), http://theweek.com/ article/index/208085/ insider-trading-on-capitol-hill ("[T]he truly disgusting thing is that it is perfectly legal, since

Overlooked in all of the media hullabaloo about so-called "congressional immunity" from the insider trading laws were several critical facts. First and foremost, Congress could not have "exempted itself" from its own insider trading laws because Congress has *never* enacted a federal securities law that explicitly prohibits *anyone* from insider trading. In this respect, the United States stands in contrast with a host of other countries that explicitly prohibit certain persons from trading securities on the basis of material nonpublic information.[16] The law in the United States is far more nuanced because, despite persistent calls for legislation and several abandoned attempts in the late 1980s,[17] Congress has never statutorily defined the offense of insider trading in securities.[18] Rather, Congress has been content to allow insider trading to be prosecuted as a violation of Rule 10b-5, a general antifraud rule which the SEC promulgated pursuant to its authority under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).[19] Rule 10b-5 broadly prohibits fraud and deception "in connection with the purchase or sale of any security,"[20] and violations of the rule may be prosecuted by the SEC as a civil offense or prosecuted by the Department of Justice (DOJ) as a crime.[21] Thus,

insider-trading laws apply to business executives but not to members of Congress or their staffs."); Ann Woolner, *It Isn't Insider Trading When Your Senator Does It*, BLOOMBERG BUSINESSWEEK (Oct. 13, 2010, 9:15 PM), http://www.businessweek.com/news/2010-10-13/it-isn-t-insider-trading-when-your-senator-does-it-ann-woolner.html ("Congress should be ashamed of itself for not passing a law forbidding conduct that is criminal if anyone else does it.").

[16] *See* Marc I. Steinberg, *Insider Trading Regulation – A Comparative Analysis*, 37 INT'L LAW. 153, 162 (2003).

[17] *See infra* notes 34, 36-38, and accompanying text.

[18] Although the federal securities laws do not explicitly prohibit insider trading, Congress has authorized the SEC to pursue stiff civil penalties against those who commit the offense. *See* Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1 (2006) (authorizing the SEC to seek a monetary penalty of up to three times the profit gained or loss avoided for violating the federal securities laws by trading securities while in possession of material nonpublic information). Congress also addressed the topic of insider trading in section 16(b) of the Exchange Act which requires certain corporate insiders to disgorge to the issuer so-called "short-swing" profits made from purchasing and selling an issuer's equity securities within a six-month time frame. 15 U.S.C. § 78p(b). Although one of the purposes of this provision was to prevent the unfair use of confidential corporate information, the provision applies regardless of whether the corporate insider was aware of material nonpublic information at the time of the short-swing trade. *See id.*

[19] 15 U.S.C. § 78j(b).

[20] SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010).

[21] Section 32(a) of the Exchange Act authorizes fines of not more than $5 million and/or imprisonment for not more than twenty years for willful violations of Exchange Act provisions and rules. 15 U.S.C. § 78ff(a). The DOJ may also pursue criminal prosecutions for insider trading under federal statutes prohibiting mail fraud or wire fraud, 18 U.S.C. §§ 1341, 1343 (2006), or under a relatively new federal statute prohibiting fraud in connection with the purchase or sale of securities of public companies, 18 U.S.C. § 1348 (2006)

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with a single exception,[22] insider trading is illegal under the federal securities laws only insofar as it can be deemed a fraudulent practice in violation of Rule 10b-5. The result is that U.S. insider trading law has been almost entirely judge-made, although much of that law has been subsequently codified in additional rules promulgated by the SEC.[23]

The recent outcry over "congressional immunity" from insider trading law likewise ignores the essential body of judicial precedent that has developed over the decades. Since 1980, when the Supreme Court decided *Chiarella v. United States*,[24] insider trading has been viewed as a fraud on the parties to a securities transaction when those parties trade with a person who remains silent about material nonpublic information in breach of a fiduciary-like duty to disclose. Pursuant to this "classical theory," persons who owe duties of trust and confidence to an issuer's shareholders must either disclose all material nonpublic information in their possession or abstain from trading in the issuer's shares.[25] The failure to "disclose or abstain"[26] in such transactions constitutes a violation of Rule 10b-5.[27]

Moreover, since 1997, when it decided *United States v. O'Hagan*,[28] the Court has recognized a second theory under which insider trading can be deemed a violation of Rule 10b-5. Under the "misappropriation theory," fraud occurs when a person owing a fiduciary-like duty to the source of material nonpublic information misappropriates that information by secretly using it to reap personal profits.[29] The misappropriation theory of insider trading liability thus focuses on the relationship of trust and confidence that exists between the securities trader and the source of the material nonpublic information, and regards the source as the person who is defrauded in connection with the securities transaction.[30]

(enacted as part of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 807, 116 Stat. 745, 804).

[22] When insider trading involves material nonpublic information pertaining to a tender offer, a special insider trading rule applies. Once "a substantial step" toward a tender offer has been taken, Rule 14e-3 prohibits trading or tipping by any person in possession of material nonpublic information relating to that tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (2010)

[23] *See infra* note 139 and Part I.B (discussing Rule 10b5-1 and -2).

[24] 445 U.S. 222 (1980).

[25] *Id.* at 227.

[26] *Id.*

[27] *See infra* Part I.A.1.

[28] 521 U.S. 642 (1997).

[29] *Id.* at 652.

[30] *See infra* Part I.A.2.

Professor Tamar Frankel's recent book[31] and earlier writings on fiduciary law and duties of entrustment[32] can help us to see precisely why insider trading by members of Congress and legislative staffers is already illegal under present law and why enactment of the proposed STOCK Act is not only unnecessary, but would also narrow considerably the present law that would apply to their securities transactions in the absence of an explicit statutory prohibition. Drawing from Professor Frankel's extensive work, and from prior applications of fiduciary principles in congressional disciplinary actions and Executive Branch prosecutions of members of Congress for honest-services fraud, this Article argues that members of Congress and legislative staffers owe fiduciary-like duties of trust and confidence to a host of persons including the citizen-investors whom they serve, as well as the federal government, other members of Congress, and government officials outside of Congress who rely on their loyalty and integrity.[33] Based on these duties of entrustment, this Article concludes that congressional officials engage in deception, and therefore violate Rule 10b-5, if they trade securities on the basis of material nonpublic information obtained through congressional service.

A new statute explicitly prohibiting the offense of insider trading would be a very welcome development under the federal securities laws.[34] But almost all instances of real or hypothesized congressional insider trading can fit squarely within either the classical or misappropriation theory paradigms under Rule 10b-5. Given that it has the authority to investigate all instances of possible insider trading in securities, the SEC should be doing more to refute the mistaken view that there is some type of congressional exemption. Indeed, education, rather than prosecution, may be the SEC's most effective enforcement tool. Any legislative change should clarify insider trading law for everyone, and until that time, the current law – with its emphasis on duties of entrustment – works as well for congressional officials as it does for every other person who trades securities in our capital markets.

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[31] TAMAR FRANKEL, FIDUCIARY LAW (2011).

[32] *See* TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD (2006); Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

[33] *See infra* Part III.A.

[34] *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that the federal prohibition of insider trading "has been developed within the framework of federal securities fraud" and concluding that "the resulting case law contains logical as well as interpretive flaws"); Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883, 889 (2010) (contending that "[t]he absence of a clear definition of insider trading under federal securities law has led to hundreds of decisions grappling with the issue" and that, without new legislation, "courts will continue to muddle through the tortuous path of Rule 10b-5 liability for insider trading").

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I. INSIDER TRADING AS A VIOLATION OF SECTION 10(b) AND RULE 10b-5

Almost twenty-five years ago, in the wake of Wall Street scandals involving Ivan Boesky and Michael Milken, among many others,[35] Congress responded to calls for an explicit statutory prohibition of insider trading and considered several specific proposals.[36] The Insider Trading Proscription Act of 1987, for example, would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a "person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."[37] Congress, however, ultimately decided against any explicit statutory prohibition because, in its view, "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."[38]

The "court-drawn parameters of insider trading" that operate today have not changed much from those that engendered congressional confidence in the 1980s, nor has the SEC's resolve to combat illegal insider trading diminished. Today, as in the 1980s, insider trading is usually prosecuted as a violation of Rule 10b-5 under either the classical or misappropriation theory.[39] To the extent that insider trading law has evolved, it has done so largely to expand

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[35] *See* Daniel Hertzberg, *The Informant: How a Bookkeeper for Boesky Helped Bring Down Milken*, WALL. ST. J., Oct. 11, 1990, at A1 (recalling the government prosecution of Boesky, Milken, and Drexel Burnham).

[36] *See* Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 200-02 (1998) (discussing the testimony and debates leading up to the Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, 98 Stat. 1264, and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677); *id.* at 218-28 (analyzing statutory proposals suggested by the ABA's Task Force on the Regulation of Insider Trading as well as by a host of securities law scholars).

[37] The Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong. (1987), *reprinted in SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep (BNA) 1817 (Nov. 27, 1987). The statutory definition of "wrongful" extended to information that:

> has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

Id.

[38] H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048.

[39] *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997) ("The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.").

these paradigms to encompass cases where material nonpublic information has been acquired or used improperly, even in instances where the trader or tipper had not been entrusted with information.[40] Moreover, as in the 1980s, the SEC continues to place a high priority on insider trading investigations and prosecutions. From 2001 through 2006, for example, the SEC's Division of Enforcement initiated more than 300 actions against more than 600 individuals and entities for alleged insider trading.[41] Over that five-year time period, insider trading cases made up about seven to twelve percent of the SEC's filed caseload.[42]

This Part of the Article is divided into three Sections. Section A recounts the judicial development of the classical and misappropriation theories of insider trading and, in so doing, highlights key cases involving persons (including several government officials) who were found liable for violating Rule 10b-5 because of their trading in securities based on material nonpublic information entrusted to them. Section B briefly examines an SEC rule which delineates specific circumstances giving rise to a "duty of trust or confidence" for purposes of the misappropriation theory. Section C discusses other obstacles frequently encountered by the government in prosecuting insider trading as a violation of Rule 10b-5.[43]

A. *The Judicial Development of Insider Trading Law*

1. The Classical Theory

Prior to the Supreme Court's landmark decision in *Chiarella v. United States*,[44] lower courts and the SEC advocated an expansive view of Rule 10b-5 liability that required "anyone in possession of material inside information [to]

[40] For recent cases recognizing Rule 10b-5 liability for insider trading notwithstanding the absence of a fiduciary-like relationship between the trader and the issuer or the source of the information, see SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (holding that a computer hacker would be liable for insider trading under Rule 10b-5 if he obtained material nonpublic information through deceptive means); SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) (holding that a defendant in an arm's-length business relationship with securities issuer could be liable for insider trading under Rule 10b-5 if he traded securities in breach of a promise not to use issuer's material nonpublic information in a securities transaction), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010). For scholarly critiques of these decisions, see sources cited *infra* note 96.

[41] *Illegal Insider Trading: How Widespread Is the Problem and Is There Adequate Criminal Enforcement?: Hearing Before the H. Comm. on the Judiciary*, 109th Cong. 4 (2006) [hereinafter *Hearings on Insider Trading*] (testimony of Linda Thomsen, Director, SEC Division of Enforcement).

[42] *Id.*

[43] Much of the background in Part I is based on the more extensive discussion in RALPH C. FERRARA, DONNA M. NAGY & HERBERT THOMAS, FERRARA ON INSIDER TRADING AND THE WALL §§ 2.01[1]-[3], 2.02[3], 2.02[6] (2010).

[44] 445 U.S. 222 (1980).

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either disclose it to the investing public, or . . . abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[45] The majority in *Chiarella* found this "parity of information" rule too broad because it contradicted the common law doctrine that a person's mere silence about material facts in a business transaction was not fraudulent in the absence of a duty to disclose.[46] In the Court's view, a duty to disclose material facts "arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"[47] Accordingly, under *Chiarella*'s classical theory, a corporate insider's silence about material nonpublic information in a securities transaction violates Rule 10b-5 because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[48]

Three years after deciding *Chiarella*, the Court made considerable use of legal fictions to expand its classical theory beyond traditional insiders (namely, an issuer's officers, directors, and employees) whose silence about material facts in securities transactions may have been (at least arguably) regarded as fraudulent under the common law.[49] In *Dirks v. SEC*,[50] the Court observed that Rule 10b-5's obligation to disclose or abstain extended as well to temporary agents or "constructive insiders" of the securities issuer, such as lawyers, accountants or consultants, who "*become* fiduciaries" of the corporation's shareholders because "they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."[51] The *Dirks* Court further extended the classical theory to trading by so-called tippees of insiders who convey the securities issuer's confidential information in exchange for a personal benefit.[52] As the Court explained, "a tippee *assumes* a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information . . . when the insider has breached his fiduciary duty to the

[45] SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

[46] *Chiarella*, 445 U.S. at 228 ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.").

[47] *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

[48] *Id.*

[49] *But see* A.C. Pritchard, United States v. O'Hagan*: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 26 (1998) (contending that from a doctrinal perspective, the *Chiarella* Court's invocation of the common law of deceit "is strained" because common law fraud required a showing of reliance (which would be impossible to show in open-market transactions on a stock exchange) and would not have recognized a fiduciary duty owed to prospective shareholders).

[50] 463 U.S. 646 (1983).

[51] *Id.* at 655 n.14 (emphasis added).

[52] *Id.* at 659-60.

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shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[53] Thus, even though constructive insiders and tippees stand as strangers to the issuer's shareholders, like traditional insiders, their Rule 10b-5 liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[54]

Although the Court undoubtedly had in mind traditional insiders and temporary agents of the securities issuer (and their tippees) when it framed its classical theory of insider trading liability,[55] its holdings in *Chiarella* and *Dirks* should apply in the context of any fiduciary or other "special relationship" between a securities trader and the issuer's shareholders.[56] Indeed, traditional insiders, constructive insiders, and tippees are hardly the only persons whose "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)."[57] In *Affiliated Ute Citizens v. United States*,[58] for instance, the Court held that two assistant bank managers, who had assumed a fiduciary-like duty to act on behalf of selling stockholders, violated Rule 10b-5 when they purchased stock from those sellers while remaining silent about material facts pertaining to the existence of a secondary market that had priced the stock substantially higher.[59] Moreover, courts, including

[53] *Id.* at 660 (emphasis added). *Dirks*'s discussion of tipper-tippee liability is discussed more extensively *infra* Part III.D.

[54] United States v. Chiarella, 445 U.S. 222, 230 (1980); *see Dirks*, 463 U.S. at 658 ("We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.'" (alterations in original) (quoting *Chiarella*, 445 U.S. at 231 n.14)).

[55] *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 5:2.1 (2d ed. 2008) (depicting a *Chiarella*/*Dirks* "classical special relationship triangle").

[56] *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting) (observing that the majority had predicated insider trading liability on a "special relationship akin to fiduciary duty" (internal quotation marks omitted)); *see also Dirks*, 463 U.S. at 656 n.15 (holding that the mere receipt of nonpublic information from an insider does not create a "special relationship" between the tippee and the issuer's shareholders); *Chiarella*, 445 U.S. at 232-33 (emphasizing that petitioner did not owe securities sellers a disclosure duty because: "He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

[57] *Chiarella*, 445 U.S. at 230.

[58] 406 U.S. 128 (1972).

[59] *Id.* at 153 ("The individual defendants, in a distinct sense, were market makers . . . . This being so, they possessed the affirmative duty under . . . Rule [10b-5] to disclose this fact to the . . . sellers."). In support of this holding, the *Affiliated Ute* Court cited *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). *Affiliated Ute*, 406 U.S. at 153. The Second Circuit had held in *Chasins* that a broker-dealer's "failure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by him, was an omission of material fact in violation of Rule 10b-5." *Chasins*, 438 F.2d at 1172.

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the Supreme Court, have held that anti-fraud provisions in the federal securities law prohibit "scalping" – that is, recommending the purchase of a security without disclosing personal ownership of that same security – in circumstances in which the recommender owes duties of trust and confidence to the recipients of the recommendation.[60] Thus, in the specific context of securities traded on the basis of material nonpublic information, *Chiarella* and *Dirks* affirmed a more general doctrine that Rule 10b-5 is violated whenever a person remains silent about material facts in breach of a fiduciary-like disclosure duty owed to the persons with whom he trades.[61] This general doctrine should apply when congressional officials and other public fiduciaries trade securities on the basis of nonpublic government information.[62]

2. The Misappropriation Theory

After years of acceptance by many federal courts and the SEC, the Supreme Court gave the misappropriation theory of insider trading its ringing endorsement in *United States v. O'Hagan*.[63] As the Court explained, the

[60] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181, 201 (1963) (holding that registered investment advisers engage in fraud and deceit under section 206 of the Investment Advisers Act when they recommend securities to clients without disclosing to them that the adviser also owned the recommended securities); *see also* Zweig v. Hearst Corp., 594 F.2d 1261, 1268 (9th Cir. 1979) ("[O]rdinarily [columnists] have no duty to disclose facts about their personal financial affairs . . . . [but] the defendant assumed those duties when, with knowledge of the stock's market and an intent to gain personally, he encouraged purchases of the securities in the market."); SEC v. Park, 99 F. Supp. 2d 889, 900 (N.D. Ill. 2000) (holding that an internet guru who operated a stock-picking and investment advice website owed fee-paying subscribers a duty of trust and confidence that could render his silence about his intention to sell a fraud in violation of Rule 10b-5). Although the Ninth Circuit decided *Zweig* prior to the Supreme Court's decision in *Chiarella*, the SEC insists that its precedent is still valid because the columnist's Rule 10b-5 disclosure obligation had been predicated on his relationship of trust and confidence with his readers. *Park*, 99 F. Supp. 2d at 899 (considering the SEC's argument and concluding that "*Zweig* still seems to be good law").

[61] In fact, the *Chiarella* Court cited *Affiliated Ute* as authority for its classical theory of insider trading. *Chiarella*, 445 U.S. at 229; *cf.* Moss v. Morgan Stanley Inc., 719 F.2d 5, 11 (2d Cir. 1983) ("[T]he Supreme Court has extended the 'duty of disclosure' requirement to nontraditional 'insiders' – persons who have no special access to corporate information but who do have a special relationship of 'trust' and 'confidentiality' with the issuer or seller of the securities." (citing *Affiliated Ute*, 406 U.S. 128; *Capital Gains*, 375 U.S. 180)).

[62] *See infra* Part III.A.1.b.

[63] 521 U.S. 642, 665 (1997). Prior to the Court's decision in *O'Hagan*, the validity of the misappropriation theory had been accepted by the Second, Third, Seventh, and Ninth Circuits. *See, e.g.*, SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985); United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981). The theory had been rejected by the Fourth Circuit in *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995), and by the Eighth Circuit in *United States v. O'Hagan*, 92 F.3d 612, 620 (8th Cir. 1996), *rev'd*, 521

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misappropriation theory extends Rule 10b-5 to outsiders who lack fiduciary connections with an issuer's shareholders, but who owe fiduciary-like duties to the source of the material nonpublic information used in the securities transaction. Accordingly, the misappropriation theory is premised "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[64]

Based on the statutory text of section 10(b) of the Exchange Act, the Court in *O'Hagan* had little trouble affirming the jury's verdict that the defendant, who had been a partner in a national law firm, had violated Rule 10b-5 by secretly trading the securities of an acquisition target based on material nonpublic information that he had learned from his law firm and its client, which had been planning the hostile acquisition.[65] In the Court's view, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality," satisfies Rule 10b-5's deception requirement because such trading "defrauds the principal of the exclusive use of that information."[66] The Court observed that misappropriators "deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal."[67] The Court also found that this deception satisfies Rule 10b-5's "in connection with" requirement because "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."[68] However, "[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of the information," the Court acknowledged that there would be no liability under Rule 10b-5 "if the fiduciary discloses to the source that he plans to trade on the nonpublic information."[69]

Although the *O'Hagan* Court based its holding on the text of the statute, the Court also grounded the misappropriation theory in the "congressional purposes underlying § 10(b)."[70] As the Court candidly acknowledged, the theory is "well tuned to an animating purpose of the Exchange Act: to ensure honest securities markets and thereby promote investor confidence."[71] Here

U.S. 642 (1997).

[64] *O'Hagan*, 521 U.S. at 652.

[65] *Id.* at 647-48.

[66] *Id.* at 652.

[67] *Id.* at 653-54 (alteration in original) (citations and internal quotation marks omitted).

[68] *Id.* at 655-56.

[69] *Id.* at 655. Here the Court emphasized two additional points: first, despite disclosure, a "fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty;" and second, when a person owes a fiduciary-like duty to two entities, disclosure to one but not the other would not absolve misappropriation theory liability. *Id.* at 655 & n.7.

[70] *Id.* at 659.

[71] *Id.* at 658.

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the Court observed that while "informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."[72] The SEC and Congress have also advanced these same policy arguments to justify rigorous federal regulation of insider trading.[73] Market integrity and investor confidence-based rationales have, however, generated a spirited debate among securities law scholars that has lasted for decades.[74]

The Court in *O'Hagan* emphasized that the misappropriation theory "is limited to those who breach a recognized duty."[75] But *O'Hagan*'s particular facts may have caused it to skimp a bit in describing the precise contours of the relationship that triggers the disclosure obligation essential to the theory. The defendant in *O'Hagan* was an attorney who clearly stood in a fiduciary relationship with both his law firm and its client.[76] Accordingly, the Court simply assumed that the defendant-attorney owed both his firm and its client a fiduciary duty that was breached when he used their information in securities trading without first informing them of his intention to do so.

Yet the Court in *O'Hagan* never implied – let alone stated – that a relationship had to be strictly a "fiduciary" one for a disclosure duty to attach under the misappropriation theory. Rather, reflecting the practice of lower courts applying the misappropriation theory,[77] the Court used the term "fiduciary duty" interchangeably with a "duty of trust and confidence."[78] This

[72] *Id.*

[73] *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,859 (proposed Dec. 20, 1999) [hereinafter SEC Proposing Release] ("We have long recognized that the fundamental unfairness of insider trading harms not only individual investors, but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets."); *infra* note 192 and accompanying text (quoting congressional statement that insider trading by temporary or constructive insiders "undermines confidence in the markets in the same manner as trading by corporate insiders").

[74] For an extensive review of the vast scholarly literature on the detriments and benefits of insider trading, see 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION §§ 1:2-1:6 (2010), and WANG & STEINBERG, *supra* note 55, §§ 2:1-2:4. A "protection of property rights" rationale for the federal insider trading prohibition is discussed *infra* note 284.

[75] *O'Hagan*, 521 U.S. at 666.

[76] *Id.* at 653 (discussing defendant's breach of fiduciary duty to his law firm and its client).

[77] *See, e.g.*, SEC v. Clark, 915 F.2d 439, 447 (9th Cir. 1990) ("The common-sense notion underlying the misappropriation theory is that one who misappropriates valuable information for his own benefit, in breach of a fiduciary or similar duty of trust and confidence, has surely committed fraud on the person or entity to whom that duty is owed.").

[78] *See O'Hagan*, 521 U.S. at 653 ("[T]he indictment alleged that O'Hagan [traded

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more flexible phraseology is consistent with the Court's insistence in *Chiarella* that common law disclosure duties were predicated on "a fiduciary or other similar relation of trust and confidence."[79] The *O'Hagan* Court's citation to the obligations reflected in sections 390 and 395 of the Restatement (Second) of Agency serves as further evidence that the Court envisioned "the recognized duty" as a broad one.[80]

Both before and after *O'Hagan*, the SEC and most lower courts have been inclined to view the disclosure obligation at the heart of the misappropriation theory quite expansively. To be sure, the overwhelming number of decisions and settlements imposing Rule 10b-5 liability under the misappropriation theory involve relationships that are quintessentially fiduciary or their "functional equivalent,"[81] such as employer-employee,[82] principal-agent,[83]

Pillsbury stock] in breach of a duty of trust and confidence he owed to his law firm . . . and to its client.").

[79] Chiarella v. United States, 445 U.S. 222, 228 (1980).

[80] *See O'Hagan*, 521 U.S. at 654-55; RESTATEMENT (SECOND) OF AGENCY § 390 (1958) ("[An agent has] a duty to deal fairly with the principal and to disclose to him all facts which the agent knows or should know would reasonably affect the principal's judgment."); *id.* § 395 ("[A]n agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury at the principal."); Pritchard, *supra* note 49, at 15 (contending that the Court in *O'Hagan* "breaks new ground in establishing a foundation for insider trading based on common law agency principles").

[81] *See* United States v. Chestman, 947 F.2d 551, 567-68 (2d Cir. 1991) (en banc) (observing that "the common law has recognized that some associations are inherently fiduciary" including such "hornbook fiduciary relations [as] those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder" and concluding that disclosure duties also apply to their "function equivalent[s]"). The court in *Chestman* also observed that all of the Rule 10b-5 circuit precedents under the misappropriation theory at that time "involved egregious fiduciary breaches arising solely in the context of employer/employee associations." *Id.* at 567.

[82] *See, e.g.*, *Clark*, 915 F.2d at 453 ("[A]n employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10b-5."); Carpenter v. United States, 791 F.2d 1024, 1026 (2d Cir. 1986) (holding that a reporter defrauded his *Wall Street Journal*-employer and violated Rule 10b-5 when he tipped stockbroker friends as to the contents of upcoming financial columns), *aff'd by a divided court*, 484 U.S. 19 (1987) (4-4 decision); SEC v. Musella, 578 F. Supp. 425, 439 (S.D.N.Y. 1984) (stating that law firm's office services manager breached duty to law firm and law firm's clients by tipping material nonpublic information he learned during employment), *aff'd*, 898 F.2d 138 (2d Cir. 1990).

[83] *See, e.g.*, SEC v. Materia, 745 F.2d 197, 199 (2d Cir. 1984) (holding an employee of a financial printer liable under Rule 10b-5 for tipping information the printing company had acquired in confidence from its clients); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (holding that employees at two investment banks violated Rule 10b-5 when they

attorney-client,[84] and doctor-patient.[85] But insider trading cases prosecuted under the misappropriation theory sometimes fall outside of these well-recognized categories and courts must then engage in ad hoc inquiries to determine whether the trader (or tipper) and the source of the information stand in a relationship of trust and confidence that renders the failure to disclose the use of material nonpublic information a fraud on the source in violation of Rule 10b-5.

In determining whether a professional, social, or familial relationship is one of trust and confidence for purposes of the misappropriation theory, courts generally look to the "reasonable and legitimate" expectations of the parties and question whether those parties had "a history or practice of sharing business confidences, [and whether] those confidences were generally maintained."[86] More controversially, courts have also recognized a relationship of trust and confidence when the trader or tipper has "expressly agreed" to keep the source's information confidential.[87] Based on such ad hoc inquiries, Rule 10b-5 liability has been imposed in cases involving: family members who traded on (or tipped) information misappropriated from their spouses and relatives;[88] participants in private placements who traded

tipped material nonpublic information that had been entrusted to their employer by clients of the banks).

[84] *See, e.g.*, *O'Hagan*, 521 U.S. at 653; United States v. Grossman 843 F.2d 78, 84 (2d Cir. 1988) (affirming conviction under Rule 10b-5 where associate at law firm both traded on the basis of confidential client information and tipped relatives who subsequently traded).

[85] *See, e.g.*, United States v. Willis, 778 F. Supp. 205, 209 (S.D.N.Y. 1991) (denying psychiatrist's motion to dismiss insider trading indictment because "[t]he relationship between a psychiatrist and patient has all the characteristics of what the [Second Circuit] calls a 'paradigmatic fiduciary relationship'" (quoting *Chestman*, 947 F.2d at 569)).

[86] SEC v. Yun, 327 F.3d 1263, 1272-73 (11th Cir. 2003).

[87] *See, e.g.*, SEC v. Nothern, 598 F. Supp. 2d 167, 175 (D. Mass. 2009) (holding that the SEC's allegation that tipper had "expressly agreed to maintain the confidentiality of . . . information is sufficient to state a claim that he had a similar relationship of trust and confidence" (internal quotation marks omitted)); SEC v. Lyon, 529 F. Supp. 2d 444, 452 (S.D.N.Y. 2008) (refusing to dismiss charges of insider trading because the SEC alleged specific facts evidencing that defendant had expressly agreed to keep information confidential). For contrary conclusions reached by courts and commentators, see *infra* notes 114, 121-128 and accompanying text.

[88] *See* SEC v. Rocklage, 470 F.3d 1, 12 (1st Cir. 2006) (stating that the SEC could show that wife deceived husband when she allowed him to share business confidences without informing him of a pre-existing agreement with her brother to share any significant information about the husband's company); *Yun*, 327 F.3d at 1273-74 ("[T]he SEC provided sufficient evidence both that an agreement of confidentiality and a history or pattern of sharing and keeping of business confidences existed between [husband and wife]."); United States v. Reed, 601 F. Supp. 685, 718 (S.D.N.Y. 1985) (holding that government may prove at trial "that Reed and his father were bound by an agreement or understanding of confidentiality, express or implied, or that some regular pattern of behavior by defendant

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securities in the public markets based on the confidential information to which they were given access;[89] an electrician who traded on information that he overheard while at a company repairing its wiring;[90] a member of a business roundtable who traded on information conveyed by a fellow member;[91] a businessman who traded on information entrusted to him by his business partner;[92] a bank that traded corporate bonds based on nonpublic information obtained through service on six bankruptcy creditors' committees;[93] a juror who tipped confidential information obtained from his service on a grand jury;[94] and a government affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department.[95] To be sure, several securities law scholars (including this Author) have criticized some of these precedents for stretching too far the relationship of trust and confidence parameters that were drawn by the Court in *Chiarella*, *Dirks*, and *O'Hagan*.[96]

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and his father generated on the part of those two men a justifiable expectation of confidentiality and fidelity"), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); LANGEVOORT, *supra* note 74, § 11:8 n.14 (citing SEC settlements in "gray areas" of liability such as those involving alleged insider trading by in-laws and a live-in non-marital partner). *But see infra* notes 109-113 and accompanying text.

[89] *See Lyon*, 529 F. Supp. 2d at 452 (concluding that the SEC's complaint "plausibly support[s] its claim that a confidential relationship arose between defendants and those four PIPE issuers"); FERRARA ET AL., *supra* note 43, § 2.08[4] (discussing SEC settlements imposing Rule 10b-5 liability in the context of PIPE (private investment in public equity) transactions). *But see infra* notes 124-128 and accompanying text.

[90] SEC v. Falbo, 14 F. Supp. 2d 508, 522-24 (S.D.N.Y. 1998) (holding that although he was not a traditional fiduciary, an electrical contractor nonetheless was placed "in a position of trust and confidence" that he violated when he "used for personal benefit information obtained during the course of his association").

[91] SEC v. Kirch, 263 F. Supp. 2d 1144, 1150 (N.D. Ill. 2003) (concluding that roundtable members had an express, unwritten policy of keeping shared information confidential and thus owed a duty of trust and confidence to each other). *But see infra* note 114.

[92] SEC v. Peters, 735 F. Supp. 1505, 1521 (D. Kan. 1990) (holding that the "partnership expected that all business matters of each partner would be held in trust and confidence"), *rev'd on other grounds*, 978 F.2d 1162 (10th Cir. 1992).

[93] Barclays Bank PLC, Litigation Release No. 20132, 90 SEC Docket 1999 (May 30, 2007) (announcing settlement whereby defendant agreed to pay $10.9 million to settle charges of insider trading).

[94] *See* John Herzfeld, *Crime: Grand Juror Sentenced to Prison for Leaks to Insider Trading Ring*, 38 Sec. Reg. & L. Rep. (BNA) No. 49, at 2098 (Dec. 18, 2006) (reporting that a former postal worker, who had been serving on a grand jury investigating Bristol-Myers, pleaded guilty to conspiracy, insider trading, and criminal contempt for tipping information about that probe to two former employees of Goldman Sachs).

[95] Davis, Litigation Release No. 18322 (Sept. 4, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18322.htm (announcing guilty plea and civil settlement with the SEC); *see also* SEC v. Nothern, 598 F. Supp. 2d 167, 173 (D. Mass. 2009) (denying summary judgment motion brought by one of the consultant's tippees).

[96] *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*,

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But the fact remains that the SEC and the DOJ have been consistent, and for the most part successful, in advancing a strikingly broad view as to what it means to be entrusted with material nonpublic information for purposes of the Rule 10b-5 insider trading prohibition.

Misappropriation theory cases involving "hornbook fiduciary relations"[97] such as employment, including government employment, typically do not involve the same ad hoc focus on the source's "reasonable and legitimate" expectations of confidentiality that is the norm in cases involving family members, businesspersons, and the like. Instead, as with other employer-employee cases,[98] in insider trading prosecutions brought against government officials, courts simply assume without question that those officials breached fiduciary duties when they used material nonpublic information obtained through government service for securities trading purposes, or when they tipped others who used that information to trade.[99] Notable Rule 10b-5 prosecutions have involved securities trading or tipping by federal officials at the Federal Bureau of Investigation (FBI),[100] the Federal Reserve,[101] the

94 IOWA L. REV. 1315, 1363-64 (2009) (arguing that several recent cases and SEC settlements reflect an evolving view that the offense of insider trading involves the wrongful use of material nonpublic information regardless of whether the trader or tipper breaches a fiduciary-like duty owed to the issuer's shareholders or the source of the information); *see also* Amended Brief of Amici Curiae in Support of Defendant's Motion to Dismiss at 1-2, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08-cv-02050), 2009 WL 1257407 [hereinafter Amended Brief of Amici Curiae] (submitted by Professors Allen Ferrell, Stephen Bainbridge, Alan R. Bromberg, M. Todd Henderson, and Jonathan R. Macey, arguing that "[u]nder both state and federal common law, a confidentiality agreement alone creates only an obligation to maintain the secrecy of the information, not a fiduciary or fiduciary-like duty to act loyally to the source of the information"); STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 83 n.33 (2d ed. 2007) (criticizing the results-oriented nature of the "trust and confidence" phraseology because "[i]f a court wishes to impose liability, it need simply conclude that the relationship in question involves trust and confidence, even though the relationship bears no resemblance to those in which fiduciary-like duties are normally imposed").

[97] *See* SEC v. Chestman, 947 F.2d 551, 567-68 (2d Cir. 1991) (en banc).

[98] *See* sources cited in *supra* note 82.

[99] Many federal agencies and executive departments also operate under specific statutes and rules prohibiting officials from using and/or disseminating nonpublic government information for nongovernmental purposes. *See* PAINTER, *supra* note 12, at 63-65 (discussing the U.S. Department of the Treasury and observing that "Congress, for over 200 years, has been adding piecemeal statutory provisions in response to conflicts of interest in particular agencies").

[100] United States v. Royer, 549 F.3d 886, 890 (2d Cir. 2008) (affirming former FBI special agent's Rule 10b-5 conviction and six year prison sentence for tipping others who traded securities based on material nonpublic information obtained from law enforcement databases).

[101] *See* Blyth & Co., 43 S.E.C. 1037, 1039 (1969) (holding brokerage firm employees liable under Rule 10b-5 for trading on material nonpublic information about an upcoming

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Department of the Navy,[102] and the Comptroller of the Currency.[103] State officials have also been prosecuted under Rule 10b-5 for trading securities on the basis of nonpublic information obtained through government service.[104] Other decisions have held government officials or their tippees liable for defrauding the government when entrusted information was misappropriated for personal profit in the securities market,[105] the commodities market,[106] or in

issuance of government securities that had been tipped to them by a manager of the Bond and Custody Department of the Federal Reserve Bank of Philadelphia); *Shift by U.S. in Insider Case*, N.Y. TIMES, Aug. 30, 1989, at D12 (reporting that Robert Rough, a former director of the New York Federal Reserve Bank, admitted that he regularly disclosed nonpublic information about the Fed's discount rate to a securities brokerage firm, and that in exchange for Rough's plea to one count of bank fraud, "the Government agreed to drop six other counts, including insider trading and . . . agreed to recommend a prison sentence of less than a year."); *see also Fed Ex-Official Gets 6 Months*, N.Y. TIMES, Sept. 14, 1989, at D7 (reporting Rough's sentence of six months in prison and 200 hours of community service during two years of probation).

[102] Saunders, Litigation Release No. 9744, 26 SEC Docket 75 (Sept. 2, 1992) (announcing guilty plea and the settlement of civil charges in Rule 10b-5 case against civilian employed by Navy who had purchased shares in a company that was about to be awarded a government contract); Mills, Litigation Release No. 11877, 41 SEC Docket 1257 (Sept. 28, 1988) (discussing an independent consultant hired by the Navy who settled Rule 10b-5 charges that he purchased shares of a company based on the material nonpublic information that the company's bid for a Navy contract was favored over its competitor's bid).

[103] Acree, Litigation Release No. 14231, 57 SEC Docket 1579 (Sept. 13, 1994) (discussing a former employee of the Office of the Comptroller of the Currency who settled Rule 10b-5 charges that he traded in securities of several bank holding companies while in possession of material nonpublic information which he misappropriated from the OCC).

[104] United States v. Bryan, 58 F.3d 933, 936 (4th Cir. 1995) (reversing Rule 10b-5 conviction of the former Director of the state-owned West Virginia Lottery who had used material nonpublic information to purchase securities in issuers about to be awarded government contracts, but affirming the Director's conviction under the federal wire fraud statute for the same conduct). The Fourth Circuit's finding that Rule 10b-5 liability could not be premised on the misappropriation theory was itself overturned with the Supreme Court's decision in *O'Hagan*, 521 U.S. 642, 650 (1997). For additional discussion of the Fourth Circuit's wire fraud holding in *Bryan*, see *infra* notes 277-280 and accompanying text. For a related prosecution of a second defendant, see *United States v. ReBrook*, 842 F. Supp. 891, 892 (S.D. W. Va. 1993) (affirming jury verdict finding violations of Rule 10b-5 and the federal wire fraud statute by an attorney with the state-owned West Virginia Lottery who had used material nonpublic information to purchase securities in issuers who were about to be awarded government contracts), *aff'd in part, rev'd in part*, 58 F.3d 961, 963 (4th Cir. 1995) (affirming wire fraud ruling but reversing Rule 10b-5 ruling that had been premised on the misappropriation theory).

[105] United States v. Peltz, 433 F.2d 48, 49 (2d Cir. 1970) (affirming defendant's conviction for "conspir[ing] with others, including an employee of the SEC, to obtain confidential inside information about matters under consideration by the Commission and use such information for private profit"). For a fascinating discussion of a dismissed

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real estate transactions.[107] Accordingly, at least at first blush, insider trading by members of Congress and legislative staffers would seem to fit squarely within these other government official precedents.[108]

B. *SEC Rule 10b5-2*

As the foregoing has explained, when confronted with non-traditional fiduciary relationships, the SEC and most lower courts have taken an expansive view of the circumstances under which a securities trader (or tipper) and the source of material nonpublic information can be said to be in a relationship of trust and confidence for purposes of the misappropriation theory. The Second Circuit's *en banc* decision in *United States v. Chestman*[109] constitutes a notable exception. The *Chestman* court reversed the defendant's conviction under Rule 10b-5 because, in the court's view, the government did not sustain its burden of proving a sufficient fiduciary-like relationship between the tipper and the source of the information.[110] Although the tipper was married to the source, and the information was imparted in confidence, the Second Circuit reasoned that "marriage does not, without more, create a fiduciary relationship"[111] and that "a fiduciary duty cannot be imposed

conspiracy prosecution against a law clerk to Supreme Court Justice Joseph McKenna for allegedly tipping others who traded securities based on information pertaining to an unreleased decision, see John B. Owens, *The Clerk, the Thief, His Life as a Baker: Ashton Embry and the Supreme Court Leak Scandal of 1919*, 95 NW. U. L. REV. 271, 272 (2000). As Owens explains it, the prosecution was dismissed even though an indictment against the law clerk had been upheld by the Court of Appeals of the District of Columbia and a writ of certiorari had been denied by the Supreme Court. *See id.* at 297-98 (citing Embry v. United States, 257 U.S. 655 (1921)). Owens maintains that the DOJ's official files "remain eerily quiet on the subject, containing no notes or memoranda explaining why the U.S. Attorney dismissed the case." *Id.* at 297.

[106] Haas v. Henkel, 216 U.S. 462, 472 (1910); Peckham v. Henkel, 216 U.S. 483, 484 (1910); Price v. Henkel, 216 U.S. 488, 494 (1910). The *Haas* Court observed that the conspiracy was to obtain crop reports from a statistician in the Department of Agriculture

> in advance of general publicity and to use such information in speculating upon the cotton market, and thereby defraud the United States by defeating, obstructing and impairing it in the exercise of its governmental function in the regular and official duty of publicly promulgating fair, impartial and accurate reports concerning the cotton crop.

Haas, 216 U.S. at 478.

[107] United States v. Keane, 522 F.2d 534, 561 (7th Cir. 1975) (affirming conviction of city councilman under conspiracy and mail fraud statutes for conduct including the purchase of tax delinquent properties based on nonpublic information).

[108] *See infra* Part III.A.2.a.

[109] United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc).

[110] *Id.* at 554.

[111] *Id.* at 568. The court reasoned that "[a] similar relationship of trust and confidence . . . must be the functional equivalent of a fiduciary relationship." *Id.* (internal quotation marks omitted).

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unilaterally by entrusting a person with confidential information."[112] Rather, as the Second Circuit saw it:

> A fiduciary relationship involves discretionary authority and dependency: One person depends on another – the fiduciary – to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. . . . These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.[113]

Other courts have emphasized the *Chestman* court's characterization of a fiduciary[114] as one who acts for "the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part."[115]

The SEC promulgated Rule 10b5-2 in direct response to what it viewed as *Chestman*'s unduly narrow parameters[116] and its failure to "sufficiently protect investors and the securities markets from the misappropriation and resulting misuse of inside information."[117] The rule bears the caption, "Duties of trust or

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[112] *Id.* at 567.

[113] *Id.* at 569.

[114] *See, e.g.*, United States v. Falcone, 257 F.3d 226, 234-35 (2d Cir. 2001) ("[Fiduciary] relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information." (citing *Chestman*, 947 F.2d at 568-69)) For cases citing *Chestman* as a reason for declining to find a fiduciary-like relationship for purposes of the misappropriation theory, see *United States v. Cassese*, 273 F. Supp. 2d 481, 485 (S.D.N.Y. 2003) (emphasizing that the business competitors were "not inherent fiduciaries, but rather potential arms-length business partners . . . [who] did not have a long-standing relationship or . . . regularly shared confidences," and concluding that "[t]his is very far from a relationship marked by 'de facto control' and 'dominance' or entailing 'discretionary authority and dependency'" (quoting *Chestman*, 947 F.2d at 568-69)), and *United States v. Kim*, 184 F. Supp. 2d 1006, 1008-09 (N.D. Cal. 2002) (holding that a member of the Young Presidents Association, a national organization of company presidents under the age of fifty, did not owe a duty of trust or confidence to fellow club member, notwithstanding the club's written requirement that all members must comply with a confidentiality agreement).

[115] *Chestman*, 947 F.2d at 568-69.

[116] *See* SEC Proposing Release, *supra* note 73, at 82,863 ("[T]he *Chestman* majority's approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.").

[117] *See id.*

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confidence in misappropriation insider trading cases,"[118] and as its preliminary note explains that the rule provides a non-exclusive list of three situations in which a person has "a duty of trust or confidence" for purposes of the misappropriation theory.[119] The three situations enumerated in Rule 10b5-2(b) include:

> (1) Whenever a person agrees to maintain [that] information in confidence;
>
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
>
> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential . . . .[120]

Accordingly, had Rule 10b5-2(b)(3) been in place at the time of the *Chestman* defendant's alleged violations, it may have changed the result.

But it is the first subsection of Rule 10b5-2(b) that has received the bulk of attention from commentators and courts. Several securities law scholars (this Author among them) have questioned whether the SEC can expand the misappropriation theory to encompass the mere breach of a confidentiality agreement notwithstanding the absence of a fiduciary or similar relationship of trust and confidence between the trader and the information's source.[121] Agreements to maintain the confidentiality of information may be entered into by persons owing duties of trust and confidence to the source (and may thus confirm a duty otherwise inherent in that relationship). But confidentiality

[118] SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2010).

[119] *Id.* at Preliminary Note.

[120] *Id.* § 240 10b5-2(b)(1)-(3).

[121] *See* Nagy, *supra* note 96, at 1357-64 (questioning the validity of Rule 10b5-2(b)(1) and observing that the rule phrases the requisite duty in the disjunctive (trust or confidence) whereas the Supreme Court has always referred to the duty in the conjunctive (trust and confidence)); *see also* Amended Brief of Amici Curiae, *supra* note 96, at 1-2 (arguing for the invalidity of Rule 10b5-2 insofar as it provides for liability under the misappropriation theory based on the mere breach of a confidentiality agreement); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1422 (2002) ("[E]xtending securities liability to any relationship where 'a person agrees to maintain information in confidence' extends the boundaries well beyond fiduciary relationships." (quoting SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2)).

agreements may also arise in the course of an arm's-length business transaction without any concomitant obligation of trust or loyalty.[122]

Although several courts have discussed Rule 10b5-2(b)(1) in their decisions under the misappropriation theory,[123] the court in *SEC v. Cuban*[124] was the first to directly confront that rule's validity. In so doing, the court concluded that "an express or implied promise merely to keep information confidential" does not, standing alone, create a duty of disclosure for purposes of the misappropriation theory.[125] It thus held Rule 10b5-2(b)(1) invalid to the extent that it purports to create such a duty.[126] But the court also recognized that "a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship," provided that the agreement goes beyond the mere promise of confidentiality to "impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain."[127] In the court's view, only then is a non-fiduciary's "subsequent undisclosed use of the information for securities trading purposes . . . deceptive under § 10(b) and Rule 10b-5."[128] The Fifth Circuit did nothing to disturb the district court's holding on appeal, but it nonetheless vacated the judgment for dismissal and remanded the case. On its reading of the SEC's complaint, there was "more than a plausible basis" to find that the defendant had promised not to use the confidential information that had been conveyed to him.[129]

C. *Other Obstacles in Prosecuting Insider Trading Cases*

In many insider trading cases, establishing a fiduciary-like relationship of trust and confidence between the defendant and the issuer's shareholders or the source of the information may be the easiest step in the government's prosecution under Rule 10b-5. The government, however, may encounter other obstacles in establishing all of the elements necessary to prove that Rule 10b-5 has been violated. In a civil prosecution, the SEC must establish these

[122] *See* Nagy, *supra* note 96, at 1362 ("[A]n agreement not to share information with third parties is analytically distinct from a fiduciary obligation not to take advantage of that information in one's personal securities trading over a stock exchange.").

[123] *See, e.g.*, SEC v. Nothern, 598 F. Supp. 2d 167, 175 (D. Mass. 2009); Nagy, *supra* note 96, at 1363 n.274 (citing cases discussing Rule 10b5-2(b)(1) in misappropriation theory decisions).

[124] SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. 2010).

[125] *Id.* at 725 (stating that there must be an accompanying promise not to use "the information for personal gain").

[126] *Id.*

[127] *Id.*

[128] *Id.* at 726.

[129] SEC v. Cuban, 620 F.3d 551, 557 (5th Cir. 2010).

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elements by a preponderance of the evidence, whereas in a criminal prosecution, the DOJ must prove its case beyond a reasonable doubt.[130]

Regardless of whether an insider trading case is prosecuted under the classical or the misappropriation theory, the government must prove that the information at issue was both nonpublic and material. Information is considered "nonpublic" if it is not generally available to the investing public. That is, information becomes public when it has been disclosed "to achieve a broad dissemination to the investing public generally"[131] or when, although it is known only by a few persons, their trading on the basis of it "has caused the information to be fully impounded into the price of the particular stock."[132] These tests, however, have been criticized for their failure "to provide businesses with certainty, the law with clarity, the market with confidence, and the layman with guidance."[133] Information is considered "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.[134] Moreover, when information is "soft" or contingent, its materiality is to be judged by "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event" in light of the totality of facts and circumstances.[135] Yet, notwithstanding the breadth of these definitions, both courts and the SEC have acknowledged that securities traders generally, and analysts in particular, should remain free to "piece seemingly inconsequential data together with public information into a mosaic"[136] which only becomes "material after the bits and pieces are assembled into one picture."[137] Whether a nonpublic fact is material or whether it is merely inconsequential data contributing to a mosaic is often a difficult question.[138]

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[130] *See* DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 13 (2d ed. 2008).

[131] Dirks v. SEC, 463 U.S. 646, 653 n.12 (1983).

[132] United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).

[133] J. Scott Colesanti, *"We'll Know It When We Can't Hear It": A Call for a Non-Pornography Test Approach to Recognizing Non-Public Information*, 35 HOFSTRA L. REV. 539, 539 (2006).

[134] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

[135] *Id.* at 238 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

[136] Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

[137] Dirks, Exchange Act Release No. 17480, 21 SEC Docket 1401, 1409 (Jan. 22, 1981) ("We have long recognized that an analyst may utilize nonpublic, inside information which in itself is immaterial in order to fill in interstices in analysis. That process is legitimate . . . ." (internal quotation marks omitted)), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

[138] *See* Joan Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1138-39 (2003) ("The facial simplicity of the basic legal standard governing materiality masks the complexities encountered by transaction planners, litigants, the SEC, the [DOJ], and courts in interpreting and applying that standard.

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Rule 10b-5 cases prosecuted under the misappropriation theory present their own unique challenges. Because the theory is premised on a defendant's use of material nonpublic information that had been entrusted to him by its source, the government has the burden of establishing that the defendant actually used that information in making his decision to trade.[139] Often, defendants in insider trading cases will deny their awareness of material nonpublic information at the time of a securities trade[140] or defendants will claim that their reason for trading was completely unrelated to the information in their possession.[141] Such misappropriation cases rarely involve a smoking gun.[142] Accordingly, the government generally must rely on circumstantial evidence to establish that the defendant was aware of material nonpublic information and then used that information in a securities transaction for personal profit.[143]

Finally, in all insider trading cases, the government must prove that the defendant acted with scienter, a "mental state embracing intent to deceive, manipulate or defraud."[144] Assuming that the government has established a disclosure duty based on a fiduciary-like relationship of trust and confidence, the additional element of scienter is generally established through evidence showing that the defendant knew, or was reckless in not knowing, that the information on which he was trading was both material and nonpublic.[145]

The interpretation and application of the materiality standard are highly fact-dependent and do not always produce predictable or certain planning options or judicial results.").

[139] Although SEC Rule 10b5-1 specifies that a securities transaction is made "on the basis of material nonpublic information about that security" if the person making the purchase or sale was "aware" of that information at the time of the trade (subject to three narrow affirmative defenses), 17 C.F.R. § 240.10b5-1 (2010), it is unlikely that the Rule's presumption of use from possession could apply where the Rule 10b-5 violation is premised on the defendant's use of material nonpublic information under the misappropriation theory. *See* Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1147 & n.88 (1999) (arguing that without proof of the defendant's use of information, there would be no misappropriation and thus no concomitant duty to disclose under Rule 10b-5).

[140] *See* Frank C. Razzano, *Insider Trading . . . or Not? Lessons Learned From an Acquittal*, 15 BUS. L. TODAY 34, 39 (2006) (discussing the "leakage" defense for denying knowledge of nonpublic information).

[141] *See, e.g.*, SEC v. Alder, 137 F.3d 1325, 1328 (11th Cir. 1998) (discussing defendant who claimed his sales of stock were preplanned and not based on his use of material nonpublic information).

[142] *See Hearings on Insider Trading*, *supra* note 41, at 5 (discussing the inability to take further action because of a lack of necessary evidence).

[143] *See* Razzano, *supra* note 140, at 41 (acknowledging that "ambiguous circumstances and trading may often be transformed by the prosecution into circumstantial evidence of insider trading," but emphasizing that "[t]he job of defense counsel is to take those same circumstances and present the jury with an equally plausible and believable story consistent with innocence").

[144] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

[145] NAGY ET AL., *supra* note 130, at 552.

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Proof that the defendant was merely negligent in failing to recognize that the information was material and nonpublic is not sufficient for liability to attach under Rule 10b-5.[146]

II. THE STOP TRADING ON CONGRESSIONAL KNOWLEDGE (STOCK) ACT

Part III of this Article makes an explicit and extensive case for why insider trading by members of Congress and legislative staffers breaches duties of trust and confidence and why it is thus already illegal under the classical and misappropriation theories of Rule 10b-5 liability. Before making that case, however, this Part briefly examines proposed legislation and highlights some of its shortcomings.

A. *The Proposed Legislation*

Convinced that current law contains an "insider trading loophole" for congressional officials[147] and that it is thus "perfectly legal to profit from information obtained within the Congress,"[148] U.S. Representatives Brian Baird (D-Wash.) and Louise M. Slaughter (D-N.Y.) introduced legislation in 2006 to "prohibit Members and employees of Congress from profiting from nonpublic information they obtain in their official positions."[149] Representative Slaughter's press release announcing the legislation posits this specific example:

> Congressman B learns that the Chairman of the Appropriations Committee has decided to provide a multi-million dollar defense contract for Company A in the Defense Appropriations bill. This information has not been released to the public, but will almost certainly drive Company A's stock price up when it becomes public knowledge. Congressman B buys stock in Company A. **THIS IS NOT ILLEGAL UNDER CURRENT INSIDER TRADING LAWS, AND IS WHAT THE LEGISLATION ADDRESSES.**[150]

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[146] *See id.*

[147] *Preventing Unfair Trading by Government Officials: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 111th Cong. 4 (2009) [hereinafter *Hearings on Unfair Trading*] (statement of Rep. Louise Slaughter).

[148] *Rep. Baird, Slaughter Seek Capitol Hill Insider Trading Ban*, U.S. FED. NEWS, Mar. 28, 2006 [hereinafter *Baird March 2006 Press Release*], *available at* 2006 WLNR 5302281.

[149] *Id.*

[150] Press Release, Rep. Louise M. Slaughter (D-N.Y.), STOCK Act Fact Check, CONGRESSWOMAN LOUISE M. SLAUGHTER (Mar. 3, 2006), http://www.louise.house.gov/index.php?option=com_content&task=view&id=433&Itemid=106 [hereinafter Slaughter Fact Check] (on file with author). The press release observes that "[j]ust as anyone else, Members of Congress and staffers are subject to current insider trading laws," but then it states that "current insider trading laws do not apply to nonpublic information about current or upcoming congressional activity." *Id.*

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This bolded legal conclusion appears to be based on what this Article will show is the faulty premise that "members of Congress and their staff do not owe a duty of confidentiality to Congress."[151]

The original version of the Stop Trading on Congressional Knowledge Act, dubbed the STOCK Act,[152] had fourteen additional co-sponsors in the House and was referred out to several Committees, but the bill failed to advance.[153] Representatives Baird and Slaughter reintroduced a similar bill in 2007[154] and again most recently in January 2009.[155] The STOCK Act was also the subject of a one-day hearing in July 2009 before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services.[156]

The latest version of the STOCK Act, according to its co-authors, would "bar members of Congress and their staffs from buying and trading stocks using nonpublic information they obtain through their positions."[157] The legislation seeks to create this "bar" by amending section 10 of the Exchange Act to include a new subsection 10(c):

> (c) NONPUBLIC INFORMATION RELATING TO CONGRESS. – Not later than 270 days after the date of enactment of this subsection, the Commission shall by rule prohibit any person from buying or selling the securities of any issuer while such person is in possession of material nonpublic information, as defined by the Commission, relating to any pending or prospective legislative action relating to such issuer if –
>
> (1) such information was obtained by reason of such person being a Member or employee of Congress; or
>
> (2) such information was obtained from a Member or employee of Congress, and such person knows that the information was so obtained.[158]

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[151] *Rep. Brian* [sic] *Introduces Legislation to Prohibit Insider Trading on Capitol Hill*, U.S. FED. NEWS, Jan. 27, 2009 [hereinafter *Baird January 2009 Press Release*], *available at* 2009 WLNR 1657232. Representative Slaughter's "STOCK Act Fact Check" press release includes a quote from a former SEC official's statement that a congressman could trade on congressional knowledge because "he is not obligated to keep that information confidential." Slaughter Fact Check, *supra* note 150.

[152] Stop Trading on Congressional Knowledge Act, H.R. 5015, 109th Cong. (2006).

[153] *See* Jerke, *supra* note 12, at 1494.

[154] Stop Trading on Congressional Knowledge Act, H.R. 2341, 110th Cong. (2007).

[155] Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Cong. (2009).

[156] *See Hearings on Unfair Trading*, *supra* note 147, at 3-8 (statements of Reps. Louise Slaughter and Brian Baird).

[157] Press Release, Rep. Brian Baird (D-Wash.), Baird Renews Call to Ban Insider Trading on Capitol Hill (Oct. 12, 2010) (on file with author).

[158] H.R. 682 § 2(a). The current version of the STOCK Act also instructs the SEC to promulgate a broader rule that would prohibit trading or tipping based on material nonpublic information obtained or derived from any federal employment. *Id.* (proposing to add a new § 10(d) to the Exchange Act). It also contains provisions requiring members of Congress

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By its terms, the STOCK Act is not self-executing; rather, the Act requires the SEC to adopt its proposed ban on insider trading through rulemaking.

B. *The STOCK Act's Shortcomings*

Ironies abound in the STOCK Act. As discussed previously,[159] neither section 10 of the Exchange Act nor Rule 10b-5 currently makes reference to the offense of insider trading; moreover Congress has never before answered the call to amend the federal securities laws to explicitly prohibit securities trading on the basis of material nonpublic information.[160] Accordingly, rather than being viewed as an effective means of closing an "insider trading loophole,"[161] the STOCK Act may well be regarded as an attempt to clarify insider trading law as it applies only to government officials, while leaving all others to struggle with the host of uncertainties inherent in the "court-drawn parameters of insider trading."[162] Shouldn't Congress first act more generally to clarify the law of insider trading for *everyone* by enacting a statute that explicitly defines and prohibits the offense of insider trading?

The claim by the co-authors of the STOCK Act that current law does not reach insider trading on congressional knowledge rings particularly hollow given the elasticity of the Rule 10b-5 insider trading prohibition. Moreover, to the extent that this elasticity has been fueled by concerns about harms to investor confidence and market integrity, an elastic interpretation of Rule 10b-5 is even more justifiable when a member of Congress uses nonpublic information obtained from his congressional service for personal profit. Indeed, even Professor Henry Manne, who has argued vehemently for the deregulation of corporate insider trading, recognizes that an unfettered ability to profit in the stock market based on nonpublic government information could

and their staffs to report specified securities transactions within ninety days of the trade, *id.* § 4(a), and requiring specified changes to the Rules of the House of Representatives, *id.* § 3. The Act also mandates rulemaking by the Commodity Futures Trading Commission (CFTC), *id.* § 2(b), although the proposed provisions regarding commodities trading may have been rendered moot by the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, which amends the Commodity Exchange Act, 7 U.S.C. § 6c(a) (2006), to prohibit employees and agents of "any department or agency of the Federal Government" from commodities trading or tipping based on material nonpublic information obtained through their governmental service Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 746, 124 Stat. 1376, 1737-39 (2010).

[159] *See supra* notes 16-23 and accompanying text.

[160] *See supra* notes 34, 36-38, and accompanying text.

[161] *Hearings on Unfair Trading*, *supra* note 147, at 4

[162] H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048; *see* Bruce Ingersoll, *Demand Rises for Law Defining Insider Trading to Provide More Than a Gut Feeling as a Guide*, WALL ST. J., Mar. 26, 1987, at 70 (quoting attorney Michael Klein's statement that insider trading law "is so laden with arcane concepts and artificial dividing lines that the layman couldn't possibly understand what's permitted and what's prohibited"); sources cited *supra* note 34.

lead to decisions "made with an eye to maximizing trading profits rather than serving the government's interests."[163] But even if legislative decisions are truly made with an eye to serving the public's interest, insider trading by members of Congress nonetheless involves personal gain from the use of government information, a practice which, in and of itself, undermines the public's trust and confidence in the government.[164] These potential ramifications make any double standard for congressional insider trading particularly vexing. As Professors Jonathan Macey and Erin O'Hara have argued, the SEC could be doing much more to refute the mistaken views of the current law: "What we find interesting is that the SEC is so willing to stretch the contours of the rules against insider trading when prosecuting private citizens . . . but is unwilling to make an appeal for a far more modest stretch of the rules in the context of elected public officials."[165]

The STOCK Act also fails to reach a host of hypothetical situations involving congressional insider trading. Under section 2(a) of the Act, the SEC is instructed to prohibit transactions in "the securities of any issuer" by persons in possession of material nonpublic information "relating to *any pending or prospective legislative action* relating to *such issuer*," if the information was obtained through congressional service.[166] Recall Representative Slaughter's example of Congressman B's insider trading on the basis of nonpublic congressional information.[167] Because the nonpublic information related to the Appropriations Committee's award of a defense contract to Company A, Representative Slaughter is undoubtedly correct in observing that an SEC rule giving effect to the statutory language would prohibit Congressman B from buying that company's stock. Consider, however, these three variations:

1. Congressman B holds Company Z's stock in his investment portfolio and Company Z is Company A's biggest competitor. Should Congressman B be able to sell his stock in Company Z based on the

[163] HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 184 (1966). *But see id.* at 189 ("Undoubtedly it will be difficult for many people to comprehend a justification of corporate insider trading and a strong condemnation of the same practice by government officials. . . . [But, t]he distinction between private economic activity and government administration is both real and fundamental.").

[164] *See* PAINTER, *supra* note 12, at 174 (arguing that "abuses of government information for private gain . . . seem incongruent with government employees' fiduciary obligations to the public" and emphasizing that "[p]ublic confidence in government policy . . . could be compromised if inside information is likely to be abused"); *see also* United States v. Miss. Valley Generating Co., 364 U.S. 520, 562 (1961) ("[A] democracy is effective only if the people have faith in those who govern, and that faith is bound to be shattered when high officials and their appointees engage in activities which arouse suspicions of malfeasance and corruption.").

[165] Macey & O'Hara, *supra* note 12, at 107.

[166] Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Cong. § 2(a) (2009).

[167] *See supra* note 150 and accompanying text.

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nonpublic information in his possession relating to Company A? What constitutes good news for Company A may well have negative ramifications on other companies in that industry. The co-authors of the STOCK Act would likely scorn such trading but, under the terms of their bill, Congressman B's sale of Company Z would not seem to be covered because the information in Congressman B's possession did not pertain to "such issuer." The information instead pertained to its competitor, Company A.

2. What if instead of stock, Congressman B purchases options on the stock of Company A based on the nonpublic good news that the Appropriations Committee will be awarding the lucrative defense contract to Company A? Options are indeed securities under the definition in the federal securities laws,[168] but Company A will not generally be the issuer of those options. Once again, the statutory phrase "of such issuer" may impede successful prosecution under the STOCK Act.[169]

3. What if instead of information pertaining to the Appropriations Committee's decision to award a multi-million dollar defense contract to Company A, Congressman B learns from an official at the Department of Defense (DOD) that it will soon be awarding a lucrative contract to Company A and Congressman B purchases stock in Company A based on that nonpublic information. Here, the nonpublic information does relate to "such issuer," but it does not relate to "any pending or prospective legislative action."[170] Instead, it relates to an administrative action by an executive department under the direction and supervision of a cabinet secretary who serves at the pleasure of the President.[171]

If the STOCK Act is the exclusive restraint on insider trading by members of Congress and their staffs, the gaps that would result from the enactment of

[168] 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2006).

[169] Here, however, this gap in the STOCK Act would likely be plugged by section 20(d) of the Exchange Act, which renders insider trading in options unlawful in instances where such trading in the underlying would violate a provision in the Exchange Act. *See* 15 U.S.C. § 78t(d) ("Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provisions of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, [or] privilege . . . with respect to such security . . . shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.").

[170] *See* United States v. Brewster, 408 U.S. 501, 512 (1972) ("A legislative act has consistently been defined as an act generally done in Congress in relation to the business before it.").

[171] For additional hypotheticals involving congressional insider trading that would likely fall outside of the current text of the STOCK Act, see Bainbridge, *Beltway I*, *supra* note 12, at 306.

that legislation would be enormous. The end result could well be perverse: rather than banning congressional officials "from using nonpublic information . . . to enrich their personal portfolios,"[172] the specificity of the provisions in the STOCK Act could provide an effective roadmap for circumventing the very ban that its co-authors had sought. Another irony is that one of the principal impediments to a general statutory prohibition of insider trading was Congress's fear that a statute could unintentionally "facilitate schemes to evade the law."[173]

Finally, the STOCK Act obfuscates the reality that other obstacles may prevent the SEC from pursuing suspected insider trading by members of Congress and legislative staffers, and that those other obstacles, rather than the lack of a legal duty to refrain from trading, may be the principal explanation for the paucity of investigations and the complete dearth of prosecutions. As discussed previously, insider trading cases rarely involve a smoking gun and must generally be constructed through circumstantial evidence establishing the elements of liability under Rule 10b-5.[174] But when trades by members of Congress or legislative staffers raise suspicions, the typical insider trading investigation may become even more complicated (and controversial). Key evidence may be located within the Capitol Building and to thwart perceived intrusions by officials from a co-equal branch of the government, members of Congress might invoke either of two constitutional protections.[175] First, the Speech or Debate Clause[176] could afford some protection from investigations involving interviews and testimony from members of Congress and their staffs, or documents and records, with respect to legislative acts.[177] Second, the

[172] *Baird January 2009 Press Release*, *supra* note 151.

[173] H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048.

[174] *See supra* notes 142-143 and accompanying text.

[175] *See Hearings on Unfair Trading*, *supra* note 147, at 35-36 (testimony of Professor Peter J. Henning, discussing possible protection for members of Congress under the Speech or Debate Clause).

[176] U.S. CONST. art. I, § 6, cl. 1 ("[F]or any Speech or Debate in either House, [Senators and Representatives] shall not be questioned in any other Place.").

[177] *See, e.g.*, United States v. Johnson, 383 U.S. 169, 171-72, 186 (1966) (affirming reversal of former Congressman Johnson's conviction for conspiring to defraud the U.S. government because principal evidence consisted of a speech by the Congressman which the prosecution alleged had been improperly motivated by his receipt of a bribe); *In re* Grand Jury Subpoenas, 571 F.3d 1200, 1203 (D.C. Cir. 2009) (holding that a congressman's statements to the House Ethics Committee were protected by the Speech or Debate Clause); United States v. Rayburn House Office Bldg., 497 F.3d 654, 663 (D.C. Cir. 2007) ("The Executive's search of the Congressman's paper files therefore violated the [Speech or Debate] Clause, but its copying of computer hard drives and other electronic media is constitutionally permissible because the Remand Order affords the Congressman an opportunity to assert the privilege prior to disclosure of privileged materials to the Executive."); *see also Hearings on Unfair Trading*, *supra* note 147, at 35-36 (testimony of Professor Peter J. Henning, observing that the proposed STOCK Act would not operate as a

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Rulemaking Clause[178] could afford some protection against claims that would require a court to construe ambiguous provisions in congressional rules.[179] Yet, evidence pertaining to legislative acts or congressional rules could often be crucial in establishing that a congressional official knew, or was reckless in not knowing, that the information was both material and nonpublic at the time of his trading.

Consider again Representative Slaughter's example involving Congressman B's trading in Company A stock based on nonpublic information obtained from the Appropriations Committee. Neither the Speech or Debate Clause nor the Rulemaking Clause should insulate Congressman B from prosecution for illegal insider trading under the proposed STOCK Act,[180] assuming that the SEC could prove by a preponderance of the evidence that he knew he was in possession of material nonpublic information at the time of the trade and that the information was obtained by reason of his membership in Congress. But the very existence of special constitutional protections for the Legislative Branch may constitute a plainly practical explanation for why the SEC might hesitate before launching an investigation into suspicious conduct. The SEC is clearly aware of the well-publicized study of securities trading by U.S. Senators.[181] The SEC has also, on occasion, investigated possible instances of securities trading on nonpublic congressional information,[182] notwithstanding

waiver from inquiry into privileged legislative acts and emphasizing the complexity of Speech or Debate Clause issues in the context of Executive Branch requests or subpoenas for testimony and materials).

[178] U.S. CONST. art. I, § 5, cl. 2 ("Each House may determine the Rules of its Proceedings . . . .").

[179] United States v. Rostenkowski, 59 F.3d 1291, 1305-06, 1310 (D.C. Cir. 1995) (holding that while "it is perfectly clear that the Rulemaking Clause is not an absolute bar to judicial interpretation of the House Rules," certain counts in the indictment against congressman may be non-justiciable under the doctrine of separation of powers because there is not a "judicially discoverable and manageable standard" clearly indicating whether alleged activity of a particular employee was "personal service" as opposed to "official work").

[180] Inquiries into insider trading, like inquiries into bribes, may not implicate the Speech or Debate Clause at all. *See* United States v. Brewster, 408 U.S. 501, 526 (1972) ("[A]n inquiry into the purpose of a bribe does not draw in question the legislative acts of the defendant member of Congress or his motives for performing them." (citation and internal quotation marks omitted)); *Rostenkowski*, 59 F.3d at 1305, 1310 (holding that neither the Rulemaking Clause nor the Speech or Debate Clause barred prosecution of a congressman with respective to counts in the indictment that required no judicial interpretation of ambiguous House rules); Bainbridge, *Beltway I*, *supra* note 12, at 302-03 (explaining why the Speech or Debate Clause "should not bar regulation of Congressional insider trading").

[181] *See* Joseph N. DiStefano, *Senators' Stock Picks Bring Profit, Scrutiny*, PHILADELPHIA INQUIRER, Nov. 7, 2004, at E1 ("Staff at the Securities and Exchange Commission say they considered, but rejected, investigating the U.S. Senate early this year after a study found senators made suspiciously high profits from stocks during the 1990s bull market.").

[182] *See* Jerke, *supra* note 12, at 1454 & n.10 (noting that SEC officials raised questions

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the fact that Congress controls not only the scope of its statutory authority but also its budget. However, according to some members of its staff, the SEC may not have "press[ed] the issue" of the Senate study's results "because it is hard to win insider-trading cases without detailed knowledge of what, if any, privileged information the subjects received and proof insiders used it to trade."[183] The Speech or Debate Clause and the Rulemaking Clause could potentially hamper investigations involving suspected Rule 10b-5 violations when the subject is a member of Congress or a legislative staffer, and the STOCK Act does not – and cannot – do anything to change the practical effect of these constitutional protections.

III. INSIDER TRADING BY MEMBERS OF CONGRESS AND LEGISLATIVE STAFFERS

Given the expansive application of the classical and misappropriation theories that has become the norm in insider trading prosecutions under Rule 10b-5, members of Congress and legislative staffers should face an uphill battle if their principal defense in an SEC prosecution is that securities trading based on material nonpublic congressional information does not violate Rule 10b-5. Yet, as we have seen, the sponsors of the STOCK Act are convinced that "it is perfectly legal" to trade securities based on congressional information,[184] a view that is shared by the *Wall Street Journal*, many others in the media, and even some former SEC officials.[185] Distinguished securities law scholars have also voiced support for the STOCK Act, in large part because of what they perceive to be limitations under current law.[186]

about possible tips to hedge funds of nonpublic information pertaining to an announcement by Senate Majority Leader Bill Frist concerning asbestos legislation); *cf.* PAINTER, *supra* note 12, at 174 ("Tony Rudy, a senior aide to former House Republican leader Tom Delay, bought and sold hundreds of stocks from his computer in the Capitol Building . . . . Both Rudy and Delay were eventually convicted of violating criminal laws on account of unrelated conduct . . . ."). The SEC has also investigated at least one member of Congress for suspected securities trading based on material nonpublic information that would have been obtained (if at all) from a source outside of Congress. *See* Floyd Norris, *What Did Bill Frist Know and How?*, N.Y. TIMES, Sept. 29, 2005, at C3 (reporting that Senator Bill Frist sold stock in a hospital chain that his father helped found, triggering inquiries from the SEC and the DOJ and a complaint to the Senate Ethics Committee notwithstanding the Senator's denial that he was aware of material nonpublic information).

[183] DiStefano, *supra* note 181 (citing Ari Gabinet, then-head of the SEC's Philadelphia office, and other SEC officials).

[184] *Baird March 2006 Press Release*, *supra* note 148.

[185] *See supra* notes 7-15 and accompanying text.

[186] *See, e.g.*, Bainbridge, *Beltway I*, *supra* note 12, at 307 ("Although the present Act still needs work, it is long over due."); Macey & O'Hara, *supra* note 12, at 109 ("The most plausible explanation for the failure of this legislation is that self-interested congressional officials do not want to put an end to the lucrative trading opportunities that are made available to them when they receive important nonpublic information in their official

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The notion that members of Congress and legislative staffers are not already prohibited from trading securities on the basis of nonpublic congressional knowledge is rooted in twin misconceptions: (1) a lack of regard for the broad and sweeping duties of entrustment that attach to public office and employment and (2) an unduly narrow view of the precedents establishing Rule 10b-5 liability for remaining silent about material nonpublic facts when under a fiduciary-like duty to disclose. Members of Congress are public fiduciaries who owe duties of trust and confidence to a host of parties including the citizen-investors whom they serve, as well as the federal government, fellow members of Congress, and other government officials who rely on their loyalty and integrity. Legislative staffers serve as agents and thus stand in paradigmatic fiduciary relationships with the congressional members and committees who employ them.

The contention that "Members of Congress and their staff do not owe a duty of confidentiality to Congress"[187] turns fiduciary law on its head. As Professor Frankel explains in her book – and as the Restatement (Second) of Agency makes clear[188] – a fiduciary is duty-bound to keep information confidential when it has been entrusted to him as part of his services.[189] A fiduciary's use of entrusted information for personal profit also constitutes a clear violation of his duty of loyalty.[190] Explicit mandates with respect to confidentiality and non-use of nonpublic information merely confirm what is otherwise inherent in fiduciary relationships. But the absence of an explicit mandate does not make the obligations of loyalty and confidentiality disappear.

With these broad principles in mind, Section A focuses on insider trading by members of Congress and sets out the case for Rule 10b-5 liability, first under the classical theory and then under the complementary misappropriation theory. The analysis assumes that the SEC could successfully gather evidence

capacities.").

[187] *Baird January 2009 Press Release*, *supra* note 151.

[188] *See* RESTATEMENT (SECOND) OF AGENCY § 395 (1958) ("[A]n agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury at the principal.").

[189] *See* FRANKEL, *supra* note 31, at 7 ("Entrustment is the most important aspect of fiduciary relationships. It greatly affects the existence, nature, and the rules of fiduciary relationships. The word 'confidence' that courts occasionally use may mean more than mere confiding in the other party. It can mean confiding secrets as well.").

[190] *See id.* at 108 ("The duty of loyalty supports the main purpose of fiduciary law: to prohibit fiduciaries from misappropriating or misusing entrusted property or power."); *see also* RESTATEMENT (SECOND) OF AGENCY § 395. Professor Frankel goes on to explain that the duty of loyalty is manifested by "important preventive rules" that prohibit actions "even though they are not necessarily injurious to entrustors." FRANKEL, *supra* note 31, at 108. These preventive rules "act to dampen the fiduciaries' temptations to misappropriate entrusted property or power, or to justify benefitting themselves, and establish a continuous reminder that entrusted property and power do not belong to the fiduciaries." *Id.*

and prove that securities were traded on the basis of material nonpublic congressional information. Using hypothetical facts such as those identified in Representative Slaughter's example, the conclusion that Congressman B breached a duty of trust and confidence and thereby violated Rule 10b-5 can be established as a matter of law. Section B argues that despite the strength of the legal arguments for Rule 10b-5 liability, education, rather than prosecution, may be the SEC's most effective enforcement tool. Section C focuses on legislative staffers and other congressional employees, and Section D briefly examines issues relating to "tips" which convey material nonpublic congressional information.

A. *Members of Congress*

1. The Case for Liability under the Classical Theory

As we have seen, Rule 10b-5 liability under the classical theory "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[191] Thus, for Congressman B's silence about the multi-million defense contract to be deemed a fraud under the classical theory, he would have to owe a disclosure duty to Company A stockholders who sold their shares without the benefit of the Appropriations Committee's information which would have made their stock more valuable. This duty of disclosure can arise from either of two relationships: (a) from the relationship of trust and confidence that exists between members of Congress and the securities issuers that have business before them (rendering congressional officials temporary or constructive insiders of the issuer) or (b) from the relationship of trust and confidence that exists between members of Congress and citizen-investors (some of whom are shareholders in Company A).

a. *Temporary or Constructive Insiders*

Under circumstances such as those postulated by Representative Slaughter, Congressman B could be viewed as a temporary or constructive insider of Company A since he was entrusted with access to nonpublic information pertaining to the Company's imminent receipt of a lucrative defense contract. Indeed, Congress itself has gone so far as to recognize that government officials can, under certain circumstances, assume the status of constructive insiders. In justifying the view that a legislative definition of insider trading is unnecessary, the Committee Report accompanying the Insider Trading Sanctions Act of 1984 (ITSA) observed (with remarkable prescience) that:

> Underwriters, investment analysts, lawyers, accountants, financial printers, *government officials*, and others often learn of profit-or-loss forecasts, imminent tender offers, mineral strikes, oil discoveries, *lucrative contracts*, and product failures before such information is

[191] Chiarella v. United States, 445 U.S. 222, 230 (1980).

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> available to the investing public. Insider trading by such persons undermines confidence in the markets in the same manner as trading by corporate insiders. The Supreme Court recently noted [in *Dirks*] that under certain conditions, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, those "outsiders" may be treated as constructive insiders. *The Committee agrees with this analysis and expects the Commission to continue to pursue violations by such persons.*[192]

Professor Louis Loss likewise included government officials in a suggested category of "quasi-insiders" who would be prohibited from insider trading under section 1603 of the American Law Institute's proposed Federal Securities Code which was presented to Congress, but never adopted.[193]

Viewing members of Congress as temporary or constructive insiders, at least when they have been entrusted with nonpublic company-specific information like the imminent receipt of a defense contract (or, for example, proprietary corporate information provided pursuant to a congressional committee's investigative subpoena), fits well within the classical framework of *Chiarella* and *Dirks*. Like an issuer's traditional insiders and temporary agents, as well as their tippees, congressional officials should not be permitted to take advantage of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone."[194] It would thus be quite reasonable to impute a disclosure obligation when a member of Congress trades with shareholders of the issuer who were not privy to facts affecting the value of their shares. The failure to disclose to shareholders in such a circumstance would constitute a violation of Rule 10b-5.

b. *Public Fiduciaries and Citizen-Investors*

Viewing Congressman B as a public fiduciary who owes disclosure duties to at least some of the shareholders of Company A provides an alternative avenue under the classical theory for rendering his stock purchases a fraud. Moreover, arguments predicated on members of Congress as public fiduciaries would apply in a host of other instances where the temporary or constrictive insider theory may not. For instance, if the information in Congressman B's possession concerned an anticipated change in the tax laws that had yet to be

[192] H.R. REP. NO. 98-355, at 4 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277 (emphasis added).

[193] FED. SEC. CODE § 1603 cmt. (3)(d) (1980) ("It would be convenient to have a new category of 'quasi insider' that would cover people like (i) judges' clerks who trade on information in unpublished opinions, [and] (ii) Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate . . . ." (citing the *Peltz*, *Blyth*, and *Keane* decisions discussed at *infra* notes 101, 269-276)). Chief Justice Burger specifically referenced this ALI proposal in his dissenting opinion in *Chiarella*, 445 U.S. 222, 242 n.3 (1980) (Burger, C.J., dissenting).

[194] Dirks v. SEC, 463 U.S. 646, 654 (1983) (internal quotation marks omitted).

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announced publicly, viewing Congressman B as a constructive insider of each and every company affected by that law may well be too much of a stretch. Yet, if Congressman B bought stock in Companies X, Y, and Z based on material nonpublic information about such a change in the tax law, the SEC would have a compelling argument that Congressman B owes at least some of the shareholders with whom he trades a disclosure obligation in accordance with his status as a public fiduciary.

As Professor Frankel observes in the epilogue to her book, "[p]rivate sector fiduciaries and government officials have much in common" because the law governing both sets of actors "address similar problems, and the guiding principles in both legal systems are similar: prevent misappropriation of entrustment and ensure a diligent and expert performance of services."[195] Here Professor Frankel quotes Professor Robert Natelson's forceful argument that the "Constitution was conceived of as a fiduciary instrument, instituting, to the extent practicable, fiduciary standards."[196] Professor Frankel also reminds us that the U.S. Constitution refers in several places to "public Trust"[197] and to public offices being "of Trust."[198] She emphasizes that the "freedom and well-being of this country's people depend on the accountability of both [private and government] fiduciaries and on preventing them from misappropriating their entrusted property and power."[199] Professor Richard Painter builds on Professor Frankel's work when he recognizes that "[p]ersons who choose elected officials are entrustors to whom officials owe fiduciary obligations."[200] He notes specifically that "[f]or members of Congress, the entrustors are the voters in their districts," though he recognizes that "fiduciary obligations may also be owed to other persons."[201]

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[195] FRANKEL, *supra* note 31, at 279. To be sure, some scholars take issue with Professor Frankel's highly expansive conception of fiduciary duties and relationships. *See, e.g.*, Larry Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 901-03 (2011) (arguing for a narrower definition of fiduciary duty and a more precise application that would turn on the concept of unselfishness); Smith, *supra* note 121, at 1402 (setting forth a definition of a fiduciary relationship that would turn on three core requirements: "when one party (the 'fiduciary') acts on *behalf of* another party (the 'beneficiary') while exercising *discretion* with respect to a *critical resource* belonging to the beneficiary" (emphasis added)). Members of Congress, as representatives elected to serve the public interest, may well fit within some of these other, more restrictive, conceptions of the term "fiduciary."

[196] FRANKEL, *supra* note 31, at 280 (quoting Robert G. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders*, 11 TEX. REV. L. & POL. 239, 281 (2007)).

[197] U.S. CONST. art. VI, cl. 3.

[198] U.S. CONST. art. I, § 3, cl. 7; *id.* art. I, § 9, cl. 8; *id.* art. II, § 1, cl. 2.

[199] FRANKEL, *supra* note 31, at 286.

[200] PAINTER, *supra* note 12, at 2.

[201] *Id.* For law review articles recognizing that government officials are fiduciaries who operate under strict limitations with respect to their use of government power and property, see Kathleen Clark, *Do We Have Enough Ethics In Government Yet?: An Answer from*

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In arguing against the classical theory's application to his purchases of stock in Company A, Congressman B might contend that his silence about material facts does not defraud the issuer's selling shareholders because his duties of entrustment vis-à-vis the public are not characteristic of the type of fiduciary-like relationship that has triggered the requisite duty to disclose under prior Rule 10b-5 insider trading precedents. To bolster this argument, he would likely point out that "[f]iduciary law does not provide citizens with broad equitable remedies against government officials for breach of trust,"[202] and that while his constituents can vote him out of office for conduct inconsistent with trust and loyalty, citizen-investors "cannot sue for breach of fiduciary duty."[203] Moreover, as a member of the House of Representatives, his responsibilities as a public official are unique because "Congress is not a job like any other, it is a constitutional role to be played upon a constitutional stage."[204] These observations are all quite valid, as far as they go.

But members of Congress can be held accountable for their fiduciary breaches in at least two additional ways. First, a member of Congress can be punished by his own House for acts that constitute a betrayal of the public's trust. Second, at least some breaches of the public's trust by a member of Congress can be prosecuted by the Executive Branch under criminal and civil statutes. These vehicles for accountability evidence that congressional duties of entrustment are both bona fide and enforceable, even if citizens typically do not have standing to vindicate those rights in court.

Congress's authority to punish its own members for breaches of entrustment is grounded in the Constitution's text, which states that: "Each House may determine the Rules of its Proceedings, punish its Members for disorderly Behavior, and with the Concurrence of two-thirds, expel a Member."[205] This

Fiduciary Theory, 1996 U. ILL. L. REV. 57 (1996); Joseph J. Kalo, *Deterring Misuse of Confidential Government Information: A Proposed Citizens' Action*, 72 MICH. L. REV. 1577 (1974); David M. Lawrence, *Local Government Officials as Fiduciaries: The Appropriate Standard*, 71 U. DET. MERCY L. REV. 1 (1993); Note, *The Fiduciary Duty of Former Government Employees*, 90 YALE L.J. 189 (1980).

[202] PAINTER, *supra* note 12, at 3.

[203] *Id.*

[204] United States v. Rostenkowski, 59 F.3d 1291, 1312 (D.C. Cir. 1995).

[205] U.S. CONST. art. I, § 5, cl. 2. For an extensive examination of this Clause (including the Framers' intent and its application from the nation's founding through modern times), see Laura Krugman Ray, *Discipline Through Delegation: Solving the Problem of Congressional Housecleaning*, 55 U. PITT. L. REV. 389 (1994). Professor Ray argues that while the text of the Constitution may be read to provide for an alternative avenue of punishment under the Impeachment Clause, U.S. CONST. art. II, § 4, "history has effectively closed that option." Ray, *supra*, at 391; *see also id.* at 397-401 (discussing the Senate's conclusion that it lacked jurisdiction over the 1797 impeachment of then-expelled Senator William Blount and speculating that the Senate (which reached its decision in closed session) may have accepted Blount's argument that the Senate's power of expulsion renders impeachment unnecessary and/or that the Constitution does not expressly include members

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self-discipline for "disorderly Behavior" is to be administered by the member's own House, and as the Supreme Court recognized in *In re Chapman*,[206] even the "right to expel" – the ultimate and the rarest form of congressional self-discipline – "extends to all cases where the offense is such as in the judgment of the Senate [or the House of Representatives] is inconsistent with the trust and duty of a member."[207]

Although Congress is frequently criticized for its reluctance to administer any self-discipline (even through the relatively mild sanctions of denouncement or reprimand), there is no doubt that each House has the authority to proscribe and sanction betrayals of the public trust.[208] Indeed, both the Senate Ethics Manual[209] and the House Ethics Manual[210] reference not only their own expansive ethical standards and jurisdiction[211] but also a general Code of Ethics for Government Service,[212] which sets out ten broadly-worded ethical standards that should be adhered to "by all Government employees, including officeholders . . . ever conscious that public office is a public trust."[213] Reflecting the fiduciary obligation of loyalty, the Code's eighth provision specifies that an official should "never use any information coming to him confidentially in the performance of government duties as a means for

of Congress in the Impeachment Clause).

[206] 166 U.S. 661 (1897).

[207] *Id.* at 669-70.

[208] *See* Theresa A. Gabaldon, *The Self-Regulation of Congressional Ethics: Substance and Structure*, 48 ADMIN. L. REV. 39, 45-46 (1996) (observing that at least one Senator has been censured for actions "derogate[ing] from the public trust expected of a senator" even though the conduct at issue had not violated "any specific law or rule in force at the time," but acknowledging that "neither the House nor the Senate has taken formal disciplinary action on a frequent basis" (alteration in original, internal quotation marks omitted)); Ray, *supra* note 205, at 390 (discussing the disciplinary role assigned to Congress under the Constitution, but contending that Congress's "performance to date scarcely vindicates its claim to effective self-discipline"). *See generally* PAINTER, *supra* note 12, at 143-63 (discussing recent Legislative Branch ethics reform).

[209] STAFF OF S. SELECT COMM. ON ETHICS, 108TH CONG., SENATE ETHICS MANUAL (Comm. Print 2003), *available at* http://ethics.senate.gov/downloads/pdffiles/manual.pdf.

[210] STAFF OF H. COMM. ON STANDARDS OF OFFICIAL CONDUCT, 110TH CONG., HOUSE ETHICS MANUAL (Comm. Print 2008), *available at* http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf.

[211] *Id.* at 1-4 (setting out "General Ethical Standards"); SENATE ETHICS MANUAL 309-11 (setting out "The Senate Code of Official Conduct").

[212] HOUSE ETHICS MANUAL 355 (including the Code in the appendix); SENATE ETHICS MANUAL 7 (referencing the Code). The Code has been explicitly incorporated into House ethics rules. HOUSE ETHICS MANUAL 20. And while the Senate's ethics rules do not incorporate the Code specifically, the Senate Ethics Manual does identify the Code as a "source of Committee jurisdiction." SENATE ETHICS MANUAL 7.

[213] Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

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making personal profit,"[214] and there has been at least one disciplinary reprimand of a congressman found to have unjustly enriched himself in violation of this provision.[215]

A member of Congress can likewise be held accountable for breaches of entrustment through prosecutions by the Executive Branch under federal criminal and civil statutes, including statutes tailored to conduct by members of Congress (as a specific class or as part of a broader class of "public officials")[216] and statutes of general application.[217] The federal statutes prohibiting mail fraud[218] and wire fraud[219] constitute cogent examples of generally-applicable criminal statutes which can encompass a member of Congress's breach of the "fiduciary duty of loyalty" that he owes to the American public.[220]

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[214] *Id.*

[215] HOUSE ETHICS MANUAL 249 (citing HOUSE COMM. ON STANDARDS OF OFFICIAL CONDUCT, IN THE MATTER OF A COMPLAINT AGAINST REPRESENTATIVE ROBERT L.F. SIKES, H. REP. 94-1364, at 3 (1976)). The House Ethics Manual recounts that the Congressman had purchased 2,500 shares of a privately-held bank's stock while he was actively assisting in the establishment of that bank on a military base, and observes that had the Congressman requested an opinion of the "House Standards Committee in advance about the propriety of the investment, it would have been disapproved." *Id.*

[216] Congress has enacted a host of anti-corruption statutes that expressly apply to government officials, including members of Congress. *See, e.g.*, United States v. Brewster, 408 U.S. 501, 502 n.2, 528-29 (1972) (holding that the Speech and Debate Clause does not bar prosecution of congressman for violation of an anti-bribery statute applying to "any public official" including any "member of Congress" even if a congressman accepted the bribe in exchange for a promise relating to an official act); *see also* WILLIAM N. ESKRIDGE, JR. ET AL., CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY 301-18 (4th ed.) (discussing anti-bribery statutes and "conflict of interest" statutes applying to "public officials," including the Ethics Reform Act of 1989, 5 U S C. § 7353(a) (2006), which prohibits members of Congress from seeking or accepting "anything of value" from any person "whose interests may be substantially affected by the performance or nonperformance of the individual's official duties").

[217] See ESKRIDGE, JR. ET AL., *supra* note 216, at 310 n.d (citing the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343 (2006), the Hobbs Act, 18 U.S.C. § 1951 (2006) (criminalizing extortion), and the Travel Act, 18 U.S.C. § 1952 (2006), as examples of federal criminal statutes that might be used to prosecute "official legislative conduct at either the federal or state level")

[218] 18 U.S.C. § 1341 (prohibiting "schemes or artifices to defraud" through the use of the mails).

[219] 18 U.S.C. § 1343 (prohibiting "schemes or artifices to defraud" through use of electronic wires. radio, or television).

[220] *Restoring Key Tools to Combat Fraud and Corruption After the Supreme Court's Skilling Decision: Hearing Before S. Comm. on the Judiciary*, 111th Cong. (2010) [hereinafter *Skilling Decision Hearing*] (statement of Lanny A. Breuer, Assistant Att'y Gen., Criminal Division, Department of Justice), http://judiciary.senate.gov/pdf/9-28-10%20Breuer%20Testimony.pdf (stating that for decades, federal prosecutors have used the

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Several members of Congress have been indicted, and have served (or are serving) time in prison, for honest services fraud prosecuted under either 18 U.S.C. § 1346[221] or the so-called pre-*McNally* interpretations of the federal mail and wire fraud statutes.[222] Congress enacted § 1346 in response to the Supreme Court's decision in *McNally v. United States*[223] which, in the context of a prosecution involving the corruption of a state public official, narrowly interpreted the mail fraud statute to apply only to fraudulent deprivations of "property rights" and not to schemes "defraud[ing] citizens of their intangible rights to honest and impartial government."[224] Section 1346 reflects

mail and wire fraud statutes to reach "schemes designed to *deprive citizens* of the honest services of public and private officials who owe them *a fiduciary duty of loyalty*" and observing that some of these prosecutions and convictions have involved members of Congress (emphasis added)).

[221] 18 U.S.C. § 1346 ("For the purposes of this chapter [(the federal mail and wire fraud statutes)], the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services.").

[222] See *Skilling Decision Hearing*, *supra* note 220 (statement of Lanny A. Breuer, testifying that, in connection with schemes involving bribery, "[f]ormer Congressman William Jefferson was convicted in 2009 of honest services fraud" and "[f]ormer Congressman Robert Ney pleaded guilty in 2006 to honest services fraud conspiracy"). Other members of Congress who were indicted under § 1346 for honest-services fraud include: former Illinois Congressman Dan Rostenkowski, *see infra* notes 249-252; former California Congressman Randy Cunningham, *see* Information at 3-4; United States v. Cunningham, Criminal Case No. 05cr2137-LAB (S.D. Cal. Nov. 28, 2005) (charging use of the mails to conspire "to devise a material scheme to defraud the United States of its right to defendant's honest services, including its right to his conscientious, loyal, faithful, disinterested, unbiased service, to be performed free of deceit, undue influence, conflict of interest, self-enrichment, self-dealing, concealment, bribery, fraud and corruption"); and former Arizona Congressman Richard Renzi, *see* Indictment at 10-11, United States v. Renzi, CR08-0212TUC (D. Ariz. filed Feb. 20, 2008) (charging use of the wires to "devise a scheme and artifice to defraud and deprive the United States of its intangible right to the honest services of Renzi performed free from deceit, self-dealing, bias and concealment" for purposes including the concealment of Renzi's financial relationship with co-conspirators from private persons, "the United States House of Representatives, and the public"). For a pre-*McNally* indictment charging former Congressman Charles Diggs with honest-services fraud in connection with a kick-back scheme, see *infra* notes 232-233 and accompanying text.

[223] 483 U.S. 350 (1987).

[224] *Id.* at 355. The majority in *McNally* noted that, like the federal mail fraud statute under which the defendant had been prosecuted, the federal anti-conspiracy statute, 18 U.S.C. § 371, also uses the words "to defraud." *Id.* at 358 n.8 (quoting statutory language making criminal any conspiracy "to defraud the United States, or any agency thereof in any manner or for any purpose." (internal quotation marks omitted)). The majority further observed that prior Court precedents had interpreted § 371 (or its statutory predecessor) to reach acts that not only defraud "the Government out of property or money," but also acts that "interfere with or obstruct one of its lawful government functions." *Id.* (internal quotation marks omitted). However, the Court acknowledged that the words "to defraud"

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Congress's intent to restore the pre-*McNally* honest-services fraud doctrine,[225] but just last term in *Skilling v. United States*,[226] the Court gave § 1346 a narrow construction, holding that constitutional due process requires the statute's proscription of fraudulent deprivations of "the intangible right of honest services" to criminalize only conduct involving bribes or kickbacks.[227]

The fact that members of Congress may be criminally liable for bribe-and-kickback schemes that "defraud and deprive American citizens of their right to [receive] honest services" presupposes that congressional loyalty and honesty are positive public rights and enforceable legal interests.[228] This presupposition squares with the *McNally* Court's description of the prior case law as holding that "a public official owes a fiduciary duty to the public, and a misuse of his office for private gain is a fraud."[229] In his *Skilling* dissent, Justice Scalia observed disparagingly that "[n]one of the 'honest services' cases, neither those pertaining to public officials nor those pertaining to the private employees, defined the nature and the content of the fiduciary duty central to the 'fraud' offense."[230] Yet, for the *Skilling* majority, such imprecision was of no moment because in its view, in the bribe-and-kickback cases held to be within § 1346's constitutional scope, "[t]he existence of a fiduciary relationship, under any definition of that term, was usually beyond dispute."[231] Among many of the honor-services fraud precedents "blessed" by

could have different meanings in each statute given the statutes' differing origins and aims. *Id.* ("Section 371 is a statute aimed at protecting the Federal Government alone; however, the mail fraud statute . . . had its origin in the desire to protect individual property rights . . . ."). The Court then concluded that "any benefit which the Government derives from the [mail fraud] statute must be limited to the Government's interest as property holder." *Id.*

[225] *See* Craig M. Bradley, *Not All Dishonesty is 'Honest Services' Fraud*, 46 TRIAL 48, 49 (2010). In *McNally*, the Court instructed that "if Congress desires to go further, it must speak more clearly." *McNally*, 483 U.S. at 360. As Professor Bradley observes, in response to *McNally*, "Congress did speak – if not very clearly – when it . . . enact[ed] the honest-services fraud statute, 18 U.S.C. § 1346, in 1988." Bradley, *supra*, at 49.

[226] 130 S. Ct. 2896 (2010).

[227] *Id.* at 2931 ("[Section] 1346 criminalizes *only* the bribe-and-kickback core of the pre-*McNally* case law."). The Court reached this holding because "there is no doubt that Congress intended § 1346 to reach *at least* bribes and kickbacks," whereas "[r]eading the statute to proscribe a wider range of offensive conduct . . . would raise the due process concerns underlying the vagueness doctrine." *Id.*

[228] United States v. Jefferson, 562 F. Supp. 2d 719, 721, 725 (E.D. Va. 2008) (denying motion to dismiss counts of indictment charging then-Congressman William Jefferson with "a scheme to defraud and deprive American citizens of their right to [his] honest services by taking bribes . . . in return for [his] performance of various official acts" and concluding that these honest-services fraud counts were not unconstitutionally vague); *see* sources cited *supra* note 222.

[229] *McNally*, 483 U.S. at 355.

[230] *Skilling*, 130 S. Ct. at 2936 (Scalia, J., dissenting).

[231] *Id.* at 2930 n.41 (majority opinion). The Court then provided three specific examples of undisputed fiduciary relationships (public official-public, employee-employer, and union

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the *Skilling* Court was *United States v. Diggs*,[232] a 1979 D.C. Circuit decision that affirmed former Michigan Congressman Charles Digg's conviction for mail fraud in connection with a staff salary kick-back scheme that "defrauded the public of not only substantial sums of money but of his faithful and honest services."[233]

The public fiduciary principles observed by Professor Frankel with respect to the appropriate use of government property and power, when combined with the specific application of those principles in the context of congressional self-discipline and § 1346 honest-services fraud prosecutions against members of Congress, form a powerful case that Congressman B would violate Rule 10b-5 under the classical theory were he to use material nonpublic information concerning an unannounced defense contract (or an anticipated change in the tax laws) to personally profit from trading in the securities of an affected company. To be sure, the Court in *Chiarella* and *Dirks* insisted that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[234] But as a person who has been entrusted with public power and authority for a public purpose, Congressman B stands in a "special relationship" with the members of the public with whom he trades,[235] and Congressman B would be using information intended only for government purposes for his own personal gain.[236] Accordingly, as a person who owes bona fide and enforceable duties of trust and confidence to the general public (including at least some of Company A's shareholders), Congressman B would violate Rule 10b-5 were he to purchase stock while remaining silent about material nonpublic facts pertaining to an anticipated change in the tax law or the imminent award of a defense contract by either the Appropriations Committee or the DOD.[237]

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official-union members) and followed those with a "see generally" to *Chiarella v. United States*, 445 U.S. 222, 233 (1980), with a parenthetical explaining that *Chiarella* discussed the "established doctrine that [a fiduciary] duty arises from a specific relationship between two parties." *Id.* (internal quotation marks omitted).

[232] United States v. Diggs, 613 F.2d 988 (D.C. Cir. 1979). *Diggs* was cited in *Skilling*, 130 S. Ct. at 2929 n.38.

[233] *Diggs*, 613 F.2d. at 998; *see infra* notes 242-248.

[234] Dirks v. SEC, 463 U.S. 646, 655 (1983) (quoting *Chiarella*, 445 U.S. at 233) (internal quotation marks omitted).

[235] *Cf. Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting) (observing that the majority had predicated insider trading liability on a "special relationship akin to fiduciary duty" (internal quotation marks omitted)); Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972); *supra* text accompanying notes 59-61.

[236] *Cf. Dirks*, 463 U.S. at 654 ("[The] fraud derives from the inherent unfairness involved where one takes advantage of information intended to be available only for a corporate purpose and not for the personal benefit of anyone." (internal quotation marks omitted)).

[237] Although they speculate that a narrower view could prevail, Professors Macey and O'Hara have expressed support for the classical theory's application to members of Congress who serve as public fiduciaries. *See* Macey & O'Hara, *supra* note 12, at 107

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2. The Case for Liability under the Misappropriation Theory

Because Congressman B's use of the Appropriations Committee's nonpublic information about the award of a defense contract would constitute a self-serving use of government property, the complementary misappropriation theory would provide an alternative ground for liability under Rule 10b-5. As a public servant and an official of the federal government, Congressman B's undisclosed misuse of nonpublic information would deceive a host of persons including: a) the United States and its citizens as "entrustors," b) the federal government in its capacity as his employer, and c) his fellow members of Congress or other government officials. Moreover, even in the absence of a court's willingness to regard Congressman B as a fiduciary owing disclosure duties to these persons, a fourth basis of liability under the misappropriation theory could attach from Congressman B's undisclosed breach of an obligation under the Code of Ethics for Government Service to never use confidential information as a means for making personal profit.

a. *The United States and its Citizens as "Entrustors" of Property*

The argument under the misappropriation theory for Congressman B's deception of the federal government and its citizens reflects many of the same fiduciary principles discussed above under the classical theory.[238] Under the misappropriation theory, Congressman B would be defrauding the government and its citizens by using their information for personal gain in securities trading while maintaining a pretense of loyalty.[239] Thus, Congressman B

("[E]lected officials who serve on committees and, in their official capacities . . . would clearly seem to owe a 'generalized' fiduciary duty to the public, including the securities markets."). Professor Donald Langevoort advanced a similar argument years before. Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 34-35 (1982) (maintaining that the investors trading with a government official "could be viewed as members of the broader class – the country's citizens – to whom the official does owe some duty of fair dealing"). Professor Langevoort points out that "[l]ike the corporate insider, the government official has an advantageous position as compared to the persons whom he is charged with serving" and thus both insider and government officials could be governed by the same principle "of preventing unjust enrichment." *Id.*; *see also* John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1374-76 (1981) (discussing insider trading by government officials and concluding that "a public official using official information for private gain violates a panoply of legal restrictions that trigger a disclose or abstain obligation under the common law and rule 10b-5"). For additional commentary written pre-*Chiarella*, see Arthur Fleischer, Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 823-24 (1973) ("[I]t is reasonable to expect that such information will not be used for the personal advantage of [government officials] who are given preferred access to it.").

[238] *Cf.* LANGEVOORT, *supra* note 74, at § 6-2 ("Virtually all cases that could be brought [under the classical theory] can also be styled as misappropriation cases.").

[239] *See* United States v. O'Hagan, 521 U.S. 642, 653-54 (1997) ("A fiduciary who

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"deal[s] in deception"[240] and his purchases of stock in Company A would violate Rule 10b-5. The first subsection below discusses prior prosecutions of members of Congress for defrauding the United States and its citizens through the misappropriation of funds and other tangible property; the second subsection discusses a government's property interest in its material nonpublic information.

i. Prosecutions for Fraudulent Misappropriation of Funds and Tangible Property

Although there has yet to be a federal prosecution for the undisclosed, self-serving use of congressional knowledge for personal profit, over the last half-century, several members of Congress have been indicted for defrauding the federal government and its citizen through the misappropriation of funds and other tangible property.[241] In *United States v. Diggs*,[242] for example, the D.C. Circuit considered an appeal by former Michigan Congressman Charles Diggs. In affirming his conviction for mail fraud under 18 U.S.C. § 1341, the court recounted the jury's findings that the Congressman had greatly increased the salaries nominally paid to his staff out of the clerk hire allowance, and that he had used the increases himself for personal expenses.[243] The D.C. Circuit concluded that the Congressman's conduct "amounted to no less than a scheme to take illicit kick-backs" and that this scheme "defrauded the public of not only substantial sums of money but of his faithful and honest services."[244] Although the constitutionality of the honest-services fraud part of this holding may have been subject to question prior to *Skilling*,[245] fraudulent deprivations of money and other tangible property have always been at the core of the federal mail and wire fraud statutes.[246] Diggs was sentenced to three years in

[pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal." (alteration in original, citation and internal quotation marks omitted)); *supra* text accompanying note 78.

[240] *O'Hagan*, 521 U.S. at 653-54.

[241] *See generally* Clark, *supra* note 201, at 59-60 (discussing a host of ethics investigations targeting members of Congress); Craig S. Lerner, *Legislators as the "American Criminal Class": Why Congress (Sometimes) Protects the Rights of Defendants*, 2004 U. ILL. L. REV. 599, 663-72 (2004) (setting out detailed appendix listing nearly 100 members of Congress who have been indicted for a wide range of criminal offenses, some of which involved the misappropriation of federal property).

[242] United States v. Diggs, 613 F.2d 988 (D.C. Cir. 1979).

[243] *Id.* at 994-95.

[244] *Id.* at 998.

[245] *See supra* notes 226-227.

[246] McNally v. United States, 483 U.S. 350, 360 (1987) (holding that the mail fraud statute was "limited in its scope to the protection of property rights" and observing that property included money or other tangible property); *supra* notes 223-225.

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prison,[247] and agreed to accept a censure by the House "in return for an end to the committee investigation of his financial dealings."[248]

Former Illinois Congressman Daniel Rostenkowski provides a second example of a member of Congress who was charged under general statutes with offenses involving, among other things, the fraudulent misappropriation of government funds and property. In *United States v. Rostenkowski*,[249] the D.C. Circuit rejected the argument that the Speech or Debate Clause and the Rulemaking Clause stood as an absolute bar to a seventeen count indictment "alleging generally that Rostenkowski and others had devised . . . a scheme to defraud the United States of its money, its property, and its right to Rostenkowski's fair and honest services" in connection with staff salary kickbacks, misappropriation of goods worth over $40,000 (including crystal sculptures, wooden armchairs, and fine china from the House Stationary Store), and misappropriation of funds by exchanging stamp vouchers for cash.[250] Rostenkowski was subsequently defeated in his bid for re-election,[251] served fifteen months in prison after pleading guilty in 1996 to two felony mail fraud counts, and was pardoned in 2000 by President Clinton.[252]

Lest it appear that misappropriation of congressional funds and property plagues only the House of Representatives, former Minnesota Senator David Durenberger's prosecution and subsequent guilty plea indicates otherwise. Durenberger had been charged with making and presenting false claims for Senate reimbursement of his travel expenses,[253] in violation of the anti-conspiracy statute[254] and the False Claims Act.[255] In affirming the district court's denial of the Senator's motion to dismiss the indictment, the D.C.

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[247] Lerner, *supra* note 241, at 666.

[248] Ray, *supra* note 205, at 414.

[249] 59 F.3d 1291 (D.C. Cir. 1995).

[250] *Id.* at 1294 (alteration in original, internal quotation marks omitted). The seventeen counts included charges that Rostenkowski had violated the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, 1346 (2006), the anti-conspiracy statute, 18 U.S.C. § 371 (2006), and the prohibition against conversion of U.S. funds and property, 18 U.S.C. § 641 (2006).

[251] Clark, *supra* note 201, at 60 n.9.

[252] Neil A. Lewis, *Clinton Issues a Pardon To Ex-Rep. Rostenkowski*, N.Y. TIMES, Dec. 23, 2000, at A12.

[253] United States v. Durenberger, 48 F.3d 1239, 1240 (D.C. Cir. 1995).

[254] 18 U.S.C. § 371 ("If two or more persons conspire . . . to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.").

[255] 18 U.S.C. § 287 (2006) ("Whoever makes or presents to any person or officer in the civil, military, or naval service of the United States, or to any department or agency thereof, any claim upon or against the United States, or any department or agency thereof, knowing such claim to be false, fictitious, or fraudulent, shall be imprisoned not more than five years and shall be subject to a fine in the amount provided in this title.").

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Circuit observed that Durenberger had allegedly concealed his ownership interest in a condominium while claiming entitlement for $3825 in reimbursement for overnight stays.[256] Durenberger was then denounced by the Senate, did not seek re-election, and later pleaded guilty to misdemeanor charges.[257]

ii. Material Nonpublic Information as Intangible Property

As we have seen, in *O'Hagan*,[258] the Supreme Court endorsed the misappropriation theory of insider trading liability under Rule 10b-5 because a "fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[259] The *O'Hagan* Court further recognized that the material nonpublic information on which the defendant-attorney had traded qualified as "property."[260] In so ruling, the Court relied on *Carpenter v. United States*,[261] a decision which held unanimously that a *Wall Street Journal* reporter's stock tips about companies mentioned in his forthcoming "Heard on the Street" columns constituted a fraudulent misappropriation of the *Journal*'s "property" within the meaning of the federal mail and wire fraud statutes.[262] The *Carpenter* Court specifically concluded that "[t]he concept of fraud includes the act of embezzlement, which is the fraudulent appropriation to one's own use of the money or goods entrusted to one's case by another,"[263] and that the "intangible nature" of

[256] *Durenberger*, 48 F.3d at 1241.

[257] Clark, *supra* note 201, at 59 n.7. To be sure, each of the fraudulent misappropriation schemes discussed above involved a member of Congress's allegedly false statements as well as material omissions of fact. Congressman Diggs, for example, was also convicted of making false statements to a U.S. agency (the House of Representatives Office of Finance) in violation of 18 U.S.C. § 1001 (2006). United States v. Diggs, 613 F.2d 988, 990-91 (D.C. Cir. 1979). Yet, presumably, the public that Congressman Diggs defrauded of "substantial sums of money," *id.* at 998, was unaware of the false statements and thus did not rely on them to their detriment. Accordingly, the D.C. Circuit Court's holding in *Diggs* implicitly recognizes that the public can be defrauded through a congressman's silence about breaches of trust and loyalty in connection with acts of misappropriation.

[258] *See supra* Part I.A.2.

[259] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[260] *Id.* at 654.

[261] 484 U.S. 19 (1987).

[262] *Id.* at 24.

[263] *Id.* at 27 (internal quotation marks omitted). The *Carpenter* Court also quoted the New York Court of Appeals' observation that "a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom." *Id.* at 27-28 (quoting Diamond v. Oreamuno, 248 N.E.2d 910, 912 (1969)) (internal quotation marks omitted).

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information "does not make it any less 'property.'"[264] Yet, while it was unanimous in upholding the defendant's convictions for mail and wire fraud, the Court had split 4-4 on the validity of the misappropriation theory for purposes of the defendants' Rule 10b-5 convictions.[265] The Court's subsequent 6-3 endorsement of the misappropriation theory in *O'Hagan* therefore broke the previous Rule 10b-5 deadlock in *Carpenter*.

Yet, prior to the decisions in *O'Hagan* and *Carpenter*, courts, including the Supreme Court, had long-recognized that the secret use of nonpublic government information defrauds the government and its citizens, even though the use of such information had not been viewed as a fraudulent deprivation of property, as such. Indeed, more than a century ago in *Haas v. Henkel*,[266] the Supreme Court reviewed an indictment charging the co-defendants with a conspiracy to obtain crop reports from a statistician in the Department of Agriculture "in advance of general publicity, and to use such information in speculating upon the cotton market."[267] The Court concluded that the conspiracy, if proven, would have defrauded "the United States by defeating, obstructing, and impairing it in the exercise of its governmental function in the regular and official duty of publicly promulgating fair, impartial and accurate reports concerning the cotton crop."[268]

Several U.S. circuit courts had likewise upheld criminal convictions in cases where the government and its citizens had been "defrauded" by schemes involving the use of nonpublic government information misappropriated for personal profit. A leading decision comes from the Second Circuit in *United States v. Peltz*,[269] in which Judge Friendly held that evidence of an agreement to secure nonpublic information from the SEC in order to profit in the stock market supported a jury verdict that the defendant had engaged in an illegal conspiracy to defraud the United States and the SEC.[270] In affirming the defendant's conviction under 18 U.S.C. § 371, Judge Friendly observed that:

> Public confidence essential to the effective functioning of government would be seriously impaired by any arrangement that would enable a few individuals to profit from advance knowledge of governmental action. The very making of a plan whereby a government employee will divulge material information which he knows he should not is 'dishonest' . . . regardless of whether such plan is secured by consideration.[271]

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[264] *Id.* at 25.

[265] *Id.* at 24 ("The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts.").

[266] 216 U.S. 462 (1910).

[267] *Id.* at 478.

[268] *Id.*

[269] 433 F.2d 48 (2d Cir. 1970).

[270] *Id.* at 49, 52.

[271] *Id.* at 52 (footnote and citations omitted).

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Another important decision is *United States v. Keane*,[272] which affirmed a jury verdict convicting a city councilman of violating the federal mail fraud statute in connection with a scheme involving, among other things, the use of "inside information" in the purchase of tax delinquent properties through nominees.[273] The indictment alleged that:

> [The] scheme defrauded the city of Chicago, its citizens and Keane's fellow alderman of their right to the "conscientious, loyal, faithful, disinterested and unbiased services, decisions, actions and performance of official duties" by the defendant and their right to have the City's business and its affairs conducted "honestly, impartially, free from deceit, craft, trickery, corruption, fraud, undue influence, dishonesty, conflict of interest, unlawful obstruction and impairments, and in accordance with the laws of the State of Illinois and the City of Chicago . . . ."[274]

The Seventh Circuit held explicitly that it was "clearly improper and therefore actionable under the mail fraud statute for the defendant to make use of inside advance information obtained by virtue of his official position for his own personal gain."[275] Citing *Peltz* and two other cases involving securities trading by corporate officials based on confidential corporate information, the court emphasized that those precedents "taken together show that advance dissemination and use of governmental information by a few individuals impairs the functioning of government and that when the use is made by a public official it amounts to a breach of a fiduciary duty which is clearly actionable under the mail fraud statute."[276]

The Fourth Circuit's opinion in *United States v. Bryan*[277] is perhaps the most instructive because, having been decided after *Carpenter*, it recognized that a West Virginia Lottery Commission Director's misappropriation of nonpublic government contract information for his own securities trading purposes can constitute a fraudulent deprivation of "property" belonging to "the citizens of West Virginia," in addition to a deprivation of their intangible right to receive honest services in violation of the federal wire fraud statute.[278] Yet, because

[272] 522 F.2d 534 (7th Cir. 1975).

[273] *Id.* at 542.

[274] *Id.* at 538-39 (quoting indictment).

[275] *Id.* at 545.

[276] *Id.*

[277] 58 F.3d 933 (4th Cir. 1995).

[278] *Id.* at 943. Although the Fourth Circuit's wire fraud holding was based on an indictment that predicated the charge on the director's "scheme to defraud the citizens of West Virginia of their right to his honest services" through trading on confidential information, the court cited with a *cf.* the Supreme Court's decision in *Carpenter* for the proposition that "confidential information is 'property,' the deprivation of which can constitute wire fraud." *Id.* (quoting Carpenter v. United States, 484 U.S. 19, 26 (1987)). The fact that the undisclosed misuse of nonpublic information constitutes a deprivation of a property right for purposes of the federal mail and wire fraud statutes is particularly

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the Supreme Court in *Carpenter* had split on the validity of the misappropriation theory, the Fourth Circuit in *Bryan* was free to rule that Rule 10b-5 insider trading liability could not be premised on the Director's misappropriation of the nonpublic information concerning the lottery contracts.[279] Today, however, in light of the Court's subsequent decision in *O'Hagan*, there should be no question that a government official's securities trading based on nonpublic state lottery information would violate Rule 10b-5. Indeed, such securities trading would defraud the public and the government of their right to the exclusive use of their property.[280]

Thus, if a court were presented with Congressman B's stock purchases in Company A, compelling precedents support the conclusion that his trading constitutes an undisclosed misappropriation of federal property which operates as a fraud and deceit on the United States and its citizens in violation of Rule 10b-5.[281] Like the *Wall Street Journal* and its owners, O'Hagan's law firm and its client, and the state and citizens of West Virginia, the United States and its citizens would be deceived and defrauded in connection with the purchase or sale of securities when a person entrusted with material nonpublic information feigns fidelity and exploits that information for his own personal profit. What is key here is that material nonpublic information had been entrusted to Congressman B by the United States and its citizens, even if the information was not explicitly confidential pursuant to a statute, internal rule, or any other specific mandate.[282] Nonpublic information about an imminent award of a

important in light of the narrow construction which must now be accorded to § 1346's protection of "the intangible right of honest services." *See* Skilling v. United States, 130 S. Ct. 2896, 2931 (2010) ("[W]e now hold that [18 U.S.C.] § 1346 criminalizes only the bribe-and-kickback core of the pre-*McNally* case law."); *see supra* notes 226-227. Whether profits from trading on the basis of material nonpublic information could be viewed as improper kick-backs for purposes of *Skilling*'s honest-services holding is a question for another day.

[279] United States v. Bryan, 58 F.3d 933, 943-44 (4th Cir. 1995) (emphasizing that while the misappropriation theory had been embraced by the Second, Seventh, and Ninth Circuits, the Supreme Court was evenly divided in *Carpenter* and thus had yet to rule definitively whether the theory is "reconcilable with the language and purposes of section 10(b) and Rule 10b-5").

[280] *Id.* at 943; *see also* United States v. ReBrook, 842 F. Supp. 891, 894 (S.D. W. Va. 1993), *aff'd in part, rev'd in part*, 58 F.3d 961 (4th Cir. 1995) (ruling on an appeal filed in a related prosecution involving an attorney who traded securities based on nonpublic lottery commission information).

[281] Congressman B's subsequent disclosure of his stock purchases in Company A pursuant to Senate reporting rules would not serve to insulate him from Rule 10b-5 because *O'Hagan* would require disclosure prior to the trade, not after, *see supra* text accompanying note 69, and would require advance disclosure to all persons who are owed a duty of loyalty, *see supra* note 69.

[282] Much nonpublic congressional information is nevertheless designated explicitly as "confidential" pursuant to a host of statutes and congressional rules. *See* George, *supra* note 12, at 166-67.

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defense contract by the Appropriations Committee does not belong to a member of Congress any more than nonpublic information about a lottery contract belongs to a state lottery director or nonpublic information about a corporation's possible ore strike belongs to its officers and directors.[283] As fiduciaries, they must hold that nonpublic information in trust for their principals.[284]

b. *The Federal Government as Employer*

Congressman B's "undisclosed self-serving use" of the Appropriations Committee's information to buy stock in Company A without prior disclosure of his intention to trade could likewise be viewed as a fraud on the federal government as his employer. As previously discussed, an employer and employee stand in a "paradigmatic" fiduciary-like relationship whereby the employee obtains access to information "to serve the ends of" his employer and "becomes duty-bound not to appropriate the property for his own use."[285] These principles account for why federal officials formerly with the FBI, the Federal Reserve, the Navy, and the Comptroller of the Currency (and/or their tippees) have all incurred liability for using nonpublic government information to profit personally from securities trading.[286] Thus, assuming he can be deemed an employee of the federal government, Congressman B's securities trading would constitute a violation of Rule 10b-5, even under the rather narrow parameters set out by the Second Circuit in *Chestman*.[287]

[283] *See* SEC v. Tex. Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968).

[284] Because this argument regards nonpublic government information as property belonging to the federal government and its citizens, it may hold particular appeal to those courts and scholars who justify the federal insider trading prohibition not on grounds of market integrity or investor confidence but rather on the protection of property rights in information. *See, e.g.*, United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) ("[T]he purpose of the misappropriation theory . . . is to protect property rights in information."); United States v. Chestman, 947 F.2d 551, 576-78 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) (discussing scholarship by then-Professor Frank Easterbrook). A principal criticism of this rationale has been that it extends Rule 10b-5 protection to property owners in fiduciary relationships with the trader or tipper, even though the beneficiaries of that relationship are not the focus of federal regulation. *See, e.g.*, Roberta S. Karmel, *Outsider Trading on Confidential Information – A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 113 (1998) ("The easiest criticism of the property rights theory is that when Congress passed and subsequently amended the Exchange Act, it was concerned about fairness and the protection of investors, not the protection of property rights in information . . . ."). Applying Rule 10b-5 to congressional insider trading is not susceptible to that criticism because the property owners (citizens) are also the principal parties protected by the anti-fraud prohibition (securities investors).

[285] *Chestman*, 947 F.2d at 569 (citing RESTATEMENT (SECOND) OF AGENCY § 395 (1958)).

[286] *See* cases cited *supra* notes 100-103.

[287] *See supra* notes 109-113 and accompanying text.

Members of Congress receive paychecks from the federal government, so at least in that sense they would seem to qualify as federal employees. Members of Congress have also been deemed employees of the federal government for the purposes of certain statutory protections or grants of immunity.[288] On the other hand, several federal statutes draw distinctions "between members of Congress and its officers and employees."[289] Moreover, as one commentator observes, "there is a sense that members of Congress are not like employees because their public election gives them autonomy to make decisions as they see fit without being accountable to anyone but their constituency (and to that extent, only in subsequent elections)."[290]

The inevitable handwringing that would occur over the question of whether members of Congress are employees of the federal government for purposes of the misappropriation theory is a function of the theory's reliance on common law to establish the duty of disclosure on which the Rule 10b-5 violation is premised. A loose analogy might be whether an independent contractor can be deemed an agent of the source of material nonpublic information, so that the contractor could be said to owe an inherent obligation of loyalty to his principal.[291] Ultimately, however, employment status, like agency status, serves as a heuristic that allows courts to find a relationship of trust and confidence that triggers the disclosure obligation in Rule 10b-5 insider trading cases. A court should find that members of Congress owe the United States

[288] *See, e.g.*, Lamar v. United States, 241 U.S. 103, 111 (1916) (holding that a member of the House of Representatives was an "officer of the government" within the meaning of a penal statute making it a crime to "falsely assume or pretend to be an officer or employee acting under the authority of the United States, or any Department, or any officer of the government thereof . . . ." (internal quotation marks omitted)); Operation Rescue Nat'l v. United States, 975 F. Supp. 92, 103 (D. Mass. 1997) (holding that Senator Edward Kennedy was an employee of the federal government within the meaning of the Federal Tort Claims Act (FTCA) and was thus entitled to immunity for alleged acts of defamation performed in the course of his employment), *aff'd*, 147 F.3d 68 (1st Cir. 1998). The district court in *Operation Rescue* specifically noted that the FTCA was one of a number of federal statutes treating Senators and Representatives as "employees of the government" and concluded that while Senators and Representatives are "elected by the people," they are "employed in the legislative branch and, therefore, fit within the literal definition of 'employee of the government.'" *Id.*

[289] *Id.* Significantly, in its Code of Ethics for Government Service, Congress drew no such distinction. *See* STAFF OF H. COMM. ON STANDARDS OF OFFICIAL CONDUCT, 110TH CONG., HOUSE ETHICS MANUAL 355 (Comm. Print 2008), *available at* http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf (stating that "it is the sense of Congress" that the Code "should be adhered to by all Government employees, including officeholders").

[290] Jerke, *supra* note 12, at 1487. *But see supra* notes 205-233 and accompanying text (discussing accountability through congressional self-discipline and Executive Branch prosecutions).

[291] *See* SEC v. Falbo, 14 F. Supp. 2d 508, 523 (S.D.N.Y. 1998).

and its citizens a disclosure obligation whether or not a member of Congress is technically a federal employee.

c. *Trust Relationships with Fellow Members and Officials Outside of Congress*

In addition to the United States and its citizens, a member of Congress who uses nonpublic government information in securities trading without disclosing his intention to do so may deceive his fellow members (or other federal officials outside of Congress) who also entrusted him with that nonpublic information. Because this theory would turn on the "reasonable and legitimate expectations" of the relevant parties, analysis would necessarily be ad hoc.[292] That is, as instructed by SEC Rule 10b-5(b)(2), a court would question whether the member of Congress and the source of the material nonpublic information "have a history, pattern, or practice of sharing confidences" whereby the member knows, or reasonably should know, that the person communicating the information expects the recipient to maintain its confidentiality.[293] If so, then that relationship provides yet another ground for liability under the misappropriation theory.

Retuning again to Representative Slaughter's example, Congressman B reasonably should know that the members of the Appropriations Committee expect him to maintain the confidentiality of nonpublic information pertaining to the imminent award of a defense contract. Members of Congress and federal officials from other parts of the government (like the DOD) rely on each other's loyalty and integrity, and these relationships routinely include "patterns and practices" of exchanging confidences. Accordingly, the members of the Appropriations Committee (or an official at the DOD) would have a "reasonable and legitimate" expectation that nonpublic information about the imminent award of a defense contract would remain confidential and would not be used to enhance the profit in Congressman B's securities portfolio.[294] Thus, in the words of *O'Hagan*, they would be "dupe[d]" or "defraud[ed]"[295] were Congressman B to purchase stock in Company A on the basis of this information without first disclosing his intention to do so.

It is possible that Congressman B could contend that members of Congress implicitly condone, or at least tolerate, the use of nonpublic congressional

[292] *See* cases cited *supra* notes 88-95.

[293] SEC Rule 10b-5, 17 C.F.R. § 240.10b5-2(b)(2) (2010).

[294] SEC v. Yun, 327 F.3d 1263, 1272 (11th Cir. 2003); *see* George, *supra* note 12, at 168-69 ("The unilateral decision by a Member or employee to release confidential information is inconsistent with the Senate's practice of making such decisions openly and collectively. Arrogation of this responsibility by individuals can destroy mutual trust among Members and be harmful to this institution" (quoting 138 CONG. REC. S17835, S17836 (daily ed. Oct. 8, 1992) (statement of Sen. Mitchell))).

[295] United States v. O'Hagan, 521 U.S. 642, 654 (1997) (internal quotation marks omitted).

information for personal profit in securities trading. One certainly would hope that this contention would not prove true empirically, and that Congressman B's stock purchases in Company A based on nonpublic information from the Appropriations Committee would instead draw scorn from other members of Congress who would regard such trading as unethical and outrageous. But even in the unlikely event that such information were viewed by other members of Congress as an emolument of office, that view would only negate a finding of deception with respect to his fellow members. It would not negate Congressman B's deception of the United States and its citizens who have had their property misappropriated.

d. *Agreements Not to Use Confidential Information for Personal Gain*

Finally, even if a court were to disregard all of the aforementioned ways in which Congressman B could be found to be in a relationship of trust and confidence with the sources of the material nonpublic information pertaining to Company A, a court might still impute a disclosure duty under Rule 10b-5 from the Code of Ethics for Government Service, which obligates all federal employees including officeholders to "[n]ever use any information coming to [them] confidentiality in the performance of governmental duties as a means for making private profit."[296] As the court maintained in *SEC v. Cuban*, even in the absence of a pre-existing fiduciary-like relationship with the source of material nonpublic information, a person can be held to an agreement "to refrain from trading on or otherwise using [information] for personal gain,"[297] and the "subsequent undisclosed use of [that] information for securities trading purposes" would constitute deception in violation of Rule 10b-5.[298] The fact that the Code is "not a law under which a Member or staffer can be prosecuted"[299] is irrelevant. Indeed, were a court to accept this agreement-not-to-use theory, Congressman B would not be prosecuted for violating the Code of Ethics. Rather, he would be prosecuted for violating Rule 10b-5 and the Code would be used as evidence of his agreement "to refrain from trading on or otherwise using"[300] congressional information for personal gain.[301]

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[296] Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

[297] SEC v. Cuban, 634 F. Supp. 2d 713, 724 (N.D. Tex. 2009).

[298] *Id.*

[299] Slaughter Fact Check, *supra* note 150 ("[The Code] is a House Rule, enforceable only by the House Ethics Committee on an internal basis . . . .").

[300] *Cuban*, 634 F. Supp. 2d at 725.

[301] *See* United States v. Rostenkowski, 59 F.3d 1291, 1305 (D.C. Cir. 1995) (upholding certain counts of an indictment charging congressman with mail and wire fraud, notwithstanding the fact that "[a]t trial, the Government will almost certainly rely upon House Rules in its effort to prove the statutory violations it has alleged"); United States v. Diggs, 613 F.2d 988, 1001 (D.C. Cir. 1979) ("The defendant clearly was tried not for violating the internal rules of the House of Representatives but for violating the mail fraud

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Congressman B could raise several arguments in defense. First, he could argue that his obligations under the Code do not amount to an agreement "to refrain from trading" within the meaning of *Cuban*. He could also argue that the *Cuban* decision is an outlier, and that the district court's reasoning does not comport with the fiduciary principles essential to the Supreme Court's holdings in prior insider trading cases.[302] Finally, he could argue that basing a Rule 10b-5 action on his alleged promise not to use the information would involve issues rendered non-justiciable by the Constitution's Rulemaking Clause,[303] because that Code provision is "too vague for judicial interpretation."[304] A court would then have to decide whether the Code is "ambiguous" or if it instead provides "judicially discoverable and manageable" standards for interpretation.[305] The answer to that question is hardly self-evident.

B. *Education as an Effective SEC Enforcement Tool*

A federal court may not be inclined to agree with each and every one of the above arguments under the classical and misappropriation theories of insider trading liability. But given the tremendously broad range of precedents, and the expansive view of the duty of trust and confidence that has become the norm in insider trading cases, if the SEC were to prosecute Congressman B for violating Rule 10b-5, the SEC would almost certainly be able to establish that multiple persons were deceived and defrauded in connection with his stock purchases in Company A, regardless of whether he obtained the nonpublic defense contract information from the Appropriations Committee or an official at the DOD. The same would be true if Congressman B purchased stock (or options) in Companies X, Y, and Z based on anticipated changes in the tax law or any other market-moving information that the SEC could prove was both material and nonpublic at the time of his trading. Given that Rule 10b-5 imposes on other government officials (as well as on attorneys, family members, electricians, roundtable members, creditors committee members, political consultants, and, of course, corporate insiders) an obligation to refrain from using material nonpublic information in their securities transactions,[306] surely it is not unreasonable to hold members of Congress to the same federal

and false statement statutes.").

[302] *See supra* notes 121-122.

[303] *See supra* notes 178-179.

[304] *Rostenkowski*, 59 F.3d at 1306.

[305] *Id.* ("[J]udicial interpretation of an ambiguous House Rule runs the risk of the court intruding into the sphere of influence reserved to the legislative branch under the Constitution. If a particular House Rule is sufficiently clear that we can be confident in our interpretation, however, then that risk is acceptably low and preferable to the alternative risk that an ordinary crime will escape the reach of the law merely because the malefactor holds legislative office." (citation omitted)).

[306] *See* cases cited *supra* notes 88-95.

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prohibition in an SEC prosecution. Indeed, insider trading defendants routinely are held criminally liable under Rule 10b-5 despite the rule of lenity which requires strict construction of criminal statutes.[307]

There should be little doubt that a single SEC Rule 10b-5 complaint filed against Congressman B for insider trading would "scare straight" other members of Congress or legislative staffers who may be operating under the misimpression that current law does not extend to securities trading on the basis of nonpublic congressional information.[308] But rather than clarifying the law through a targeted enforcement action, it would be far better for the SEC to first state unequivocally that Rule 10b-5's prohibition against insider trading applies to congressional knowledge in the same manner that it applies to other market-moving information that is both material and nonpublic. Given the claims circulating the media and blogosphere (not to mention in the halls of the Capitol), the SEC should be aggressively seeking to refute the congressional

[307] United States v. O'Hagan, 521 U.S. 642, 679 (Scalia, J., concurring in part and dissenting in part) (rejecting the majority's fraud-on-the-source misappropriation theory because under the "rule of lenity," section 10(b)'s "unelaborated statutory language . . . must be construed to require the manipulation or deception of a party to a securities transaction"); *see* Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1035 ("[T]he rule of lenity . . . requires strict construction of statutory ambiguities in order to avoid subjecting criminal defendants to surprise.").

[308] Some commentators have even suggested that the publicity generated by the 2004 study on Senate trading profits, Ziobrowski et al., *supra* note 5, may have "scared straight some Capitol Hill types." John Carney, *Has Congress Been Scared Straight on Insider Trading?*, CNBC (Oct. 12, 2010, 1:33 PM), http://www.cnbc.com/id/39634284/Has_Congress_Been_Scared_Straight_On_Insider_Trading. After his study was published, Professor Ziobrowski heard from other researchers who reported that members of Congress were no longer consistently outperforming other investors in the market in the years following his study. *Id.* He also observed that it is now much easier to track stock holdings of and trading by members of Congress because groups such as the Center for Responsive Politics have searchable databases of lawmakers' financial disclosures. *Id.* Furthermore, members of Congress may now be more likely to place their investment assets in blind trusts. *See* JACK MASKELL, CONG. RESEARCH SERV., RS21656, THE USE OF BLIND TRUSTS FOR FEDERAL OFFICIALS 1 (2005) (describing a blind trust as "a device employed by a federal official to hold, administer and manage the private financial assets, investments and ownerships of the official, and his or her spouse and dependant children, as a method of conflict of interest avoidance"). Members of Congress may also be wary about the possibility of private securities litigation. Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (2006), provides contemporaneous traders with an express right of action against any person who violates any provision of the Exchange Act "by purchasing or selling any security while in possession of material, nonpublic information." *Id.* Private plaintiffs suing under section 20A need not prove that the defendant owed them a duty of disclosure; rather, to recover a defendant's illegal gain from insider trading, plaintiffs need only to plead and prove a predicate violation of the Exchange Act, such as a violation of Rule 10b-5. *See* FERRARA, ET AL., *supra* note 43, at § 3.02.

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immunity mantra and should be counseling the sponsors of the STOCK Act as to Rule 10b-5's exceedingly broad scope. A series of speeches or statements to the press would be important first steps toward changing practices in Congress that may have become entrenched but that nonetheless undermine the integrity not only of securities markets but also of government itself. In view of the constitutional and other obstacles that the SEC could encounter while investigating congressional insider trading, education, rather than prosecution, may well be the SEC's most effective enforcement tool.

C. *Legislative Staffers and Other Congressional Employees*

Like Congressman B's securities trading based on nonpublic information about a defense contract, insider trading by a legislative staffer – or any other congressional employee – would violate Rule 10b-5 pursuant to both the classical theory and the misappropriation theory. These individuals work for the members of Congress who were elected to serve the public as Senators and Representatives, and their disclosure obligations under Rule 10b-5 are thus both derivative and direct. As agents for public fiduciaries, legislative staffers and other employees of Congress owe the general public (some of whom are investors trading contemporaneously) the same disclosure duties that are owed by the members or congressional committees who employ them, and their failure to disclose material nonpublic facts in a securities transaction would violate Rule 10b-5 under the classical theory.[309] These employees also stand in a direct fiduciary-like relationship with one or more members of Congress and their "undisclosed, self-serving use"[310] of their employer's information would violate Rule 10b-5 under the misappropriation theory as well.[311] As discussed above, even scholars who have questioned the reach of existing law to members of Congress are quick to conclude that legislative staffers and other congressional employees would be liable under Rule 10b-5 based on the well-established employer-employee misappropriation theory precedents.[312]

D. *Nonpublic Congressional Information Conveyed Through Tipping*

Given the size and the complexity of the so-called "political intelligence" industry in the United States,[313] how the foregoing discussion relates to the

[309] *See supra* Part III.A.

[310] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[311] *See supra* Part III.A-B.

[312] *See* Bainbridge, *Beltway I*, *supra* note 12, at 294-95 ("[T]he relationship between the government and one of its employees is such that the undisclosed use by the latter of information gained in the course of his employment would give rise to liability under the misappropriation theory . . . . [and the] employment relationship should suffice for Congressional staffers to be deemed to have an agency or other relationship of trust and confidence with their employing agency."); Lambert, *supra* note 12.

[313] For extensive analysis of what has become known as the "political intelligence industry," see Jerke, *supra* note 12, at 1510-19 (seeking to curb the use of "political

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topic of tipping merits an entire article all on its own. For present purposes, though, we can look to the Court's express statements in *Dirks* that a "tippee's duty to disclose or abstain is derivative"[314] and that a tippee's disclosure obligation under Rule 10b-5 arises "from his role as a participant after the fact in the [tipper's] breach of a fiduciary duty."[315] Thus, to establish Rule 10b-5 liability on the part of a congressional official for tipping material nonpublic information (as opposed to trading on that information himself), the SEC would have to show that the official breached a fiduciary-like duty for some "direct or indirect personal benefit . . . such as a pecuniary gain or a reputational benefit" or that the official intended to make "a gift of confidential information to a trading relative or a friend."[316] Moreover, even if the SEC could establish such a breach on the part of the congressional official, his tippee would be liable under Rule 10b-5 only if the SEC could prove that the tippee knew, or should have known, that there had been a breach.[317]

Congressional officials may have a host of reasons for sharing material nonpublic information with others outside Congress.[318] But under the framework set out by the Court in *Dirks*, Rule 10b-5 liability for illegal tipping and trading would be entirely dependent on the congressional official's motivation for sharing such information. *Dirks*'s "personal benefit" requirement would thus constitute a hurdle in any insider trading case where nonpublic congressional information is alleged to have been used. But just as that hurdle is cleared routinely in tipper-tippee cases outside of Congress (including in several cases involving tips by federal officials),[319] that hurdle could be overcome in cases involving tips by members of Congress, legislative staffers, and other congressional employees where nonpublic congressional information was conveyed in exchange for a personal benefit.[320]

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intelligence" through changes in congressional ethics rules rather than through an expanded application of Rule 10b-5).

[314] Dirks v. SEC, 463 U.S. 646, 659 (1983).

[315] *Id.* (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12).

[316] *Id.* at 663-64. Although some courts disagree, the predominant view is that *Dirks*'s personal benefit requirement applies in both classical and misappropriation theory cases. *See* FERRARA ET AL., *supra* note 43, at 2-74.

[317] *Dirks*, 463 U.S. at 660.

[318] *See* PAINTER, *supra* note 12, at 167-70 (observing that campaign fundraisers, social events, and official briefings of industry groups are all "venues where government officials can be pumped for nonpublic information" and suggesting that elected officials who share such information may be "behaving very similarly to a tipper who, in return for payment, leaks misappropriated information to a tippee").

[319] *See* cases cited *supra* notes 100-103.

[320] *See* PAINTER, *supra* note 12, at 170 & n.246 (suggesting that, in some circumstances, campaign contributions could be viewed as a personal benefit to elected officials within the meaning of *Dirks*). Of course, in the corporate context, *Dirks*'s personal benefit requirement often prevented the SEC from pursuing Rule 10b-5 actions against persons who had traded securities on the basis of so-called "selective disclosures" that were arguably

CONCLUSION

Congress, the SEC, and the Supreme Court all share in the view that the federal securities laws prohibit the offense of insider trading to promote market integrity and to foster investor confidence in the capital markets. Insider trading on the basis of nonpublic congressional knowledge undermines these important objectives while simultaneously compromising the public's trust and confidence in the government itself.

The conventional wisdom that "it is perfectly legal to profit from information obtained within the Congress,"[321] and that members of Congress and legislative staffers are "immune from insider-trading laws"[322] is thus highly problematic. Not only are such statements inaccurate, but they also fuel a troubling public perception that congressional officials are taking advantage of their positions to the public's own detriment and that the SEC is utterly helpless to prevent it. The SEC should be doing more to refute both the flawed legal claims and the public's misperceptions.

The issue of congressional insider trading can serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. But the STOCK Act addresses only a slice of the much larger problem and, ironically, its enactment would likely narrow the general law under Rule 10b-5 that would otherwise apply to insider trading by congressional officials in the absence of a new statute. Unless and until Congress acts to change the law more generally, the classical and misappropriation theories – with their emphasis on duties of entrustment – can function as well for congressional officials as they do for everyone else who trades securities in the capital markets.

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motivated by a corporate purpose. *See* NAGY ET AL., *supra* note 130, at 491-92, 552. Securities analysts and other investment professionals, however, now operate in the wake of Regulation FD, which effectively prohibits public companies and their insiders from selectively disclosing material information to persons who are likely to trade on it, if the information has not been shared with the general public. *See* SEC Regulation FD, 17 C.F.R. § 243.100(a)-(b)(1) (2010). A Regulation FD analogue for elected officials is an intriguing possibility that warrants further consideration. *See* PAINTER, *supra* note 12, at 171 (positing a "Regulation FD for government" but contending that it "would be difficult to design and implement").

[321] *Baird March 2006 Press Release*, *supra* note 148.

[322] McGinty & Mullins, *supra* note 9.

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Hearing on Insider Trading and Congressional Accountability before the United States Senate Committee on Homeland Security and Governmental Affairs

Testimony of Donald C. Langevoort,
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December 1, 2011

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My name is Donald C. Langevoort, and I am the Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center in Washington, D.C. I have spent much of my professional career writing and teaching about the law of insider trading, including a treatise on the subject entitled *Insider Trading: Regulation, Enforcement and Prevention* (West), and have testified before committees of Congress numerous times on matters relating to insider trading and securities enforcement. Before becoming an academic, I served on the staff of the Office of the General Counsel at the United States Securities & Exchange Commission, where I worked on insider trading matters in the aftermath of the Supreme Court's seminal 1980 decision in *Chiarella v. United States*.

My testimony today strongly supports legislative efforts to explicitly proscribe insider trading by Members of Congress and their staffs, as is intended by the various STOCK Act bills recently introduced in the House and Senate. To be sure, there is no current exemption from the main thrust of U.S. insider trading law for either Members or staff, and many forms of trading or tipping by such persons are adequately proscribed under existing legal authority. Indeed, it is possible that courts would rule that current insider trading law adequately proscribes *all* abusive trading in securities on Capitol Hill. But there is sufficient doubt, especially in light of how courts recently have been reading Section 10(b) and SEC Rule 10b-5, so that explicit legislative clarification is desirable.

The ban on unlawful insider trading plays an important role with respect to the U.S. capital markets. Economists have shown that an insider trading prohibition plays a useful role in addressing dysfunctional consequences from permitting those in possession of material non-public information from exploiting their unique positions of access—adverse selection in markets, agency cost problems, threats to corporate privacy, and the like. But just as important, the prohibition performs an expressive function in signaling to the people of the U.S. and around the world that our markets are open, transparent and fair, and not rigged in favor of the economically or politically powerful. It is part of the American brand of deep and liquid capital markets that invite participation by ordinary retail investors as well as large financial institutions. Public trust in the openness and fairness of marketplace institutions is important for economic stability and growth.

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Countries that have credibly committed to the enforcement of an insider trading prohibition have more robust capital markets than those that do not.[1] Just the perception (whether or not accurate) that Congress is "above" the prohibition that applies broadly outside of Capitol Hill threatens our long-standing commitment to fair and open markets.

The law of insider trading requires balan ce. Information is the lifeblood of markets, and we want those who have generated their own private information about the value of traded securities to seek to profit from it. The competitiveness of our markets—and their crucial role in private capital formation—depends on their efficiency, and so the law should not discourage productive trading. As I will explain more fully below, our insider trading law seeks this balance by limiting liability largely to those who breach a fiduciary-like duty to the true "owner(s)" of the information by trading or tipping while in possession of information that is both material and non-public. Putting aside the legal issues, I am not aware of any argument that either the fairness or efficiency of our markets is enhanced by letting a government official step in front of the investing public to take advantage of information that has come to them in connection with their official duties. Even the strongest critics of U.S. insider trading law as applied in the private sector, like the well-known legal economist Henry Manne and his contemporary academic disciples, find no cause to permit insider trading inside the government.[2]

So, there is really no doubt that insider trading by members of Congress or their staffs should be proscribed. The only question is whether it already is, to which I now turn.

The Existing Insider Trading Prohibition

In 1934, when the principal legislation designed to bring regulation to securities trading in the U.S. was enacted, Congress expressed substantial concern about insider

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[1] See Battacharaya & Daouk, *The World Price of Insider Trading*, JOURNAL OF FINANCE, vol. 57, p. 75 (2002).

[2] See HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966), p. 184.

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trading abuses, but addressed them in a very narrow way. Section 16 of the Securities Exchange Act requires the reporting of trades by a limited category of insiders—those who are officers, directors, or large shareholders of public companies—and requires the disgorgement of short-swing trading profits made by such persons. From Section 16 alone, one might perhaps infer that Congress is not covered by (or has "exempted itself" from) the law of insider trading. But Section 16 does not cover the vast majority of the American investing public either.

It was quickly understood that this limited statutory response to insider trading was inadequate to the task of promoting fair and open markets. Some years later, the SEC took the position that it is *fraudulent* for insiders to unfairly exploit positions of access to information, whether or not covered by Section 16, and gradually the courts came to agree. It is now clear that the basic antifraud provision of the Securities Exchange Act, Section 10(b) as implemented by SEC Rule 10b-5, provides the main prohibition against insider trading. But Rule 10b-5's potency with respect to insider trading derives from SEC and judicial interpretation of a general antifraud rule, not express legislative action. Congress has by legislation enhanced the penalties for insider trading violations under Rule 10b-5, but—perhaps unfortunately—left the definition of what constitutes fraudulent insider trading to the courts and the SEC.

Section 10(b) and Rule 10b-5 apply to "any person" who engages in the fraudulent or manipulative acts subject to prohibition. There are no exemptions for anyone, which readily disposes of the misimpression that Congress is not subject to this form of insider trading law. Anyone who intentionally commits securities fraud, whether by insider trading or otherwise, violates federal law. The question is what *constitutes* fraudulent insider trading.

In its early years, insider trading law as articulated by the lower courts under Rule 10b-5 was fairly open-ended, applying expansively to any unfair exploitation of privileged access to information. In 1980, the Supreme Court—in an opinion by Justice Lewis Powell—imposed more restraint on the prohibition by holding that persons who trade while in possession of material nonpublic information act fraudulently only to the extent that they are subject to a pre-existing duty of trust and confidence vis-à-vis those

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with whom they trade.[3] Absent such a duty, traders are free to pursue profitable advantage. The most obviously situation where such a duty exists, as Justice Powell recognized, is when corporate insiders trade with shareholders of their own corporation—the "owners" for whom the insiders work.

Many insiders who seek to exploit information do not trade for themselves but rather tip friends or family members in order to enrich them. In 1983, again speaking through Justice Powell, the Supreme Court said that "tippers" and "tippees" violate Rule 10b-5 if they act jointly in such a way that the insider breaches a fiduciary-like duty by seeking his or her *own personal benefit* from the tip—whether pecuniary benefit, reputational benefit, or simply by making a gift of the information.[4] This corruption element was designed to assure that bona fide communications in the securities markets are not chilled by the insider trading prohibition. Where selfish gain is the objective, on the other hand, insiders cannot pass on the information outside the company.

These legal principles—which we refer to today as the "classical" approach—require the presence of an insider of the company whose shares were being traded, as either trader or tipper. In the eyes of the SEC and many others, this threatened a large gap in insider trading regulation as applied to persons privy to inside information that affects the value of stock of *other* companies—for example, an investment banker who buys stock in a company that is going to be subject of a takeover bid, or a government official who knows of action about to be taken (e.g., an antitrust action) against a particular company. These people may be fiduciaries, but not vis-à-vis the issuer of the securities in question. To address this, the SEC began to argue that the deception element of Rule 10b-5 can be met by showing that a person was entrusted with confidential information by the "owner" of that information, and breached that trust by secretly misappropriating it for personal gain, either by trading or tipping. This was a controversial move because in many cases the fiduciary duty in question was disconnected from the corporate setting where most insider trading occurs. Lower courts

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[3] Chiarella v. United States, 445 U.S. 222 (1980).

[4] Dirks v. SEC, 463 U.S. 646 (1983).

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split about the validity of this so-called "misappropriation theory" of insider trading, but in 1997 a divided Supreme Court upheld the theory as applied to a partner in a law firm who traded in the stock of a takeover target that he learned from the firm's client, the bidder in that takeover battle.[5] The Court said that so long as a fiduciary relationship exists, the person who trades deceives the source of the information by pretending to act as a loyal agent while in fact acting selfishly. When that deception—"feigning loyalty"—involves trading in securities, it constitutes securities fraud.

With the law's reach broadened this way, the SEC or criminal prosecutors can now bring an insider trading case against a person who trades or tips while in possession of material nonpublic information by showing one of two things: that such person either owed a fiduciary-like duty to the person or persons on the other side of the trade and breached that duty by failing to disclose, or owed a fiduciary-like duty to the source of the information and breached that duty by secretly misappropriating that information for personal gain. Nearly all insider trading prosecutions or enforcement actions involve one of these two well-established theories.[6]

Insider Trading in Congress

Some cases against members of Congress could be fairly straightforward under the law just described. For instance, if a senator attended a dinner party with the CEO of a public company who improperly (i.e., for personal benefit) shared a tip with everyone at the table, the senator would be no more free to act on that tip than anyone else in attendance. Or information given to a Member of Congress where the Member agreed to respect the confidentiality of the information in question (e.g., a voluntary submission by

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[5] United States v. O'Hagan, 521 U.S. 642 (1997).

[6] There is also a special insider trading prohibition (Rule 14e-3) adopted by the SEC to address tender offers. This on its face applies to any person, and requires that the information in question be derived either from the bidder or the target company. In contrast to the law under Rule 10b-5, there is no explicit fiduciary duty requirement.

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an issuer where the member agreed to respect the issuer's rights to that information) would trigger the misappropriation theory via SEC Rule 10b5-2.[7]

However, many cases involving Members of Congress would not fall so neatly into place, especially as they involve pending or contemplated legislative activity. To take the quintessential example, suppose a senator was seeking favorable legislative treatment for a company in his or her state and had now found the votes for such a deal. Could the senator buy stock or options in that company? Or suppose that the senator had just succeeded in gaining consensus to the inclusion of legislative language in a bill that would reduce the intellectual property protection for certain biopharmaceutical companies. Could the senator sell short or sell put options on those stocks (or trade exchange traded funds, indexes or futures to the same result)?

The SEC's challenges in making this case are easy to spot. Under the misappropriation theory described above, it would have to prove that the senator breached a fiduciary or fiduciary-like duty owed to some person or entity who entrusted that information to him or her, "feigning loyalty" while in fact acting corruptly. But as elected officials, members of Congress are not employees or agents in any conventional sense, and so it becomes difficult to identify a separate owner of the information to which they owe a legally enforceable fiduciary duty of loyalty. Under our constitutional system, duly elected Members have a status separate and distinct from that of partner, agent or employee, far different from those with whom in mind the misappropriation theory was devised. Information they glean from their own legislative activities does not necessarily *belong* to someone else, and existing insider trading law does not prohibit a person from taking advantage of his or her own information. Because of this, a number of commentators have concluded that existing insider trading prohibitions do not reach this sort of trading or tipping on Capitol Hill.[8]

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[7] Rule 10b5-2 describes certain kinds of relationships that give rise to an expectation of trust or confidence under the misappropriation theory. The rule has been challenged as exceeding the SEC's rulemaking power in litigation to the extent that it seeks to create a fiduciary-like duty based simply on a confidentiality agreement.

[8] See Bainbridge, *Insider Trading Inside the Beltway*, JOURNAL OF CORPORATION LAW, vol. 36, p. 281 (2011). Similar views can be found in a number of other writings. See, e.g., Macey & O'Hara, *Regulation*

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That is contestable, of course. Long ago, with reference to the "classical" theory, I suggested that all government officials might owe a fiduciary-like duty to the citizens of the United States generally that could support a duty to disclose.[9] And as Professor Donna Nagy has ably argued much more recently, there is precedent for saying that members owe duties both to the public and Congress as a distinct institution that would support a duty to disclose under either the classical or misappropriation theories.[10] Existing ethics codes covering Members of both the House and Senate specifically address the duty to respect legislative confidences. Because she is also testifying today, I will leave it to her to elaborate on this.

As an SEC enforcement lawyer or criminal prosecutor, I would willingly embrace these arguments in favor of a fiduciary-like duty in making my case. Indeed, if I were a judge I would probably find them persuasive enough to apply to most forms of Congressional insider trading. But I have qualms about whether this is what all, or even most, of today's federal courts would do if confronted with the types of cases I described.

In recent years, the Supreme Court in particular has articulated a severely restrained approach to applying Rule 10b-5 in novel or ambiguous situations involving important policy issues, saying that it is for Congress, not the courts, to extend the Rule's reach. While these cases have largely involved private litigation, the negative effect on the scope of the SEC's reach has been substantial. We have by told by the Court, for example, that Rule 10b-5 does not apply to those who knowingly aid and abet securities fraud,[11] or to securities transactions that are executed outside United States borders[12]—both of which, thankfully, Congress quickly rectified as applied to SEC enforcement

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and Scholarship: Constant Companions or Occasional Bedfellows?, YALE JOURNAL ON REGULATION, vol. 26, p. 86 (2009); Jerke, *Comment: Cashing In on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 158, p. 1451 (2010).

[9] Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, CALIFORNIA LAW REVIEW, vol. 70, pp. 1, 34-35 (1982).

[10] Nagy, *Insider Trading, Congressional Officials and Duties of Entrustment*, BOSTON UNIVERSITY LAW REVIEW, vol. 91, p. 1105 (2011).

[11] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).

[12] Morrison v. National Australia Bank, 130 S.Ct. 2869 (2010).

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actions. More recently, the Court held that a mutual fund adviser does not "make" a misrepresentation even if it knowingly wrote the false report, so long as the report was filed under the name of the mutual fund itself[13]—a decision, I believe, that deserves the same fate. In all these cases, the Court stressed that Congress should take on these scope issues, not leave them to the judiciary.

I can readily foresee a similar response to Congressional insider trading. That issue is far enough removed from conventional insider trading on Wall Street and Main Street so that the fiduciary-based tools usually employed do not work cleanly, and constitutional issues such as the Speech and Debate Clause lurk in the shadows. The risk is even greater now that the issue has captured Congress' and the public's attention, leading to hearings such as these. A refusal on the part of Congress to act in the face of this interest might well be interpreted by the courts as an additional reason for judicial restraint.

These same impediments, on the other hand, do not apply with respect to insider trading by Congressional staff members. As employees, they are more conventionally agents for the members or committees whom they serve. The SEC has brought numerous cases against government officials (or those connected to government officials) for trading or tipping, and I doubt that cases against staff members pose special legal challenges. Of course, one might imagine a staff member—particularly on a member's personal staff—arguing that insider trading was implicitly condoned in his or her particular office (or implicitly, maybe in Congress generally), so that profiting from information would not really involve any "feigned loyalty." But the presumption, at least, is a legally enforceable expectation of loyalty with respect to Congressional confidences, and I suspect that arguments to the contrary would not receive a sympathetic response from many judges. That said, there is no reason why legislation designed to address Congressional insider trading should not apply to staff as well.

[13] Janus Capital Group Inc. v. First Derivative Traders, 131 S.Ct. 2296 (2011).

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The Appropriate Legislative Response

For these reasons, I strongly support efforts to clarify that our insider trading prohibition applies to members of Congress and their staffs. This should be coupled with a prompt and effective requirement that Members and staff report trading activity in securities and related financial instruments that they beneficially own.

I do have some concerns with how the pending STOCK Act bills have been drafted, however, though I have not done a thorough line-by-line analysis at this point.[14] In some significant respects, the standards for liability may be overbroad (though I recognize that the legislation would be implemented and hence the overbreadth possibly cured by agency rulemaking). For instance:

(a) The definition of "material nonpublic information" refers to something that does not exist—an SEC rule defining that term[15]—and then speaks of *any* information that is gained by reason of status as a member of Congress or employee that the person knows or should know has not been made available to the general public. Missing is a qualifier that limits the insider trading prohibition to information significant enough to influence a reasonable investor—meaning that receipt of even the most trivial information, if nonpublic, would impose a ban on trading.

(b) The ban on trading by persons who obtain information from members of Congress or staff has no reference to how or why such information was communicated to them, and hence would have an unduly broad sweep.

On the other hand, there are elements that seem seriously under-inclusive, which is especially troubling if this legislation is deemed as a matter of statutory interpretation

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[14] I will limit these comments to securities-based insider trading in Congress, even though I recognize that the bills would apply to federal employees more generally. I fully support the effort in these bills to cause the Commodities Futures Trading Commission to address insider trading in non-securities financial instruments. As you may be aware, the Dodd-Frank Act of 2010 substantially expanded the CFTC's reach with respect to insider trading, including a prohibition (section 746) dealing explicitly with tipping and trading by government officials.

[15] The word "material" is defined in an SEC rule (Rule 405), but not with reference to insider trading.

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the exclusive statement of Congressional member and staff responsibilities.[16] For example:

(a) There is no explicit prohibition on tipping, no matter how deliberate the improper intent to benefit the recipient might be.[17]

(b) The trigger to responsibility is that the information must relate to "pending or prospective legislative action," which would not cover confidential briefings, information relating to government contracts, etc., of which the member or staff learn through their service. Just by way of one example, a Member might privately learn of a forthcoming antitrust action by the Justice Department based on discussions with officials of that agency, which would not involve pending or prospective legislation.

(c) That the pending or prospective legislative action must relate to the securities of the issuer leaves open trading in non-issuer specific instruments like exchange traded funds, or in securities of issuers who are not the subject of legislation but directly or indirectly the beneficiary or victim of some pending governmental action that the Member or staff has learned about on the job.

Given that the intent of this legislation—and public expectations—are to impose an effective insider trading ban on Congress and its staff, it would be quite troublesome for Congress to enact legislation that had the effect of protecting Members and staff from liability that would readily follow as insider trading law is applied generally.

There is a much simpler route to an effective Congressional insider trading prohibition, which would avoid these drafting challenges. First, the legislation should articulate a duty on the part of members of Congress and their staffs to respect the confidentiality of material nonpublic information they gain in the scope of their legislative service and not seek to profit directly or indirectly therefrom. It should then provide that a fraudulent breach of such duty in connection with the purchase or sale of a

[16] I would in any event state that the Congressional prohibition supplements rather than preempts insider trading law of general applicability.

[17] Section 746 of the Dodd-Frank Act, applying to tipping by government officials of commodities-related information, bans the imparting of material nonpublic information by an official "in his personal capacity and for personal gain with intent to assist another person, directly or indirectly, to use the information."

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security constitutes a violation of the Securities Exchange Act of 1934, subjecting the person to the same liabilities and remedies as any other person who violates that Act by misusing material nonpublic information.

This approach would conform the prohibition against Congressional insider trading with the prohibition applied to the rest of the investing public. The large body of precedent on the meaning of insider trading apart from the question of duty would be incorporated. With respect to materiality, for example, the information in question would have to be sufficiently concrete in terms of likelihood of occurrence and magnitude of impact in order to trigger the ban on trading or tipping. Like other investors, Members and staff would remain free to buy and sell securities based on their general insight about particular stocks, industries or markets—even if that is derived from their legislative work—so long as they do not possess discrete information acquired in the course of Congressional service that the law would treat as material.

Existing law also does a reasonably good job of limiting tipping liability, so that members and their staff need not fear a chill in terms of communicating with the public about legislative activity. While courts disagree about the precise articulation of tipper-tippee liability in misappropriation cases, the standard is clearly one of intentionally misusing the information, typically for personal gain. This required element of corruption protects bona fide communications under existing insider trading law. Indeed, the relative freedom to engage in non-corrupt private communications under existing law was the reason why the SEC felt it necessary to impose a separate obligation on high-ranking corporate insiders to refrain from selective disclosure to favored investors in Regulation FD. Reg FD only applies in the corporate setting, and would not affect bona fide (i.e., non-corrupt) private communications on Capitol Hill. If anything, I would worry that existing law permits too much private communication, rather than too little.

To be sure, there are ambiguities in existing law relating to materiality, "non-publicness" and scienter that would be imported into the law of Congressional insider trading (and which may already be present to the extent that existing law is applicable). This is partly a consequence of the fact that there is no statutory definition of insider trading to create a coherent normative framework, which I think is unfortunate. But

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Congress should be on the same footing as the investing public, and any resolution of the ambiguities should be in the form of legislation that applies to insider trading cases generally.

Conclusion

The idea that Members of Congress or their staffs can freely step ahead of ordinary investors to profit from information acquired as a result of their legislative roles is disturbing, to say the least. While current insider trading law is more potent with regard to such activity than some of the public commentary on this issue suggests, Congress should act eliminate any doubt and state clearly that both the trading and tipping prohibitions apply to Members and staff. It would be extremely unfortunate were the SEC or prosecutors to bring an action and have the Member or staff person raise the defense, which they surely would, that service in Congress carries with it no fiduciary-like duty to respect governmental confidences. That would be the last headline Congress should want to see.

The SEC deserves resolution of this as well. An insider trading case against a Member (or even a powerful staff person) will always be a matter of great political sensitivity, likely to be brought only to the extent that the case—legally and factually—is very strong. The external pressures to bring such cases, or not bring them, will inevitably be great when any suspicions arise. Leaving any ambiguity as to the question of whether, and to what extent, the insider trading on Capitol Hill is unlawful is hardly an encouragement to those matters that deserve to be courageously investigated and pursued. Conversely, an explicit statement by Congress that its Members and staff are subject to a duty of trust and confidence would make plain, to the SEC and the American public, that Congress expects no special privilege or treatment with respect to the rules of fair play in the U.S. capital markets.

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Testimony of Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law
Columbia University Law School

at a Hearing Before the

Senate Committee on Homeland Security and Governmental Affairs

"INSIDER TRADING AND CONGRESSIONAL ACCOUNTABILITY"

December 1, 2011

Dirksen Senate Office Building
SD-342

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Chairman Lieberman, Ranking Member Collins and Members of the Committee:

I am honored to be invited by you, and will proceed directly to the point:

Are Members of Congress exempt from the insider trading laws? Can they sometimes engage in securities or commodities trading based on material non-public information, which trading would be unlawful (and potentially criminal) if engaged in by private citizens?

In a brief Executive Summary, my testimony will conclude:

(1) There are substantial ambiguities in the judge-made law on insider trading that would make it difficult to enforce the existing prohibition against Members of Congress in some settings. Although the Supreme Court could resolve these ambiguities in favor of liability, there is little certainty that they will, and public enforcers may hesitate in enforcing the law to its full extent in the interim. Hence, I believe there are good arguments for Congress to act to fill this possible loophole.

(2) While both S.1871 and S.1903 are well intentioned, they leave major loopholes that undercut their deterrent effect, because much material, nonpublic information that a Member of Congress receives does not relate to "pending or proposed legislation" (as these proposed statutes would require).

(3) A less drastic alternative to the proposed legislation is available: Congress could simply pass legislation declaring that a Member of Congress is a fiduciary for purposes of insider trading liability, and that no personal benefit or deceptive act is required to establish liability. This would enable Congress to sidestep the need to define terms such as "material" or "nonpublic" and instead rely on the existing case law. The one thing that Congress should not

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attempt is a universal, comprehensive statute that defines all aspects of insider trading law. That risks a debacle.

(4) Members of Congress can rely on "Rule 10b5-1" plans so that the proposed extension of the insider trading prohibition to their trading should not render them illiquid. Congress could also instruct the SEC to give guidance in "no action" letters on a confidential basis to Members of Congress who are concerned about whether trading might violate the law. Opinions from private counsel would also provide substantial protection if all relevant details were provided to the counsel giving such opinion.

(5) Ultimately, "sunlight is the best disinfectant," and a requirement that Members of Congress disclose their trading within a brief period thereafter and that such information be made publicly available on a website could prove the most effective and least intrusive deterrent to improper use of material, nonpublic information by them.

I. The Legal Status of Trading by Members of Congress On Material, Non-Public Information

As you are no doubt aware, there has been a spirited debate among academics and journalists about whether Members of Congress can trade on the basis of material nonpublic information that they learn in the course of their duties.[1] Some have argued that they cannot be held liable (at least in most cases),[2] while others have replied, just as

[1] Compare Stephen Bainbridge, Insider Trading Inside the Beltway, 36 Iowa J. Corp. Law 281 (2011) with Donna Nagy, Insider Trading, Congressional Officials and Duties of Entrustment, 91 B.U.L. Rev. 1105 (2011). See also, Stephen Bainbridge, The Stop Trading on Congressional Knowledge Act (available at http://ssrn.com/abstract=1449744) (2011).
[2] See Bainbridge, supra note 1.

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fervently, that they can.[3] I must note that the participants in this debate have all been respected academics, knowledgeable in this field, and nothing in my comments is meant to imply disrespect for either side in this debate. Rather, because insider trading is not defined by statute, the contours of unlawful insider trading are shaped by a maze of decisions, about which reasonable experts can disagree.

Nonetheless, I believe that there is a correct answer to the question whether Members of Congress can engage in what the public would consider to be insider trading. That answer is: SOMETIMES. In my judgment, Members of Congress could be successfully sued by the SEC in the following (but limited) instances:

(1) they traded on material non-public information relating to a tender offer;[4]

(2) they breached a duty of confidentiality that they voluntarily assumed (including by contract) that required them not to trade on that information;[5]

(3) they knowingly received a "gift of information" from an insider who would, himself or herself, be barred from trading;[6] or

(4) they have a defined family relationship or prior "history, pattern or practice of sharing confidences" with the person who confided the material, non-public information to them.[7]

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[3] See Nagy, supra note 1.

[4] Such trading is expressly prohibited by Rule 14e-3, which does not require that there be any breach of a fiduciary duty. See 17 C.F.R. § 240.14e-3.

[5] See Rule 10b5-2(b)(1) (specifying that such a "duty of trust or confidence" exists "whenever a person agrees to maintain information in confidence"). See 17 C.F.R. § 240.10b5-2. This rule was challenged and found unauthorized in SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) rev'd on other grounds, 620 F.3d 551 (5th Cir. 2010), but that court did uphold the idea that a contract can create a duty of confidentiality that bars trading if it is sufficiently explicit.

[6] See Dirks v. SEC, 463 U.S. 646, at 667 (1983) (discussing a "gift of confidential information to a trading relative or a friend" and finding it to be within the reach of Rule 10b-5).

[7] See Rule 10b5-2(b)(2).

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It should be obvious that these examples cover only the minority of cases. Thus, I am in general agreement with those (including Professor Stephen Bainbridge[8]) who argue that Members of Congress are not clearly covered by the prohibition on insider trading.

Why is that? Certainly, no law or decision has expressly exempted Member of Congress from the insider trading prohibition. My answer is that there are at least three serious obstacles that interfere with attempting to apply the standard doctrine on insider trading to Members of Congress:

1. The Missing Fiduciary Duty. First, Members of Congress do not clearly owe a fiduciary duty (or any similar duty requiring them to be loyal and hold information in confidence) either to their trading partners in a securities (or commodities) transaction or to the source of the material, nonpublic information.[9] Since at least the Supreme Court's principal decision in 1983 on insider trading, Dirks v. SEC,[10] a prerequisite to insider trading has been a breach of a fiduciary duty (or a similar legal duty requiring the defendant to subordinate his self-interest to that of the beneficiary). This element of a required fiduciary breach is not a problem in most corporate cases because corporate directors, officers and employees do owe such a duty to the corporation and its shareholders. Similarly, other agents of the corporation – lawyers, investment bankers,

[8] See Bainbridge, supra note 1.

[9] To explore the full dimensions of the concept of fiduciary status would take an additional 100 pages. Very different conclusions are reached by courts depending on the context. In the enforcement context (civil or criminal), courts do not view the concept of fiduciary as expansively as they do in other, more aspirational contexts. Thus, in the leading case of United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), the Second Circuit (in an en banc decision) defined the term "fiduciary" in terms of two elements: (1) reliance, and (2) de facto control. Id. at 568. A fiduciary relationship, it said, involves "discretionary authority and dependency." Id. at 569. These critical elements of discretionary authority and dependency are not clearly present when, for example, an Executive Branch official confides confidential information in a Member of Congress.

[10] 463 U.S. 646 (1983).

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and other advisers – are said to become "constructive insiders" who similarly owe such a duty to the corporation. The tippees of these persons are viewed as co-conspirators who share liability if they know that the information on which they traded was misappropriated from the corporation (much as the "fence" shares liability with the thief if the former receives the stolen property with knowledge).

Because Congressional staffers are employees of Congress, their liability seems clear if they trade based on material nonpublic information that they acquire as the result of their professional duties or status. But Members of Congress are different. They are neither employees nor agents of any larger entity. Some decisions have said that public officials "owe a fiduciary duty to the public to make governmental decisions in the public's best interest."[11] But it is particularly difficult to say that Members of Congress owe a duty to respect the confidentiality of nonpublic information that they acquire in the course of their work. Any Member of Congress is constitutionally entitled by the Speech and Debate Clause of the U.S. Constitution to reveal any information – including material nonpublic information – in Congressional debate. Of course, a distinction can be drawn between revealing information and trading on it, but the core duty applicable to most fiduciaries to protect the secrets entrusted to them does not apply to a Member of Congress.

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[11] See, e.g., United States v. Woodward, 459 F.3d 1078, 1086 (11th Cir. 2006). I acknowledge that there is indeed some possibility that U.S. Attorneys could prosecute the misuse of material nonpublic information by Members of Congress under the mail and wire fraud statutes. See Carpenter v. United States, 484 U.S. 19 (1987). But the SEC lacks jurisdiction to enforce, or sue under, these criminal statutes. In addition, Carpenter applies when the employer owns the information in question and the employee in effect embezzles it for the employee's own use. But a Member of Congress is not an employee of the Treasury Department or the Defense Department when he or she trades on information obtained from or through them and thus does not clearly breach a duty owed to them.

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2. The Personal Benefit Requirement. A second major barrier to imposing insider trading liability on Members of Congress is Dirk's personal benefit rule. Typically, the Member of Congress will be a tippee, rather than someone who owed a fiduciary duty. To hold the tippee liable, Dirks insisted that there must first be a showing that the tipper breached a duty in disclosing the information to the tippee and received a personal benefit for doing so. Specifically, the Dirks Court said:

> "Thus, the test is whether the tipper personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[12]

Typically, it will be hard to show that the tipper received anything of value in return for disclosing material nonpublic information to a Member of Congress. The tipper may more likely only want to earn the long-term goodwill of the Member of Congress. This personal benefit (which essentially requires a quid pro quo exchange) applies both to Dirks-based cases and to cases brought under the more recent "misappropriation theory."[13]

3. The Need to "Feign Fidelity to the Source." Finally, the most likely scenario in which a civil or criminal action could be brought against a Member of Congress arises under what is known as "misappropriation theory." Here, the defendant is said to have

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[12] 463 U.S. at 662-663.

[13] The SEC has resisted this interpretation that the "personal benefit" rule applies to misappropriation theory cases, but has been unsuccessful in convincing courts that the two theories have different elements. See SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003) (finding that same standards apply under "classical" theory and misappropriation theory because both are derived from same statutory language and same rule). The "personal benefit" requirement can be satisfied by a reputational benefit that translates into future earnings, and thus a tipper who exchanges material information in return for the Member's vote has not only bribed the Member of Congress but possibly engaged in insider trading as well. This is not, however, likely to be the typical case.

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breached a duty not to the trading partner in a securities transaction, but to the source of the information (i.e., the person or entity disclosing the information to the Member of Congress). This more recent theory of liability, which the Supreme Court endorsed in United States v. O'Hagan,[14] vastly increased the scope of insider trading liability. But at the same time that the Court announced its acceptance of this theory, it also insisted that to satisfy the requisite element of deception under Section 10(b) of the Securities Exchange Act of 1934, the defendant must be shown to have engaged in "feigning fidelity to the source of the information."[15] This was easy enough on the facts of O'Hagan, where a partner in a law firm representing a bidder in a takeover elaborately contrived to learn the identity of the takeover target. But such feigning may not be present in a case where a Cabinet Secretary calls leading Members of Congress into an emergency meeting and advises them of major developments that will move the market. Absent some act of "feigning fidelity to the source," there may not be the requisite deception to support liability under Rule 10b-5.

Summary. These problems do not mean that it would be impossible for a court to find that Members of Congress owed a fiduciary duty that was breached when a member traded on confidential information. However, only the Supreme Court could definitively so rule, and in the interim I doubt that U.S. Attorneys would feel entitled to indict even in an egregious case, given the uncertain state of the law. Although I suspect that the SEC will disagree with my assessment and maintain that they do have adequate authority, they have long been in denial about the degree to which Dirks undercuts their traditional theory of insider trading. Moreover, the SEC has now lost a string of cases in the D.C.

[14] 521 U.S. 642 (1997).
[15] Id. at 655.

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Circuit Court of Appeals and seems no longer to receive Chevron deference from that Court.[16] My point is not that the SEC deserved to lose these cases, but that their views no longer command the deference that they once received from some courts.

The bottom line is simple: at worst, the proposed legislation is superfluous; at best, it is essential. In my judgment, there is no harm or risk in attempting to clarify a body of law that clearly has serious ambiguities. But Congress should not attempt a comprehensive statute defining all of insider trading law. Congress has attempted that before, only to give up. The moment Congress attempts a comprehensive statute, special interest groups will appear in droves, seeking safe harbors for their members. The result could give rise to even greater uncertainty.

II. An Analysis of the Proposed Legislation

I have reviewed two proposed bills: S.1871 (introduced by Senator Brown) and S.1903 (introduced by Senator Gillibrand and seven other Senators). They are closely similar. My comments relate only to their provisions on insider trading and not to their provisions on lobbying or related matters (where I am not an expert).

Although both bills appear well-intentioned, they are both subject to two major flaws that are likely to nullify their effectiveness. At the outset, let me hypothesize that the most likely (and profitable) form of insider trading by a Member of Congress will be trading based on nonpublic information relating to the budget, taxes, or broad economic legislation or regulation. For example, a Member of Congress might learn in advance of

[16] The most recent example of this lack of deference is Business Roundtable v. SEC, 647 F.3d 1144 (D.C. 2011) (invalidating SEC Rule 14a-11, the "proxy access" rule). See also, Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166, 167-168 (D.C. Cir. 2010). In the area of insider trading, the Government has also lost outside of the D.C. Circuit when it has attempted to stretch the law. See, e.g., United States v. Chestman, 947 F.3d 551 (1991) (en banc); SEC v. Yun, supra note 12.

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proposed regulatory action by a major federal agency because that agency has learned (from experience) to advise the principal Congressional committees having oversight over it before it takes major action. Such information could have broad macro-economic effect (for example, a change in interest rates or indications about likely terrorist acts) that will affect much of the market. Clearly, such information is not firm-specific, because it will affect entire sectors of the economy, possibly with greater impact on some industries. The most efficient way to trade on such information would be to buy options – either put or call options – or futures or swaps on an index of securities. In short, if one learns negative news of broad scope, one may wish to bet on a decline in the S&P 500 index.

Against that backdrop, two provisions in both of the proposed bills undercut the intended impact of each bill:

First, Section 2(b) of both statutes instructs the SEC and the CFTC to adopt rules prohibiting any person from buying or selling securities or security-based swaps "while such person is in possession of material nonpublic information relating to any pending or prospective legislation action relating to such issuer." (emphasis added) (Section 2(a) does the same with respect to any commodity for future delivery or swap). This language is seriously underinclusive. It covers only information relating to "pending or prospective legislative action." Yet, Congress does much more than simply legislate. For example, the Senate confirms (or rejects) Presidential appointments and ratifies (or rejects) treaties. More importantly, both Houses of Congress have oversight functions. Thus, the Secretary of the Treasury (or the Federal Reserve Chairman) might tell leading Members of Congress that interest rates are about to go up (or down) significantly, and this

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information will move the market dramatically. Or, the Secretary of Defense could alert them to an impending war in the Middle-East or military developments or a specific defense contract that is to be awarded. In neither case does this information relate to "pending or prospective legislative developments." In both cases, such information could be traded on profitably (often by trading in futures, swaps, or options on some index).

Thus, the language of both Sections 2(a) and 2(b) needs to be revised and expanded. I suggest the simplest change would be to replace the words "while such person is in possession of material nonpublic information relating to any pending or prospective legislative action relating to such issuer" with the following words:

> "while such person is in possession of material nonpublic information (i) derived from such person's position as a Member of Congress or Federal employee or gained during the performance of such person's duties, or (ii) obtained, directly or indirectly, from a Member of Congress or Federal employee where the recipient of such information knows, or should have known, that the information was so obtained."

This language would cover both (i) trading by a Member of Congress or Federal employee or (ii) trading by a tippee thereof (who knew, or should have known, that the information was so obtained). This language would not cover tipping by either a Member of Congress or Federal employee, but such a prohibition could (and should) be added by an additional section that stated:

> "Not later than _ days after the date of enactment of this Act, the Commission shall, by rule, prohibit any person from communicating any material nonpublic information (other than by means of a statement communicating such information to the public generally), with the intent to enable another person, directly or indirectly, to purchase or sell any [security] [security-based swap] [commodity] based on material, nonpublic information originally communicated to a Member of Congress or Federal employee."

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This language would reach not only the Member of Congress or Federal employee who tips material nonpublic information but also intermediate links in the chain (as sometimes the information may be passed through multiple tippees).

The second major problem lurks in the existing language of proposed Section 2(b): both S.1871 and S.1903 only prohibit the purchase or sale of "securities or security-based swaps of any issuer." This overlooks that most options are issued by third parties (i.e., securities dealers). In order to maximize his or her profits, the insider who trades on material nonpublic information will typically buy put or call options from such dealers. It is also important that any statute not define the material nonpublic information so that it must relate to any specific issuer. Macro-economic information about a pending financial crisis, an oil shortage, or the prospect of war or terrorism someplace does not relate to specific issuers, but to the market generally. The above suggested language makes this deletion so that the language would cover options issued by third parties.

III. Safe Harbors And Less Drastic Alternatives

Concern has been expressed by some that a statute extending the insider trading prohibition to Members of Congress would overreach; that is, if poorly drafted, it could prove a trap for the unwary, snaring relatively innocent mistakes by busy Members of Congress. Or it could impose illiquidity on Members of Congress who would not dare to trade.

Nonetheless, Members of Congress can find considerable reassurance in the protections afforded by Rule 10b5-1, adopted by the SEC under the Securities Exchange Act of 1934.[17] This provision immunizes trading pursuant to a "written plan for trading

[17] See 17 CFR § 240.10b5-1.

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securities" that empowers another person – a trustee or broker, typically – to trade for him pursuant to detailed instructions. Such a plan does "not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales" (see Rule 10b5-1(a)(1)(i)(3)). However, Rule 10b5-1 plans allow the person creating them to give very detailed instructions as to what should be done under various contingencies; they are thus not the same as "blind trusts." Such plans are today widely used by senior management of public companies who know that they will from time to time come into possession of material nonpublic information. Thus, a Member of Congress could instruct a broker entrusted with trading discretion over his or her portfolio to sell if stock prices fell below defined levels or if other market tests were triggered.

Still another possibility is that the draft legislation could instruct the SEC to give guidance (possibly through "no action" letters) to Members of Congress who are uncertain as to whether they possessed material nonpublic information and whether, if so, it restricted them from carrying out specific trading plans. Such a no-action letter would immunize the Member from any enforcement action by the SEC, at least if the Member did in fact disclose all material information in his possession to the SEC. The one drawback with this approach is that the SEC could prove to be overly conservative and decline to grant permissions, even in appropriate cases, out of an excess of caution.

In this light, a Member of Congress could also rely on an opinion of counsel, given in advance of the trade by an attorney with experience in securities law and regulation, that the information possessed by the Member was not material or did not apply to specified securities. The Commission has long recognized the "reliance on

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counsel" defense and would be unlikely to challenge a Member of Congress who had received such an opinion from experienced counsel.

Finally, Members of Congress do have one unique protection that they alone could sometimes utilize. Rule 10b-5 is often said to impose a duty to "disclose or abstain" with respect to securities trading. Many corporate officials may not disclose confidential and possibly material information because it would breach a duty owed by them to their corporation to maintain its confidentiality. But Members of Congress have an absolute and Constitutionally-protected right to disclose information under the Speech and Debate Clause.[18] If a Member of Congress disclosed such information on the floor and then, after a decent interval for the market to absorb it (at most until the next trading day), he could then trade, because the information would no longer be non-public.

I have been asked: what would be the minimum intervention that could satisfactorily resolve the status of Members of Congress, without Congress having to potentially disturb the elaborate judge-made law on insider trading. From such a minimalist perspective, I believe the least drastic intrusion would be a one sentence statute that defined a Member of Congress as a fiduciary for purposes of insider trading liability. Such a statute might simply provide:

> "Members of Congress [and their staffs] shall be deemed fiduciaries with respect to material, nonpublic information that they receive in the course of performing their duties or as a result of their status, regardless of whether they exchange anything of value for such information or engage in any deceptive act, and they may not purchase or sell or otherwise trade in securities, commodities, security-based swaps, or other financial instruments based upon such information, unless such trading is specifically exempted or permitted by rules adopted by either the

[18] U.S. Const., art I, § 6, ch. 1. This protection also applies to Congressional staffers working for a Member of Congress. See Gravel v. United States, 408 U.S. 606, 622 (1972).

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> Securities and Exchange Commission or the Commodities Futures Trading Commission."

This language would work to cover all the problems previously noted and does not require Congress to define what "material" or "nonpublic" means, as courts could rely on the existing case law. Indeed, a sentence could be added instructing courts to use the existing case law in interpreting this provision.

Finally, "sunlight is the best disinfectant" (to borrow from Justice Brandeis), and this remedy could also be better structured to increase the sunlight focused on Congressional trading. Section 4 of both bills would require reporting of the purchase or sale of certain securities within 90 days after such event. (It would be highly advisable to include the term "option" in Section 4's list of securities that must be reported). The report would be made to the Clerk of the House of Representatives or the Secretary of the Senate, respectively. This 90 day delay seems unusually long, given that similar reports of purchases and sales must be made under Section 16 of the Securities Exchange Act of 1934 by corporate directors and senior executives within two business days. Although a two business day test seems overly confining, some intermediate period, possibly such as 10 days, would be preferable.

More importantly, because "sunlight is the best disinfectant," such reports should be publicly available on a website so that journalists and others could easily access them. A compromise here may be necessary if the Member has adopted a Rule 10b5-1 trading plan. Obviously, if disclosure is made to the world only days after the trade, the blind trust is no longer blind. The person who created the Rule 10b5-1 trading plan would know what was in his portfolio and might be able to exercise a low visibility influence.

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Hence, in the case of a Rule 10b5-1 trading plan, it may be advisable to delay reporting the trade for some longer period (say 30 to 60 days).

Today, the one thing that we know for certain is that trading by Members of Congress is attracting media attention. That probably is as it should be. If a Member of Congress buys 10,000 shares of the common stock of a defense contractor five days before it receives a multi-billion dollar defense contract, the press will be suspicious and even the existence of a Rule 10b5-1 plan will not assuage their skepticism. In the long-run, public disclosure of trades may prove to be the most effective deterrent of suspicious trading behavior.

To sum up: there is little downside in Congress legislating and considerable upside, both to fill the void in the law and to restore public confidence in Congress. But Congress should pursue a narrow, surgically targeted statute and not take on the very complex problem of codifying the entire law of insider trading. That could prove a disaster.

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Statement to the Committee on Homeland Security & Governmental Affairs, United States Senate, on "Insider Trading and Congressional Accountability"

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December 1, 2011

Good morning Chairman Lieberman, Ranking Member Collins, and Members of the Committee, and thank you for the opportunity to appear before you to discuss the important issue of insider trading and congressional accountability.

In my testimony and prepared remarks I have been asked to address primarily the extent to which the congressional ethics rules and standards already in place address, or may be applied to address, potential instances of insider trading in securities by Members and staff of Congress, and I will focus on this area. As an initial matter, however, I do want to state my view that the current prohibitions on insider trading under federal securities laws and rules, as worked out and applied by the courts through the "misappropriation theory" of insider trading, do apply to members and staff of Congress. In other words, in my view, Members and staff of the House and Senate do not enjoy any blanket immunity from enforcement actions, whether civil or criminal, for violations of the prohibitions on insider trading; an enforcement action may be brought where a Member or employee of Congress uses – in connection with a securities trade – material, nonpublic information, to the source of which the Member or employee owes a duty of trust or confidence.

Having said that Members and staff of Congress *could* be prosecuted for insider trading under the "misappropriation theory" as a matter of law, I do not say that any such prosecution or civil enforcement action against a congressional individual would be easy. Difficult matters of proof – difficult factual issues – could, and almost certainly would, arise. For example, there could well be proof problems as to the "materiality" of the information in question. Would a reasonable shareholder of the security traded by the congressional individual consider the information important in making an investment decision or – because congressional action on a matter often comes after extensive disclosures about a given company through other avenues -- would such information more likely be seen as moot or cumulative? Given the flow of information in, around, and through the Capitol, was the information truly "nonpublic"? Or, to cite a point discussed by Professor Nagy in her important article on the subject, was the information actually used in the securities trade in question or was the trade made on a separate and independent basis?

So there are practical difficulties to bringing an insider trading case against a congressional individual based on the "misappropriation theory." To my understanding, however, there are inherent practical, proof difficulties to bringing a "misappropriation" insider case -- or, to use another term, an "outsider" insider trading case -- regardless of the arena or institution in which the questioned conduct occurs. On the other hand, not to

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minimize the potential practical difficulties of proving an insider case in Congress, proof in some such cases could be impeded by Speech or Debate Clause concerns; but such issues could arise as well in connection with enforcement actions brought under the STOCK Act, since no statute could trump constitutional concerns.

I have not yet discussed the potential practical and factual problems that could arise in the congressional context in proving the final element of an insider trading allegation under the "misappropriation theory." To sum up these potential problems in a question: Did the congressional individual under investigation for allegedly trading on the basis of material, nonpublic congressional information have the requisite duty of confidentiality with respect to that information? It is by way of addressing the question of what duty of confidentiality (or similar duty of trust) obtains on the part of Members and staff of Congress in connection with information before the Congress that I discuss those congressional ethics rules and standards already in place in the House and Senate that may – or may not – be used internally within each house of Congress to address alleged insider trading activity.

The Code of Ethics for Government Service, Senate Rule XXIX.5, and Congressional Obligations of Confidentiality

The "Code of Ethics for Government Service" provides, at paragraph 8, that a person in government service should "Never use any information coming to him confidentially in the performance of governmental duties as a means for making private profit."

The "Code" was passed by the House and Senate by Concurrent Resolution in July 1958. The Code is specifically listed in the Rules of the Senate Select Committee on Ethics as one source for the Committee's investigative and disciplinary jurisdiction. The Committee on Ethics of the House states in its *Manual* that the Code not only states "aspirational goals for public officials, but violations of provisions contained therein may also provide the basis for disciplinary action . . .." Provisions of the Code have formed the basis for disciplinary and/or admonitory action against Members by each of the congressional ethics committees.

Quite clearly, paragraph 8 of the Code of Ethics for Government Service – with its prohibition on the use of confidential information as a means for making private profit – may be used by the House and the Senate, and their respective ethics committees, to capture and sanction the kind of conduct covered by the "misappropriation theory" of insider trading. What is less clear is the extent to which information before Congress, or before a committee or office of Congress, may be considered "confidential."

There are no House or Senate rules, or policies, that impose a blanket duty of confidentiality on Members and employees in connection with information coming before them in the course of their official duties. The rules of some committees – for example, the rules of the ethics committees of both the House and the Senate – explicitly impose obligations of confidentiality on committee members and staff with respect to committee information. The rules of some other committees impose an obligation of

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confidentiality with respect to specific classes of information. For example, to my understanding the rules of this Committee provide for the confidential treatment of: any testimony given before the Committee in executive session; classified information; and controlled unclassified information. The rules of many other committees of the House and Senate, however, do not impose any specific duties of confidentiality with respect to committee information.

Paragraph 5 of Senate Rule XXIX may appear to impose on Members and staff of the Senate a general obligation of confidentiality with regard to Senate business. This paragraph provides that:

> Any Senator, officer, or employee of the Senate who shall disclose the secret or confidential business or proceedings of the Senate, including the business and proceedings of the committees, subcommittees, and offices of the Senate, shall be liable, if a Senator, to suffer expulsion from the body; and if an officer or employee, to dismissal from the service of the Senate, and to punishment for contempt.

Rule XXIX generally addresses "Executive Sessions," so the sanctions set forth in paragraph 5 would manifestly apply to violations of the "injunction of secrecy," set forth elsewhere in Rule XXIX, covering business conducted by the Senate in closed Executive session. Beyond such instances, however, this provision refers to the "the secret or confidential business or proceedings of the Senate" but does not address or define which "business or proceedings" this includes. Is it all "business and proceedings of the committees, subcommittees, and offices of the Senate"?

The legislative history of this provision – which was incorporated in Senate Rule XXIX through the adoption by the Senate of S. Res. 363 on October 8, 1992 – notes, somewhat circularly, that, "[a]s used throughout rule XXIX, the words secret and confidential refer to all information the Senate treats as confidential, including information received in closed session, information obtained in the confidential phases of investigations, and classified national security information." While this legislative history also makes clear that the Senate Ethics Committee has jurisdiction to consider all allegations of violations of paragraph 5 of Rule XXIX, such jurisdiction "should be reserved for grave breaches of confidentiality that cannot be resolved by the committee or offices in which those breaches occur." So the rule, in large part, leaves it to individual committees and offices to determine what Senate information should be considered to be "confidential." The situation in the House is similar in that there is no general, institution-wide definition as to what information should be considered "confidential."

Where does this lack o f any institution-wide definition of "confidentiality" leave use of paragraph 8 of the Code of Ethics for Government Service as a vehicle for addressing, within the congressional disciplinary process, allegations of insider trading, allegations that "confidential information" coming to a Member or employee "in the performance of governmental duties" was used "as a means for making private profit"? It ties congressional enforcement of paragraph 8 of the Code to a case-by-case, committee-by-

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committee, office-by-office analysis of whether a duty of confidentiality existed with respect to the information in question. If this is viewed as insufficiently systematic or insufficiently rigorous by some, doesn't such a case-by-case approach largely characterize enforcement of insider trading prohibitions under the "misappropriation theory" in the world outside of Congress? Should Congress, by blanket rule or law, impose on itself stricter prohibitions against insider trading than apply to the general public? In my view, the STOCK Act would impose such stricter standards on congressional Members and employees.

One possible alternative to the blanket approach taken by the STOCK Act, would be for the House and Senate to require committees and offices to adopt more specific policies, procedures and rules regarding what information must be treated as confidential and what sanctions will apply if and when the duty of confidentiality is violated.

House and Senate Conflict of Interest Rules

Apart from paragraph 8 of the Code of Ethics for Government Service, do any other House or Senate ethics rules or standards capture insider trading? It is arguable that the general conflict of interest provisions of House and Senate rules would cover instances of insider trading by Members and staff based on information coming to them in the course of their official duties. Consider, for example, paragraph 1 of Senate Rule XXXVII (on "Conflicts of Interest"):

> A Member, officer, or employee of the Senate shall not receive any compensation, nor shall he permit any compensation to accrue to his beneficial interest from any source, the receipt or accrual of which would occur by virtue of influence improperly exerted from his position as a Member, Officer, or employee

The House "Code of Official Conduct," at Rule XXIII, paragraph 3, contains a similarly worded provision.

It is arguable that the operative phrase "by virtue of influence improperly exerted from his position" in Congress should and does include instances where a Member or employee, in effect, "improperly" influences the securities markets by trading on material, nonpublic information that has come to the Member or employee through his or her official position. However, in the Senate, at least, application of this provision has been reserved for instances where an individual's official power or position has been used to obtain some personal benefit "under color of official right" or office. For instance, the following examples from the legislative history to the rule are provided in the *Senate Ethics Manual*, at page 66, to illustrate the meaning of this provision:

> For example, if a Senator or Senate employee intervened with an executive agency for the purpose of influencing a decision which would result in measurable personal financial gain to him, the provisions of this paragraph would be violated. Similarly, if a Senator or Senate employee intervened with an agency

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> on behalf of a constituent, and accepted compensation for it, the rule of this paragraph would also be violated.[1]

Similarly, the discussion in the *House Ethics Manual*, at page 186, of the parallel House provision emphasizes that "[a]s noted in the debate preceding adoption of this rule, an individual violates this provision if he uses 'his political influence, the influence of his position . . . to make pecuniary gain.'" (Citation omitted.)

A broader reading and application of this provision in the Senate – whereby the rule might be applied to allegations of insider trading – could be supported by other language from the legislative history of the rule, which, as stated in the *Senate Ethics Manual* at page 66, indicates that the provision was intended "as a broad prohibition against members, officers, or employees deriving financial benefit, directly or indirectly from the use of their official position."[2] And as, the House Ethics Committee points out in its discussion of this provision in its *Manual*,

> Members and staff, when considering the applicability of this provision to any activity that they are considering undertaking must also bear in mind that under a separate provision of the Code of Official Conduct . . . they are required to adhere to the spirit as well as the letter of the Rules of the House.

Notwithstanding such suggestions by the House and Senate Ethics Committee's regarding the potential scope of Senate Rule XXXVII, paragraph 1, and House Rule XXIII, paragraph 3, it is my view that application of either of these provisions to instances of alleged insider trading by Members and staff of Congress would be an innovation going beyond the intent of these rules.[3]

Two other provision of Senate Rule XXXVII, on "Conflicts of Interest," bear discussion here. Paragraph 3 of Rule XXXVII provides that

> No officer or employee shall engage in any outside business or professional activity or employment for compensation unless he has reported in writing when such activity or employment commences and on May 15 of each year thereafter so long as such activity or employment continues, the nature of such activity or employment to his supervisor. The supervisor shall then, in the discharge of his duties, take such action as he considers necessary for the avoidance of conflict of interest or interference with duties to the Senate.

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[1] S. Rep. No. 95-49. The "Nelson Report."

[2] *Id.*

[3] I take this view notwithstanding the following language from The Senate Ethics Committee's discussion of the "Basic Principles" of conflicts of interest at page 66 of the *Manual*: "The Senate's commitment to avoiding conflicts of interest is embodied in Senate Rule 37. Paragraphs 1 through 4, 7, and 10 target the possibility or appearance that Members or staff are "cashing in" on their official positions . . .."

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This rule has been consistently read by the Ethics Committee to apply to an outside occupation or to outside employment, whether for pay or not. It has not been read, in my experience, as having potential application to the personal securities trading of a Member or employee.

On the other hand, paragraph 7 of Senate Rule XXXVII does have direct application to the extent to which employees of Senate committees may hold or trade in securities posing a potential conflict with official duties. This paragraph provides that

> An employee on the staff of a committee who is compensated at a rate in excess of $25,000 per annum and employed for more than ninety days in a calendar year shall divest himself of any substantial holdings which may be directly affected by the actions of the committee for which he works, unless the Select Committee [on Ethics], after consultation with the employee's supervisor, grants permission in writing to retain such holdings or the employee makes other arrangements acceptable to the Select Committee and the employee's supervisor to avoid participation in committee actions where there is a conflict of interest, or the appearance thereof.

As discussed further below in connection with the disclosure provisions of the STOCK Act, as a historical matter the remedy of divestment has not been the preferred approach taken to addressing potential conflicts of interest posed by the financial holdings of Members and employees of the legislative branch. Essentially, paragraph 7 of Senate Rule XXXVII stands alone in requiring divestment under certain circumstances by Senate committee staff. Could a similar approach be taken regarding the holdings of employees of the personal offices of Senators? This would be more difficult to do in that the work of the personal office and, at least, of the senior staffers in a personal office is not confined to one issue area or economic sector. This same difficulty would be compounded if Senators were required to divest financial holdings that could be affected by their official actions. A Senator's official and representative duties comprehend all areas of potential legislation, all economic and industry sectors. If divestment were required for Members to avoid potential financial conflicts, what holdings would they not be required to divest?

Conduct Reflecting Discredit

I want to discuss one further current congressional ethics standard pursuant to which allegations of insider trading by Members and staff may be addressed. Paragraph 1 of House Rule XXIII provides that a "Member, Delegate, Resident, Commissioner, officer, or employee of the House shall behave at all times in a manner that shall reflect creditably on the House." Although the Senate Code of Conduct does not explicitly contain a similar provision, the Senate Ethics Committee is obligated by its authorizing resolution "to investigate allegations of improper conduct which may reflect upon the Senate." The Senate Ethics Committee and the Senate have admonished and disciplined Members for violations of this deliberately open-ended and flexible "catchall" provision.

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In my view and experience, if credible allegations of insider trading by a Member or employee were to come before the Senate Ethics Committee or the House Ethics Committee, and these allegations were supported by sufficient specific evidence -- that is, if the allegations were more than merely conclusory or based on more than mere coincidence -- even if it were determined that none of the specific provisions discussed above were applicable, these allegations would be diligently pursued and investigated by the Committees as, potentially, constituting conduct reflecting discreditably on the institution.

The STOCK Act Disclosure Provisions

The versions of the STOCK Act that I have reviewed would each amend the financial disclosure requirements applicable to Members and senior staff of Congress to require that the "purchase, sale, or exchange" of any "stocks, bonds, commodities futures, or other forms of securities" be reported publicly within 90 days. Current financial disclosure requirements mandate only annual public disclosure of securities transactions.

As mentioned in my remarks above, in the legislative branch, as a historical matter, public financial disclosure – rather than recusal or divestment – has been viewed as the principal means for policing potential conflicts of interest. The Senate Ethics Committee, in its *Manual*, has "made the case" for this reliance on disclosure:

> Senators enter public service owning assets and having private investment interests like other citizens. Members should not ''be expected to fully strip themselves of worldly goods'' — even a selective divestiture of potentially conflicting assets is not required. Unlike many officials in the executive branch, who are concerned with administration and regulation in a narrow area, a Senator exercises judgment concerning legislation across the entire spectrum of business and economic endeavors. The wisdom of complete (unlike selective) divestiture may also be questioned as likely to insulate a legislator from the personal and economic interests that his or her constituency, or society in general, has in governmental decisions and policy.
>
> Thus, public disclosure of assets, financial interests, and investments has been required and is generally regarded as the preferred method of monitoring possible conflicts of interest of Members of the Senate and certain Senate staff. Public disclosure is intended to provide the information necessary to allow Members' constituencies to judge official conduct in light of possible financial conflicts with private holdings.
>
> *Senate Ethics Manual*, at pages 124-125, citations omitted.

Enactment of the STOCK Act provision requiring public reporting of securities transactions by Members and employees of Congress within 90 days of the transaction would undoubtedly be viewed as intrusive and burdensome by some Members and employees. I don't think anyone who is subject to the current annual disclosure

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requirements enjoys filling out the form; an annual disclosure filer once told me he found completing his income tax form to be more enjoyable. However, increasing the frequency of reporting on securities transactions would be more consistent with the current framework for addressing potential congressional conflicts of interest than an approach that would directly restrict trading itself or an approach that would create and impose new obligations of confidentiality, the unintended repercussions from which on the necessary and beneficial flow of information in and through Congress may be impossible to predict.

The "Political Intelligence" Provisions of the STOCK Act

Finally, I have a few observations in connection with the provisions of the STOCK Act that would amend the Lobbying Disclosure Act (the "LDA") to impose registration and disclosure requirements on so-called "political intelligence consultants" and "political intelligence firms."

First, the Act defines "political intelligence contacts" to include "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 . . .." This seems very broadly worded. Is the language on "informing investment decisions" intended to cover potential capital investment decisions by, for example, a company in the oil services industry in connection with which a representative of the company has a purely informational, non-lobbying contact with an executive branch agency official about the administration or execution of a federal energy program in the Gulf?

Further, with respect to who would qualify as a "political intelligence consultant," the act takes a strict "one and done" approach; in other words, a "political intelligence consultant" means anyone "who is employed or retained by a client for financial or other compensation that include *one or more* political intelligence contacts." (Emphasis added.) This definition is not consistent with the manner in which "lobbyist" is defined under the LDA; the definition of "lobbyist" excludes any "individual whose lobbying activities constitute less than 20 percent of the time engaged in the services provided by such individual to [a] client over a 3-month period." Other than potentially deterring many individuals outright from becoming "political intelligence consultants," what purpose is served by imposing the burdensome registration and disclosure requirements of the LDA on a person who simply makes one contact requesting information from a government official?

My final point concerns overburdening the LDA as a vehicle for regulating protected conduct. It is important for you to remember that the LDA creates an anomaly, that is, it creates a regulatory scheme that lives within the legislative branch. As such it is not subject to the legal tests and requirements to which other, executive branch regulatory schemes are subject pursuant to the Administrative Procedure Act. Violations of the LDA are potentially subject to civil and criminal enforcement, and yet no agency or office provides legally dispositive or authoritative guidance regarding the meaning of the

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terms or requirements of the LDA or regarding the application of the LDA in specific circumstances. The LDA requires the Secretary of the Senate and the Clerk of the House of Representatives to provide guidance and assistance on the registration and reporting requirements of the LDA and to develop common standards, rules and procedures for compliance with the LDA. But the LDA does not provide the Secretary or the Clerk with the authority to write substantive regulations about or issue definitive opinions on the interpretation of the LDA. It is problematic enough that a regulatory scheme for which no government office or agency is truly accountable – that is, the LDA – currently regulates the First Amendment protected activities of one class of persons, lobbyists. Extending the requirements and potential sanctions of the LDA to yet an entire new class of persons, "political intelligence consultants," would compound this arguably constitutional concern.

* * *

Thank you for considering my views on the STOCK Act and on other approaches to addressing allegations of insider trading within Congress. I would certainly welcome any questions you may have.

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Statement on the Application of Insider Trading Law to Trading by Members of Congress and Their Staffs

By

Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission

Before the United States Senate Committee on Homeland Security and Governmental Affairs

December 1, 2011

Chairman Lieberman, Ranking Member Collins, and Members of the Committee:

Thank you for the opportunity to provide a statement for the record on behalf of the U.S. Securities and Exchange Commission on the subject of insider trading.

Insider trading threatens the integrity of our markets, depriving investors of the fundamental fairness of a level playing field. To deter this conduct and to hold accountable those who fail to play by the rules, the detection and prosecution of those who engage in insider trading remains one of the Division of Enforcement's highest priorities.

My statement provides a summary of the Division of Enforcement's recent work in the area of insider trading,a n overview of the law of insider trading as developed through our enforcement program and judicial precedent, and a description of how the current law of insider trading applies to securities trading by Members of Congress and their staffs.

Enforcement's Insider Trading Program

Insider trading has long been a high priority for the Commission. Approximately eight percent of the 650 average annual number of enforcement cases filed by the Commission in the past decade have been for insider trading violations. In the past two years, the Commission has been particularly active in this area. In fiscal year 2010, the SEC brought 53 insider trading cases against 138 individuals and entities, a 43 percent increase in the number of filed cases from the prior fiscal year. This past fiscal year, the Commission filed 57 actions against 124 individuals and entities, a nearly 8 percent increase over the number of filed cases in fiscal year 2010.

The increased number of insider trading cases has been matched by an increase in the quality and significance of our recent cases. In fiscal year 2011 and the early part of fiscal year 2012, the SEC obtained judgments in 18 actions arising out of its investigation of Galleon hedge fund founder Raj Rajaratnam, including a record $92.8 million civil penalty against Rajaratnam personally. The SEC also discovered and developed information that ultimately led to criminal convictions of Rajaratnam and others, including corporate executives and hedge fund managers, for rampant insider trading. In addition, we recently filed an insider trading action against Rajat

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Gupta, a former director of both Goldman Sachs and Procter & Gamble, whom we allege provided confidential Board information about both companies' quarterly earnings and about an impending $5 billion Berkshire Hathaway investment in Goldman Sachs to Rajaratnam, who traded on that information.

Among others charged in SEC insider trading cases in the past fiscal year were various hedge fund managers and traders involved in a $30 million expert networking trading scheme, a former Nasdaq Managing Director, a former Major League Baseball player, a Food and Drug Administration chemist, and a former corporate attorney and a Wall Street trader who traded in advance of mergers involving clients of the attorney's law firm. The SEC also brought insider trading cases charging a Goldman Sachs employee and his father with trading on confidential information learned by the employee on the firm's ETF desk, and charging a corporate board member of a major energy company and his son for trading on confidential information about the impending takeover of the company.[1]

The Division also has targeted non-traditional cases involving the misuse or mishandling of material, non-public information. This past fiscal year, the Commission charged Merrill Lynch, Pierce, Fenner & Smith with fraud for improperly accessing and misusing customer order information for the firm's own benefit. The Commission also censured broker-dealer Janney Montgomery Scott LLC for failing to enforce its own policies and procedures designed to prevent the misuse of material, nonpublic information. Charles Schwab Investment Management was charged for failing to have appropriate information barriers for nonpublic and potentially material information concerning an ultra-short bond fund that suffered significant declines during the financial crises. This deficiency gave other Schwab-related funds an unfair advantage over other investors by allowing the funds to redeem their own investments in the ultra short-bond fund during its decline. The Commission also charged Office Depot, Inc. and two of its executives for violating Regulation FD by selectively disclosing to certain analysts and institutional investors that the company would not meet its earnings.

To respond to emerging risks, the Enforcement Division has developed several new initiatives targeted at ferreting out insider trading, which have enhanced our effectiveness in this area. During our recent reorganization, the Division established a Market Abuse Unit, with an emphasis on various abusive market strategies and practices, including complex insider trading schemes.

The Market Abuse Unit has spearheaded the Division's Automated Bluesheet Analysis Project, an innovative investigative tool that utilizes the "bluesheet" database of more than one billion electronic equities and options trading records obtained by the Commission in the course of insider trading investigations over the past 20 years. Using newly developed templates, Enforcement staff are able to search across this database to recognize suspicious trading patterns and identify relationships and connections among multiple traders and across multiple securities, generating significant enforcement leads and investigative entry points. While still in its early stages of development, this new data analytic approach already has led to significant insider

[1] A broader discussion of select insider trading cases from fiscal years 2011, 2010, and 2009 is available on the SEC's website at our Insider Trading Spotlight page, http://www.sec.gov/spotlight/insidertrading/cases.shtml.

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trading enforcement actions that were not the subject of an SRO referral, informant tip, investor complaint, media report, or other external source.[2]

As part of the reorganization, the Division also established a cooperation program to encourage key fact witnesses to provide valuable information. Insider trading investigations are extremely fact-intensive. Enforcement staff undertake the often painstaking work of collecting and analyzing trading data across equity and options markets, analyzing communications (email, telephone calls and instant messages, among others) and analyzing market-moving events (e.g., announcements of corporate earnings, product development, and acquisitions and mergers) to identify persons who may have engaged in insider trading or who may have information about such activity. Our new cooperation program is a valuable tool that can help us break open an insider trading investigation earlier in the process, thereby preserving resources. We are already seeing the effectiveness of the cooperation program in our insider trading cases and expect this trend to continue as more cooperators come forward in our investigations.

With an aggressive investigative approach that includes early coordination with the FBI, Department of Justice, and other law enforcement agencies, we have been able to identify potential cooperators who may assist criminal authorities with their covert investigative techniques, helping amass critical evidence in numerous insider trading investigations. Our work with certain SROs has provided valuable early tips, helping us mitigate the harm from insider trading schemes by freezing the illicit proceeds before funds are moved to offshore jurisdictions.

Law of Insider Trading

There is no express statutory definition of the offense of insider trading in securities.[3] The SEC prosecutes insider trading under the general antifraud provisions of the Federal securities laws, most commonly Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, a broad anti-fraud rule promulgated by the SEC under Section 10(b). Section 10(b) declares it unlawful "[t]o use or employ, in connection with the purchase or

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[2] *See, e.g., SEC v. Nicos Achilleas Stephanou, Ramesh Chakrapani, Achilleas Stephanou, George Paparrizos a/k/a Georgios Paparrizos, Konstantinos Paparrizos, Michael G Koulouroudis and Joseph Contorinis*, Civil Action No. 09 CV 1043 (S.D.N.Y. Feb. 5, 2009), http://www.sec.gov/litigation/litreleases/2009/lr20884.htm; *SEC v. James W. Self Jr and Stephen R Goldfield*, Civil Action No. 10-CV-4430-ER (E.D. Pa. Sept. 1, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21638.htm; *SEC v. Jeffery J. Temple and Benedict M. Pastro*,Case No. 10-CV-1058 (D. Del. December 7, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21765.htm; *SEC v. Matthew H. Kluger and Garrett D. Bauer*, Case No. 11-cv-1936 (D.N.J. April 6, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21917.htm *SEC v. Jonathan Hollander*, Civil Action No. 11-CV-2885 (S.D.N.Y. April 28, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21950.htm.

[3] On several occasions, Congress has considered but ultimately declined to enact an explicit statutory prohibition of insider trading. *See,e .g.*, H.R. Rep. No. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048 (legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988 notes that although Congress had considered a legislative definition of insider trading, the Committee declined to include a statutory definition in the bill because in its view "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."). Congress has specifically provided the SEC with authority to seek civil money penalties for insider trading, 15 U.S.C. § 78u-1, and provided an express private right of action for certain contemporaneous traders in insider trading cases. 15 U.S.C. § 78t-1.

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sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[4] Rule 10b-5 broadly prohibits fraud and deception in connection with the purchase and sale of securities. As the Supreme Court has stated, "Section 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception," because "[n]ovel or atypical methods should not provide immunity from the securities laws."[5]

There are two principal theories under which the SEC prosecutes insider trading cases under Section 10(b) and Rule 10b-5. The "classical theory" applies to corporate insiders – officers, directors, and employees of a corporation, as well as "temporary" insiders, such as attorneys, accountants, and consultants to the corporation.[6] Under the "classical theory" of insider trading liability, a corporate insider violates Section 10(b) and Rule 10b-5 when he or she trades in the securities of the corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under Section 10(b), because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[7] That relationship "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.'"[8]

The Supreme Court has recognized that corporate "outsiders" can also be liable for insider trading under the "misappropriation theory."[9] Under this theory, a person commits fraud "in connection with" a securities transaction, and thereby violates Section 10(b) and Rule 10b–5, when he or she misappropriates confidential and material information for securities trading purposes, in breach of a duty owed to the source of the information. This is because "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[10] The misappropriation theory thus "premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[11] Under

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[4] 15 U.S.C. § 78j(b).

[5] *Superintendent of Insurance v. Bankers Life & Cas. Co.*,4 04 U.S. 6, 11 n.7 (1971) (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967))

[6] *Dirks v SEC*, 463 U.S. 646, 655 n.14 (1983).

[7] *Chiarella v United States*, 445 U.S. 222, 228 (1980).

[8] *Id.* at 228–29 (citation omitted).

[9] *United States v O'Hagan*, 521 U.S. 642, 653 (1997).

[10] *Id* at 652.

[11] *Id*

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either the classical or misappropriation theory, a person can also be held liable for "tipping" material, nonpublic information to others who trade, and a "tippee" can be held liable for trading on such information.[12]

A common law principle is that employees owe a fiduciary duty of loyalty and confidence to their employers. In addition, employees often take on contractual duties of trust or confidence as a condition of their employment or by agreeing to comply with a corporate policy. Accordingly, employees have frequently been held liable under the misappropriation theory for trading or tipping on the basis of material non-public information obtained during the course of their employment.[13] This includes prosecution of federal employees who, in breach of a duty to their employer, the federal government, trade or tip on the basis of information they obtained in the course of their employment. For example, the SEC recently brought insider trading charges against a Food and Drug Administation employee alleging that he violated a duty of trust and confidence owed to the federal government under certain governmental rules of conduct when he traded in advance of confidential FDA drug approval announcements.[14]

In light of existing precedent regarding the liability of employees – including federal employees – for insider trading, any statutory changes in this area should be carefully calibrated to ensure that they do not narrow current law and thereby make it more difficult to bring future insider trading actions against any such persons.

Application of Insider Trading Law to Trading by Members of Congress and Their Staff

The general legal principles described above apply to all trading within the scope of Section 10(b) and Rule 10b-5. There is no reason why trading by Members of Congress or their staff members would be considered "exempt" from the federal securities laws, including the insider trading prohibitions, though the application of these principles to such trading, particularly in the case of Members of Congress, is without direct precedent and may present some unique issues.

Just as in any other insider trading inquiry, there are several fact-intensive questions – including the existence and nature of the duty being breached and both the materiality and nonpublic nature of the information – that would drive the analysis of whether securities trading (or tipping) by a Member of Congress or staff member based on information learned in an official capacity violates Section 10(b) and Rule 10b-5.

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[12] *Dirks v SEC*, 463 U.S. at 660-62.

[13] *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *Carpenter v United States*, 791 F.2d 1024, 1026 (2d. Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

[14] *See, e g., SEC v. Cheng Yi Liang, et al.*, Exchange Act Rel. No.2 1097 (March 29, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21907.htm; *see also United States v. Royer*, 549 F.3d 886 (2d. Cir. 2008) (affirming a conviction of an FBI agent for tipping information about ongoing investigations and information on law enforcement databases); *SEC v. John Acree*, Litigation Rel. No. 14231, 57 SEC Docket 1579 (Sept. 13, 1994) (announcing a settled action with a former employee of the Office of the Comptroller of the Currency for trading on the basis of material non-public information concerning banks).

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The first question is whether the trading, or communicating the information to someone else, breached a duty owed by the Member or staff. Although there is no direct precedent for Congressional staff, there is case law from other employment contexts regarding misappropriation of information gained through an employment relationship. This precedent is consistent with a claim that Congressional staff, as employees, owe a duty of trust and confidence to their employer and that a Congressional staff member who trades on the basis of material non-public information obtained through his or her employment is potentially liable for insider trading under the misappropriation theory, like any other non-governmental employee.

The question of duty is more novel for Members of Congress. There does not appear to be any case law that addresses the duty of a Member with respect to trading on the basis of information the Member learns in an official capacity. However, in a variety of other contexts, courts have held that "[a] public official stands in a fiduciary relationship with the United States, through those by whom he is appointed or elected."[15] Commenters have differed on whether securities trading by a Member based on information learned in his or her capacity as a Member of Congress violates the fiduciary duty he or she owes to the United States and its citizens, or to the Federal Government as his or her employer.[16]

Existing Congressional ethics rules also may be relevant to the analysis of duty for both Members and their staff. For example, Paragraph 8 of the Code of Ethics for Government Service provides that "Any person in Government service should . . . [n]ever use any information coming to him confidentially in the performance of governmental duties as a means for making private profit."[17]

The second question is whether the information on which the Member or staff trades (or tips) is "material" – that is, is there "a substantial likelihood" that a reasonable investor "would consider it important" in making an investment decision?[18] Materiality is a mixed question of fact and law that depends on all the relevant circumstances. In some scenarios, it may be relatively clear that an upcoming Congressional action would be material to a particular issuer or group of issuers, while in others it may be more challenging to establish that.

The third critical question is whether the information on which the Member or staff traded (or tipped) is "nonpublic." The Commission has stated that "[i]nformation is nonpublic when it has not been disseminated in a manner making it available to investors generally."[19]

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[15] *United States v. Podell*, 436 F. Supp. 1039, 1042 (S.D.N.Y. 1977) (citing *Trist v. Child*, 88 U.S. (21 Wall.) 441, 450 (1874)). *See also United States v. Carter*, 217 U.S. 286, 306 (1910) ("The larger interests of public justice will not tolerate, under any circumstances, that a public official shall retain any profit or advantage which he may realize through the acquirement of an interest in conflict with his fidelity as an agent.").

[16] *Cf.* Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U.L.R. 1105, 1111, 1148 (2011); Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011).

[17] H.Con.Res. 175, 85th Cong., 2d Sess., 72 Stat., pt. 2, B12 (1958).

[18] *Basic, Inc v Levinson*, 485 U.S. 224, 231-32 (1988).

[19] *In re Investors Management Co.*, 44 SEC 633, 643 (1971), (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), *cert denied*, 394 U.S. 976 (1969)).

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Whether information is "nonpublic" would likely depend on the circumstances under which the Member or staff learned the information and the extent to which the information had been disseminated to the public.

As with all issues of liability with regard to insider trading and other claims under Section 10(b), the conduct at issue must be intentional or reckless.[20] Since all of these issues are inherently fact-specific, it is difficult to generalize about the likely outcome of any particular scenario. However, trading by Congressional Members or their staffs is not exempt from the federal securities laws, including the insider trading prohibitions.

Application of Tipper and Tippee Liability Theories to Members of Congress and Their Staff

Communication of nonpublic information to others who either trade on the information themselves or share it with others for securities trading purposes,c ould be analyzed under the case law relating to tipper and tippee liability and also would turn on the specific facts of the case.

A person can be liable as a tipper where he or she discloses information in breach of a fiduciary duty or other similar duty of trust or confidence and the tippee trades on the basis of that information. The same duty requirement described above is applicable in the tipper context, as are the requirements that the tipped information be nonpublic and material. In addition, a court may require a showing that the Member of Congress or staff member personally benefited from providing the tip.[21]

A person who trades on the basis of material, nonpublic information conveyed by a Member or staff member in breach of a duty also could be liable for illegal insider trading as a tippee. An additional element of liability is that the tippee knew or should have known of the tipper's breach of duty in disclosing the information.[22]

Investigations into potential trading or tipping by Members of Congress or their staff could pose some unique issues, including those that may arise from the Constitutional privilege

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[20] *See, e.g., Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Greebel v. FTP Software, Inc* , 194 F.3d 185, 198-201 (1st Cir. 1999); *SEC v Environmental, Inc.*, 155 F.3d 107, 111 (2d Cir. 1998).

[21] *See Dirks v SEC*, 463 U.S. 646, 662 (1983).

[22] *Id.* at 660.

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provided to Congress under the Speech or Debate Clause, U.S. Const. art. I, § 6, cl.1.[23] The Supreme Court has stated that "[t]he Speech or Debate Clause was designed to assure a co-equal branch of the government wide freedom of speech, debate, and deliberation without intimidation or threats from the Executive Branch."[24] The Clause "protects Members against prosecutions that directly impinge or threaten the legislative process."[25] While the "heart" of the privilege is speech or debate in Congress, courts have extended the privilege to matters beyond pure speech and debate in certain circumstances.[26] There may be circumstances in which communication of nonpublic information regarding legislative activity to a third party falls "within the 'sphere of legitimate legislative activity,'"[27] and thus may be protected by the privilege.

Conclusion

The SEC's continued focus on insider trading and innovative investigative techniques demonstrates our commitment to pursuing potentially suspicious trading in a variety of contexts. While recent innovations in the Division of Enforcement are enhancing our ability to obtain that evidence, to establish liability we must satisfy each of the elements of an insider trading violation, including the materiality of the information, the nonpublic nature of the information, the presence of scienter, and a fiduciary or other duty of trust and confidence that was violated by the trading or tipping. While trading by Members of Congress or their staff is not exempt from the federal securities laws, including the insider trading prohibitions, there are distinct legal and factual issues that may arise in any investigations or prosecutions of such cases. Any statutory changes in this area should be carefully calibrated to ensure that they do not narrow current law and thereby make it more difficult to bring future insider trading actions against individuals outside of Congress.

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[23] *See, e.g., In re Grand Jury Subpoenas*, 571 F.3d 1200, 1203 (D.C. Cir. 2009) (holding that testimony and documents relating to a Congressman's testimony to the House Ethics Committee were protected under the Speech or Debate clause); *United States v. Rayburn House Office Building*, 497 F.3d 654, 663 (D.C. Cir. 2007) (finding that the Speech or Debate clause prohibited law enforcement officials from searching a Member's office and reviewing documents concerning legislative activities without the Member's consent).

[24] *Gravel v. United States*, 408 U.S. 606, 616 (1972).

[25] *Id.*

[26] *Id.* at 625 (citing *United States v. Doe*, 455 F.2d 753, 760 (1st Cir. 1972)).

[27] *Id.* at 624 (citing *Tenney v. Brandhove*, 341 U.S. 367, 376 (1951)).

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Common Cause Statement to the
Senate Committee on Homeland Security and Governmental Affairs

December 1, 2011

Submitted by Bob Edgar
President and Chief Executive Officer
Common Cause

Common Cause is a national nonpartisan advocacy organization founded in 1970 by John Gardner as a vehicle for ordinary citizens to make their voices heard in the political process. On behalf of our 300,000 members and supporters, Common Cause appreciates the opportunity to submit this statement to this Committee regarding insider trading and congressional accountability.

Recent press reports concerning Congressional insider trading raise serious questions about the strength of our nation's laws that guard against profiting or trading on material nonpublic information.[1] Under current law, individuals are prohibited from trading on the basis of material nonpublic information in violation of a duty of trust and confidence.[2] However, the state of the law is far from a beacon of clarity, and its nuances are absent from the United States Code.[3] In the wake of thin statutory guidance, insider trading law has largely taken shape in court decisions interpreting Section 10(b) of the Securities Exchange Act of 1934 and Rule 10-b5.[4]

Although there is no explicit provision of law that specifically exempts anyone – members of Congress and their staffs included – from insider trading, much of the uncertainty around what is prohibited centers on the elastic concept of materiality and the scope of fiduciary duties. The definition of what exactly constitutes "material" inside information, and to whom duties of trust and confidence extend, does not relieve members of Congress, their staff, or any other federal employee from the bounds of the law or each chamber's ethics rules.[5] No one is above the law. Members of Congress and their staff owe a duty to their constituents and the Constitution, and information they glean in closed-door negotiations, away from the eyes of the public and the market, must not serve as a catalyst for trading and profiting.

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[1] *60 Minutes* (CBS television broadcast Nov. 13, 2011); Brody Mullins, Tom McGinty & Jason Sweig, *Congressional Staffers Gain from Trading in Stocks*, WALL ST. J., Oct. 11, 2010, at A1.
[2] *See United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).
[3] *Preventing Unfair Trading by Government Officials Before the H. Subcomm. on Oversight and Investigations of the H. Financial Serv. Comm.*, 111th Cong. 3 (2009) (testimony of Peter J. Henning, Professor of Law, Wayne State University Law School.
[4] *See id.*, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
[5] Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. Rev. 1106, 1138 (2011).

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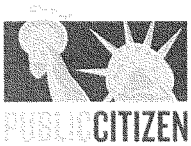
The law should be clear: members of Congress, their staff, and all federal employees, must not trade or profit on the basis of information that is not available to the general public, but is obtained solely because of their position in government service. Moreover, financial disclosure statements should be enhanced to ensure compliance with these matters. The "Stop Trading on Congressional Knowledge Act" (STOCK Act) begins to address both of these concerns.

American citizens must have faith that their elected representatives are protecting the public interest. Congress must be held to the highest standard of accountability. Unfair gain by virtue of public position cannot be tolerated, and brighter lines concerning insider trading on Capitol Hill and in other branches of government will strengthen our democracy. Closing any perceived loopholes will ensure that in the future, the mere fact that an official obtained material nonpublic information via Congressional business will not serve as a defense to insider trading.

Common Cause supports the introduction of the bipartisan STOCK Act and calls on this Committee to closely examine how it can serve as the vehicle to strengthen the law on matters of insider trading. The momentum that this legislation has gained on both sides of the aisle is encouraging, and Congress should act to pass a bill that clarifies once and for all that trading on Congressional knowledge violates the law and undermines public trust in government.



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The Hon. Joseph Lieberman, Chairman
The Hon. Susan Collins, Ranking Member
Committee on Homeland Security & Government Affairs
U.S. Senate, 340 Dirksen Senate Office Building
Washington, D.C. 20510

Dec. 1, 2011

Statement Submitted on Behalf of Public Citizen
Supporting the "Stop Trading on Congressional Knowledge" (STOCK) Act

Dear Chairman and Ranking Member:

Public Citizen strongly supports passage of the bipartisan legislation designed to prevent congressional insider trading, known as the "Stop Trading on Congressional Knowledge" (STOCK) Act.

The STOCK Act is common sense legislation that has languished in Congress for years and, for the first time, has been introduced in the Senate. Sens. Kirsten Gillibrand (D-NY) and Scott Brown (R-Mass.), along with a combined total of 16 co-sponsors, have introduced long-overdue legislation to apply the laws against insider trading to members and staff of Congress and provide an important system of transparency for commodities and securities trading to help ensure that the law is monitored and enforced (S. 1903 and S. 1871).

It comes as quite a surprise to most Americans that the laws against insider trading are not clearly and uniformly applied to members and staff of Congress. "Insider trading" under the Securities Exchange Act is generally defined as the buying or selling of securities or commodities based on non-public information in violation of confidentiality – either to the issuing company or the source of information. Unfortunately, most ethics and enforcement officers believe that, since members and staff of Congress do not owe a duty of confidentiality to the federal government, the law against insider trading does not apply to information gained by members and staff in the course of their official duties. As a result, there have been no enforcement actions taken against members or staff for trading on congressional non-public information.

While it is noteworthy that a handful of scholars argue the insider trading law should be interpreted to apply to Congress, and the House ethics committee recently issued a memorandum suggesting that it deems such insider trading as a violation of the trust of office, the fact of the matter is that the law has not been applied to Congress. The STOCK Act would make it very clear to all that congressional insider trading is illegal. The measure further creates a system of

full transparency of stock trading by members, staff and others who do business with Congress so that the law can be realistically enforced.

Certain technical corrections should be made to improve the legislative language. For example, it should be clear that material non-public information about administrative actions, such as the issuing of government contracts, should be covered as well as legislative actions. Also, the practice of "shorting" in the stock markets should be considered part of stock trading subject to regulation and disclosure. These and other technical issues should be ironed out as the legislation moves forward.

The STOCK Act is a legislative imperative. Many senators, representatives and their staff are very active traders in the stock market, and disturbingly, much of this trading goes on in the very markets they oversee. Academic research has even attempted to quantify the problem. A study published in the *Journal of Financial and Quantitative Analysis* found "abnormal returns from the common stock investments of members of the U.S. Senate" -- returns that generally provided senator-investors with a 12 percent higher rate than enjoyed by most other investors.[1]

In the wake of the recent financial collapse, Congress is actively engaged in overseeing Wall Street, the financial markets, and U.S. financial regulators. The possibility that government insiders could "cash in" has provoked understandable public outrage.

The time to pass this legislation is now. With the federal government assuming a larger role in financial services under the watchful eye of Congress, it is imperative that Congress act quickly to assure the nation that the government's involvement is solely in the public's interest. Public Citizen encourages the committee to pass the STOCK Act and send it to the full floor for consideration.

Sincerely,

David Arkush, Director, Public Citizen's Congress Watch
Lisa Gilbert, Deputy Director, Public Citizen's Congress Watch
Craig Holman, Government Affairs Lobbyist, Public Citizen

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[1] Alan Ziobrowski, Ping Cheng, James Boyd and Bridgette Ziobrowski, "Abnormal Returns from the Common Stock Investments of the U.S. Senate," *Journal of Financial and Quantitative Analysis* (Dec. 2004).