Insider Trading in Congress

The Need for Regulation

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I. Introduction

Imagine you are a financially-savvy United States congressman. In a week, you intend to announce the proposal of an appropriations bill that will award a huge, no-bid contract to a publicly traded energy company. You expect the news to increase sharply the price of that company's stock. Enticed by this foolproof investment opportunity, you decide to purchase shares of stock in the company that will be receiving the contract—as does your legislative aide, who can also foresee the stock price increase. A week after your stock purchase, you make your announcement. The stock price rises, and the privileged few who knew your announcement was coming make handsome capital gains. Those who sold the shares to both you and your aide are deprived of a major windfall.

The apparent lack of fairness in this hypothetical is enough to make most advocates of corporate and legislative transparency cringe. The situation above presents some obvious analogues to corporate insider trading. Yet, under current law, none of these described actions is illegal. So would argue Representative Louise Slaughter, a Democrat from New York, who initially proposed the aptly named STOCK (Stop Trading on Congressional Knowledge) Act ("the Act"). According to Slaughter and her cosponsors, Congressional trading on material nonpublic legislative information is currently legal, but should be banned. Advocating for the passage of the Act, Slaughter has asserted that, currently, "The potential for abuse is incredible."[1] Representative Brian Baird, a cosponsoring Democrat from Washington, has waged a similarly public campaign for the Act, asserting that "The American people expect Members and staffers

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[1] Brody Mullins, *Bill Seeks to Ban Insider Trading By Lawmakers and Their Aides*, WALL ST. J., Mar. 28, 2006, at A1.

to work on their [the people's] behalf and to represent their interests, not to increase the returns on our investments and fatten our stock portfolios."[2]

The debate over the STOCK Act raises the question: Is regulation of Congressional insider trading desirable? We intend to use the STOCK Act as a springboard for approaching the need for Congressional insider trading regulation from a slightly more academic perspective. First, we describe the STOCK Act by placing it in recent historical context. Understanding the motivation to reform Congressional ethics that existed earlier this decade is crucial to evaluating the STOCK Act and its prospects for eventual passage by Congress. Second, we review the body of insider trading law that already operates to restrain corporate insiders and others from making some trades. The most important SEC rules, as well as the most significant cases in establishing insider trading doctrine—among them, *Chiarella v. United States*,[3] *Dirks v. Securities and Exchange Commission*,[4] and *United States v. O'Hagan*[5]—are considered with an eye toward their relevance to what we will generally refer to as Congressional insider trading. To assess the practical need for regulation of Congressional insider trading, we also discuss Congressional ethics rules and the Speech or Debate Clause.[6] The behavior of legislators and their aides is affected by both formal rules and informal norms, and we endeavor to explore both. The adequacy of current enforcement mechanisms for these rules and standards is also considered.

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[2] Press Release, Congressman Brian Baird's Newsroom, Reps. Baird and Slaughter Introduce Legislation To Prohibit Insider Trading on Capitol Hill (2007), http://www.house.gov/apps/list/press/wa03_baird/stockact.html.
[3] 445 U.S. 222 (1980).
[4] 463 U.S. 646 (1983).
[5] 521 U.S. 642 (1997).
[6] U.S. CONST. art. I, § 6, cl. 1.

Having addressed the factual and legal background of Congressional insider trading, our analysis shifts to normative concerns. Some observers have made persuasive academic arguments in favor of corporate insider trading; others have countered with arguments for its prohibition. We review these arguments and describe their applicability to Congressional insider trading. Beyond the traditional points from the classical corporate insider trading literature, we also consider original arguments that are uniquely applicable to Congressional insider trading. Finally, we offer an endorsement of regulating Congressional insider trading via legislation like the STOCK Act—while making some practical suggestions for amending the Act, as some provisions in the current proposal may not create the best possible scheme of incentives. While regulating Congressional insider trading may compromise the efficiency of capital markets to some slight degree, this concern is ultimately outweighed by concerns about abuse and the potential for perverse incentives among legislators and those who associate with them.

II. Historical Context and Provisions of the Act

The STOCK Act was first proposed on March 28, 2006 as H.R. 5015. It was sponsored by Slaughter and Baird, along with 13 other cosponsors.[7] Despite Slaughter's visibility as Chairperson of the House Rules Committee, the STOCK Act never advanced very far; indeed, it was quickly referred to the House Agriculture Committee, where it remained until the end of the 109th Congress.[8] The Act was reintroduced to the 110th Congress as H.R. 2341 on May 16, 2007, where it again did not advance past the House

[7] Stop Trading on Congressional Knowledge Act, H.R. 5015, 109th Cong. (2006).
[8] *Id.*

Agriculture Committee.[9] Most recently, the Act was introduced to the 111th Congress on January 26, 2009, as H.R. 682, where it has been referred to the House Committee on Standards of Official Conduct.[10] The Committee on Standards of Official Conduct has not yet taken any action.[11] It is possible that the STOCK Act has languished because of the primacy of other priorities—among them, war, immigration reform, economic crisis. However, another probable factor in the STOCK Act's lack of success is that the impetus for the Act has unfortunately faded from public consciousness in the last few years.

A. Trading Activities of Legislators and Their Aides

Indeed, when the STOCK Act was first proposed—or not long before the STOCK Act was proposed, at least—Congressional ethics reform was in much greater demand. A number of minor public controversies had inspired calls for reform. The first such controversy involved the trading activities of then-Senate Majority Leader Bill Frist and those associated with his office. In 1968, Frist's family founded the Hospital Corporation of America ("HCA"), a $25 billion international company. On July 8, 2005, with his brother currently a director of HCA,[12] Senator Frist sold all of his stock, reportedly "to avoid conflict-of-interest questions if he ran for President."[13] Less than a week later, HCA's stock price fell by roughly nine percent in one day.[14] The price continued to fall over the next few weeks, dropping a total of about fifteen percent from the level at which

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[9] Stop Trading on Congressional Knowledge Act, H.R. 2341, 110th Congress (2007).
[10] Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Congress (2009).
[11] *Id.*, The STOCK Act's progress can be tracked using Govtrack, http://www.govtrack.us/congress/bill.xpd?bill=h111-682 (last visited Feb. 8, 2009).
[12] Thomas Frist, Jr. had also previously served as CEO and Chairman of the Board of HCA.
[13] Carrie Johnson, *Frist Not Charged as Investigators Close Probe of His Hospital Stock Sales*, WASH. POST, Apr. 27, 2007, at A13.
[14] Jonathan M Katz, *Senator Sold Stock Before Price Dropped Shares Fell Two Weeks Later*, WASH. POST, Sept. 21, 2005, at A03.

Frist sold it.[15] After being investigated for eighteen months, Frist was exonerated by the U.S. Attorney in the Southern District of New York and the SEC.[16] Still, the initial appearance of impropriety brought public attention to legislators' stock trades. Frist's name was at the center of another trading controversy later in 2005, when he announced that the Senate would vote on a bill which would make $140 billion of public funds available to pay off asbestos liability claims.[17] In the days prior to Frist's announcement, the stock prices of several firms that could have been subject to asbestos liability claims rose, prompting an informal SEC investigation into the possible transmission of information from Frist's office to asset management firms.[18] Again, the investigations yielded no charges, but the appearance of possible impropriety resulted in increased public attention for Congressional ethics.

Minor waves were also created by President Barack Obama's brush with accusations of financial conflicts of interest as a senator. In 2005, Obama invested $5,000 in a biotech company—and campaign donor—that was trying to create a drug to combat avian flu. According to a New York Times report, Obama "took the lead in a legislative push for more federal spending to battle the disease" just two weeks later.[19] As in the case of Senator Frist, Obama's investment portfolio was reportedly a blind trust. Unlike Frist, however, Obama sold his stocks at a loss. Upon learning about his biotech investment and another investment in a campaign donor's company, Obama immediately

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[15] *Id.*
[16] Johnson, *supra* note 11, at A13.
[17] Brody Mullins & Kara Scannell, *Hedge Funds Hire Lobbyists to Gather Tips in Washington*, WALL ST. J., Dec. 8, 2006, at A1.
[18] *Id.*
[19] Mike McIntire & Christopher Drew, *Obama, in Brief Investing Foray In '05, Took Same Path as Donors*, N.Y. TIMES, Mar. 7, 2007, at 1.

traded both away, losing $13,000.[20] Incidentally, Obama is not the only Democrat with presidential aspirations whose investment history has created some speculation about wrongdoing; Hillary Clinton's 1978 trades of cattle futures, on which she earned a $99,541 profit on a $1,000 initial investment over a ten-month period, have also been a focus of investigation (in addition to jealousy).[21]

Finally, the most notable public outcry over Congressional insider trading was prompted by the activities of Representative Tom DeLay and a DeLay staffer named Tony Rudy. Indeed, Rudy's activities have been cited by Slaughter and Baird as one of the primary motivations for the STOCK Act.[22] Rudy is suspected of consistently trading based on material, nonpublic legislative information in 1999 and 2000.[23] Any profits Rudy might have made on these transactions remain unknown, and may never come to light. Still, his actions epitomize the type of behavior that the STOCK Act seeks to proscribe. Rudy has never been charged in connection with his securities trades, but he pled guilty to conspiracy charges in 2006 for his connection with the Jack Abramoff lobbying scandal. The subsequent attachment of his name to Congressional insider trading thus helped raise the profile of the issue considerably.

Besides the anecdotal evidence of Congressional insider trading that registered in the public consciousness, academic research has also indicated the need for potential reform of legislators' trading practices. In 2004, Alan Ziobrowski and colleagues

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[20] *Id.*
[21] Caroline Baum & Victor Niederhoffer. *Herd Instincts: Hillary's Investment Profits - Ethics of Hillary Clinton's Cattle Futures Investments*, NAT'L REV., Feb. 20, 1995, http://findarticles.com/p/articles/mi_m1282/is_n3_v47/ai_16709018/pg_7.
[22] Mullins & Scannell, *supra* note 15, at A1.
[23] *Id.*

published an article entitled *Abnormal Returns from the Common Stock Investments of the U.S. Senate*. Using federally-mandated annual financial disclosure reports, Ziobrowski et al. reconstructed Senators' common stock portfolios and trades from 1993 to 1998.[24] The average returns on these investments were staggering. A trade-weighted portfolio combining Senators' stock purchases and sales beat the market by 97 basis points per month, for an average annual return of 12.3 percent above the market.[25] Lest this result be attributed to the skill of financial advisors available to Senators and others in powerful, lucrative positions, corporate insiders trading their companies' own stock received an average return of just 6.2 percent above the market average.[26] Ziobrowski also noted that abnormally high returns were especially common among more junior Senators,[27] and were equally impressive regardless of party affiliation.[28]

Perhaps the most striking aspect of the Ziobrowski study is not the Senators' apparent aptitude for picking stocks, but their seemingly preternatural talent for knowing exactly when to buy and sell:

> For the 12 months prior to acquisition, common stocks purchased by Senators exhibit relatively small positive CARs [Cumulative Abnormal Returns] (3.4%). After being acquired, the CARs increase to 28.6% during the next calendar year. The CARs for the sample of sell transactions are equally interesting. The CARs after sale by the Senators

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[24] Alan Ziobrowski, Ping Cheng, James W. Boyd & Brigitte J. Ziobrowski, *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661, 662 (2004).
[25] *Id.* at 663.
[26] Leslie A. Jeng, Richard J. Zeckhauser & Andrew Metrick, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, REV. OF ECON. & STAT., May 2003, at 453.
[27] Ziobrowski et al., *supra* note 22, at 674.
[28] *Id.* at 670.

are nearly zero. However, prior to sale, we see another large run-up in the CARs during the 12 months before the event-day (25.1%).[29]

In other words, the prices of common stocks bought by Senators tended to stagnate prior to purchase, soar after purchase, and then stagnate again after sale (see Figure 1, next page).[30] The prices for common stocks sold by Senators tended to increase dramatically just before the sale, followed by no further increases. These discoveries are likely the most robust evidence for Congressional insider trading presented by the study. Indeed, it is after this revelation that Ziobrowski et al. are emboldened to claim, “These results clearly support the notion that members of the Senate trade with a substantial informational advantage over ordinary investors.”[31]

Perhaps attributing this informational advantage to legislators’ and federal employees’ willingness to trade on nonpublic material information, the STOCK Act’s drafters focused the Act’s second section on reforming the Securities Exchange Act of 1934 (“the SEA”) and the Commodity Exchange Act of 1936 (“the CEA”). Both the SEA and the CEA would be augmented with provisions prohibiting transactions by those “in possession of material nonpublic information, as defined by the Commission, relating to any pending or prospective legislative action . . . .”[32] The Act’s third section makes

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[29] *Id.* at 667.
[30] Reproduced from *Id*. at 667.
[31] *Id.* at 667.
[32] Stop Trading on Congressional Knowledge Act, H.R. 682 § 2(1), 111th Cong. (2009).

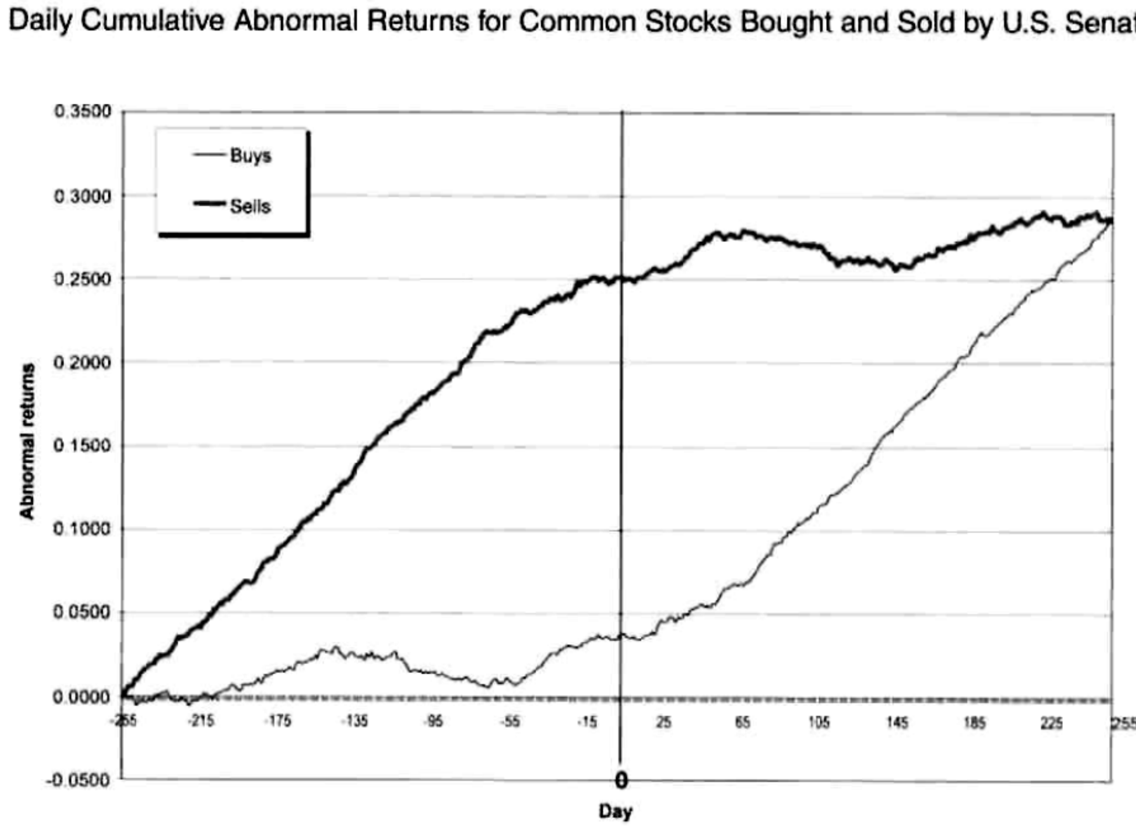

Figure 1.

similar additions to the Rules of the House of Representatives (also known as the "Code of Official Conduct").[33] Were these provisions to pass, one imagines that most of the informational advantage identified by Ziobrowski et al. would disappear, leaving those involved in the legislative process on more even footing with other investors.

III. Current Deterrents to Insider Trading

Despite the evidence that Congressional insider trading may be relatively common, parties have suggested that formal Congressional insider trading restriction is

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[33] *Id*

either unnecessary or unproductive.[34] Some of these arguments suggest that existing provisions in law or in informal norms render such regulation essentially superfluous. Thus, reviewing the history of insider trading law is necessary to determine whether Congressional insider trading is currently illegal. This analysis also provides the background against which arguments for and against Congressional insider trading restrictions can be interpreted.

A. Insider Trading Law: Disclose or Abstain, Fiduciary Duty, 14e-3, Tippee Liability, and Misappropriation

Insider trading restrictions have developed significantly since the early 1900s. Broadly, insider trading has been restricted in three ways. Throughout the first half of the twentieth century, insiders were subject to a duty either to disclose relevant inside information before trading, or to abstain from trading. This disclosure requirement was modified in *Chiarella v. United States*[35] and *Dirks v. Securities and Exchange Commission*[36] to prohibit insider trading only when the insider owed a fiduciary duty to his source of information. In response to *Chiarella*, the Securities and Exchange Commission passed Rule 14e-3[37] to prohibit insider trading in the tender offer context. Most recently, in *United States v. O'Hagan*,[38] the Supreme Court of the United States has augmented the fiduciary duty theory with a "misappropriation theory." According to this

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[34] Daniel Gross, *Insider Trading, Congressional-Style*, SLATE, May 21, 2007, http://www.slate.com/id/2166664/.
[35] 445 U.S. 222 (1980).
[36] 463 U.S. 646 (1983).
[37] 17 C.F.R § 240.14e-3 (2008).
[38] 521 U.S. 642 (1997).

theory, insiders are liable if they have misappropriated inside information. Each of these three periods will be discussed in detail.

1. Disclose or Abstain and 10b-5

The United States Supreme Court set the tone for insider trading regulation in *Strong v. Repide.*[39] In that case, Repide, a director and majority shareholder in the Philippine Sugar Estates Development Company, purchased shares in the Company from plaintiff Strong through an agent to conceal his interest. Although the shares were close to worthless, the Philippine Government had made an offer to purchase a large area of land, including that owned by the Philippine Sugar Estates. Repide, representing the Company in these negotiations, had refused the government's offer, but the impending transaction would greatly increase the value of the shares when it finally went through. Strong did not know about the government's interest, and her agent sold her shares to Repide's agent shortly before the transaction with the government was finalized and the value of the shares increased dramatically.

In determining that Repide owed a duty to disclose his knowledge about the potential value of the shares before purchasing from shareholders, the Court asserted that "there are cases where, by reason of the special facts, such a duty exists."[40] The Court declined to outline what such special facts might generally be, but concluded that Repide's position as director, majority shareholder, and negotiator with the government regarding the purchase created a special relationship between him and shareholders that

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[39] 213 U.S. 419 (1909).
[40] 213 U.S. at 431.

does not ordinarily exist and resulted in a fraudulent transaction.[41] Because of this relationship, he was required either to disclose his inside knowledge, or to refrain from trading.

This case developed a prototype for the "disclose or abstain" rule, although its application to situations with special facts offered shareholder protection only in limited cases. In particular, a duty could arise only in situations when a director personally sought a stockholder.[42] In transactions occurring at a stock exchange where the identities of the buyer and seller were not known to each other, such a duty usually did not apply, as there was no special relationship that would create such a duty between the insider and the other party.[43] In general, most states recognized a director's duty only to his corporation and the maximization of its profits, and not towards the shareholders.[44] They declined to extend the trustee relationship to the situation of a director dealing with a shareholder.[45] However, the sphere of the disclose or abstain rule's influence would become significantly enlarged over the next decades with the Securities Exchange Act of 1934 and resulting rules and litigation.

The Securities Exchange Act of 1934 ("the SEA") was passed to "insure the maintenance of fair and honest markets . . . ."[46] The SEA regulates the buying and selling of secondary securities, which is how most securities are traded, as opposed to primary securities issues which are covered by the Securities Act of 1933. Although the

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[41] 213 U.S. at 431-32.
[42] Goodwin v. Agassiz, 283 Mass. 358, 363 (1933).
[43] 283 Mass. at 362-63.
[44] Michael Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 55 (1960).
[45] *Id.* at 56.
[46] Securities Exchange Act of 1934, 48 Stat. 881, 882 (codified as amended at 15 U.S.C. § 78 (2008)).

only section of the SEA to deal explicitly with regulating insider trading is Section 16,[47] the SEA also created the Securities and Exchange Commission ("the SEC")[48] and gave it the power to promulgate various rules and regulations,[49] perhaps the most important of which is Rule 10b-5 ("the Rule").

The SEC adopted the Rule in 1948. The Rule states that

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[50]

On its surface, it is unclear how the Rule restricts prototypical insider trading. In fact, insider trading is not explicitly mentioned in the Rule at all, making one wonder how it can be proscribed by the Rule. Additionally, the Rule does not define what a "material fact" is or what insider behavior would constitute operation of a fraud, which appears essential to having insider trading fall under the Rule's purview. The landmark

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[47] 48 Stat. at 896. Section 16 requires both disclosure of insiders' transactions in their own securities, as well as disgorging profits on short-term (six month) purchases and sales in company stock to the company.
[48] 48 Stat. at 885.
[49] 48 Stat. at 891.
[50] 17 C.F.R. § 240.10b-5 (2008).

insider trading case of *SEC v. Texas Gulf Sulfur*[51] provided clarifications for many of these ambiguities.

SEC v. Texas Gulf Sulfur is one of the pivotal insider-trading regulation cases, and it defined the disclose or abstain rule that became the dominant rule at the time.[52] This period represents the high point of insider trading restrictions.[53] The case was an action by the SEC to enjoin defendants, various officers and employees of Texas Gulf Sulfur ("TGS"), from engaging in future insider trading violations and to force rescission of their alleged insider trades. While exploring in Canada, TGS found a drill site that "was unusually good and . . . it excited the interest and speculation of those who knew about it."[54] In an effort to prevent the information from spreading and to enable TGS to buy surrounding land cheaply, the company president instructed the workers and officers who knew about the find to keep the information confidential. Although they did not directly leak information, the employees and officers began buying stock and options in the company before the news of the drill site was publicly released, with the result that the stock price increased from $18 per share in November 1963, the time of the discovery, to approximately $30 per share in April 1964, just prior to TGS's public announcement of the valuable site.[55] The stock closed at $36 3/8 per share at the end of the day in which the find was announced.[56]

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[51] 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
[52] This rule was put forth by the SEC in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), but was not adopted by the Supreme Court until this case.
[53] The sweeping restriction on insider trading in *SEC v. Texas Gulf Sulfur* has been dubbed "the utopian dream of information parity among investors." James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 631.
[54] 401 F.2d at 843-44.
[55] 401 F.2d at 847.
[56] 401 F.2d at 847. Defendants' transactions are documented at 401 F.2d at 842.

The Second Circuit held select defendants of TGS liable for insider trading under Rule 10b-5. Quoting the SEC's *Cady, Roberts*[57] decision, the Court determined that

> The essence of the Rule [10b-5] is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public.[58]

The Court then proceeded to state the disclose or abstain rule that became the dominant insider trading restriction:

> Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[59]

Material information was held to include any information that a reasonable man would think was important in determining a security's price.[60] Therefore, because the information of the valuable ore lode was material, defendants had a duty either to disclose this information before trading, or to abstain from trading. Their promise of

[57] *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)
[58] 401 F.2d at 848.
[59] 401 F.2d at 848.
[60] 401 F.2d at 849. The U.S. Supreme Court determined in *Basic Inc. v. Levinson* that for information to be material "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the `total mix' of information made available." 485 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449). The Court makes clear that it does not want to set too low a threshold on material information for fear of "bury[ing] the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decision making." 485 U.S. at 231 (1988) (quoting TSC v. Northway, 426 U.S. at 448-49).

confidentiality towards TGS's president meant their only course of action that did not involve a breach of duty was to abstain from trading.

Arguably, the *Texas Gulf Sulfur* rule is too broad and restricts behavior, particularly by financial analysts, that is socially useful and desirable.[61] Investment houses would have little incentive to search for company information if they were forced to disclose it publicly, rather than allowed to use it to make a profit. This searching for information, and subsequent trading, yields more efficient securities markets whose prices more accurately reflect the underlying assets' values. Well-priced securities ensure that capital flows to the most productive projects, and allow managers to better gauge when potential investments will have positive net present values, since their calculations often use prices of other companies as an input.[62] Furthermore, analysts might be prohibited from using even material, *public* information to form security price opinions, because their manipulations of that information are not public, but might be deemed material. Nevertheless, this restrictive rule persisted until the Supreme Court's decision in *Chiarella*,[63] when it required a fiduciary duty to exist between the insider and his trading partner for liability.

2. Fiduciary Duty

Chiarella worked for Pandrick Press, a financial printer that printed materials including corporate takeover bids. When Pandrick Press was contracted to print merger

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[61] *See, e.g.*, Matthew Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771, 1774 (1984).
[62] For instance, a popular method (the Capital Asset Pricing Model) for calculating the required rate of return for a security requires determining how the security's price moves relative to the market, which incorporates stock prices of all companies. An accurate required rate of return, therefore, depends not only on an accurately-priced security but also an accurately-priced market.
[63] 445 U.S. 222 (1980).

documents, it would receive the documents with missing or false names, which were not filled in until the night before final printing. This practice was intended to give Pandrick Press time to set up its printers, yet prevent them from learning the identities of the companies engaged in the mergers, thus keeping the information secret as long as possible. However, Chiarella was able to figure out the parties involved in five merger documents he handled, and he purchased stock in the target companies without disclosing this information. He was consequently charged by the SEC for violating Rule 10b-5.

The Second Circuit Court of Appeals upheld Chiarella's conviction under the equal access disclose or abstain rule announced in *Texas Gulf Sulfur*, holding that "*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[64] Chiarella thus breached this duty towards his trading partners by failing to disclose his material, nonpublic information.

In reversing the Court of Appeals on Chiarella's convictions, the Supreme Court narrowed the reach of the disclose or abstain rule, determining that a duty to disclose does not arise from "the mere possession of nonpublic market information."[65] Instead, an insider might have a duty to his trading partner if he acts as his agent, fiduciary, or person in whom the trading partner has placed trust and confidence.[66] Because Chiarella had no relationship with his trading partners, with whom he traded over an impersonal public

[64] 588 F.2d 1358. 1365 (1978).
[65] 445 U.S. at 235.
[66] 445 U.S. at 233.

exchange, he had no duty to disclose his inside information to them.[67] The question of whether Chiarella might have owed a duty to the tender offeror who contracted with Pandrick Press was not raised before the original jury, so the Court did not reach this question. However, a version of such a duty was advocated by Chief Justice Burger in dissent[68] and would eventually be adopted by the Supreme Court in *O'Hagan*.

3. Rule 14e-3

In response to the Court's holding in *Chiarella*, the SEC adopted Rule 14e-3 in 1980 to prevent the type of behavior in which Chiarella engaged.[69] Rule 14e-3 prohibits insider trading on tender offer information in two ways. First, if a tender offer is underway, or if significant steps towards a tender offer have been taken, a trader with information relating to a tender offer is prohibited from trading if he knows or has reason to know that the information came from the tender offeror, a company involved in the tender offer, or anyone acting on behalf of the offeror. Notice that this restriction does not depend upon any fiduciary duty between the potential trader and his trading partner or one of the tender offer parties. Second, Rule 14e-3 makes it unlawful for people involved in a tender offer to communicate inside information if it is reasonably foreseeable that the information will be used for insider trading. Chiarella's behavior would have violated insider trading restrictions under the first part of this rule had it been in place when he was prosecuted. However, general insider trading behavior is not subject to this rule, as it applies only in the tender offer context.

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[67] Note that the Supreme Court would later require intent to manipulate, deceive, or defraud rather than simple negligence for a private action under Rule 10b-5. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).
[68] 445 U.S. at 240.
[69] *See* 17 C.F.R. § 240.14e-3 (2008).

4. Tippee Liability

Dirks[70] was the next important case that shaped current insider trading liability. Dirks worked as an insurance sector analyst when he was approached by a former employee of Equity Funding of America, who alleged that fraudulent activities had resulted in the company's assets being largely inflated. While Dirks investigated the claims, he freely discussed the allegations with some of his institutional clients, who consequently sold their holdings. As a result of this sale, Equity Funding share prices plummeted, trading was halted, and an investigation by the Wall Street Journal and the SEC was undertaken. Throughout this period, neither Dirks nor his company traded in Equity Funding stock.

Dirks raised issues of when an outsider could be held liable for insider trading violations. Dirks did not work for Equity Funding and had no relationship with them, meaning he was not an insider in the traditional sense. Rather, he was considered a "tippee"—someone who gained information from an insider, or the "tipper." Traditional insiders have independent fiduciary duties to the corporation and its shareholders that can be used to hold them liable for insider trading; Dirks, as a tippee with no connection to Equity Funding or its shareholders, did not clearly have these relationships that are required to find liability after *Chiarella*.[71] The Supreme Court took this opportunity to define when a tippee acquires a duty to disclose or abstain.

While reaffirming its requirement from *Chiarella*,[72] the Supreme Court determined that a tippee (Dirks in this case) gains an obligation to disclose or abstain

[70] Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646 (1983).
[71] 463 U.S. at 655.
[72] 463 U.S. at 657-58.

when the tipper (Dirks's source) violates his insider's fiduciary duty.[73] Such a breach occurs when "the insider personally will benefit, directly or indirectly, from his disclosure . . . . And absent a breach by the insider, there is no derivative breach."[74] Because Dirks's source did not derive direct or indirect gain from passing his information along, the source did not breach his fiduciary duty, and therefore Dirks had no derivative duty to abstain from using the inside information.[75]

Dirks also attempted to carve out a safe haven for stock analysts. As the majority notes, "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[76] As long as an analyst's source does not gain directly or indirectly from passing information to the analyst, neither the analyst nor his source will be liable for any trades that result. Thus, analysts can continue their information-gathering activities that might be stopped if the Court recognized a general duty either to disclose all nonpublic material information or to abstain from trading.

Following the Supreme Court decisions in *Chiarella* and *Dirks*, the misappropriation theory outlined by Burger in his *Chiarella* dissent was a controversial theory of insider trading liability. Some courts accepted the theory,[77] while others

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[73] 463 U.S. at 661-62.
[74] 463 U.S. at 662.
[75] 463 U.S. at 667.
[76] 463 U.S. at 658.
[77] *See, e.g.*, United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

rejected it.[78] Finally, in 1995, the Supreme Court officially adopted the theory in *United States v. O'Hagan*.[79]

5. Misappropriation Theory

James O'Hagan was a partner in a law firm that had been hired to represent Grand Metropolitan PLC regarding a potential tender offer for Pillsbury. Although O'Hagan did not work on the case, he found out about the impending tender offer and proceeded to buy stock and call options in Pillsbury, ultimately making more than $4.3 million in profit once the tender offer was announced.[80] He was convicted in Federal District Court for violating Rule 14e-3's restriction against trading on inside information related to a tender offer. He was also held to have violated Rule 10b-5 for having breached a fiduciary duty by "misappropriating" inside information.[81] The Eighth Circuit Court of Appeals, however, reversed all O'Hagan's convictions, holding that misappropriation was not a valid theory for finding liability, and that Rule 14e-3 exceeded the SEC's rulemaking authority by not requiring a showing of fiduciary duty for liability.[82] The Supreme Court reversed the Court of Appeals on both counts, in the process upholding Rule 14e-3 and adopting the misappropriation theory.

The misappropriation theory posits that a trader commits fraud under Rule 10b-5 in connection with a securities transaction when he breaches a duty of loyalty or

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[78] *See, e.g.*, United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).
[79] 521 U.S. 642 (1997). The Supreme Court had previously split evenly on whether to adopt the misappropriation theory. *See* Carpenter v. United States, 484 U.S. 19, 24 (1987).
[80] 521 U.S. at 647-48.
[81] 901 F. Supp. 1461 (1995).
[82] 92 F.3d 612, 622, 627 (8th Cir. 1996).

confidentiality by misappropriating confidential information.[83] In this case, O'Hagan breached a duty towards his law firm and Grand Metropolitan, the tender offeror, when he traded on the confidential tender offer information. Note, however, that if the trader discloses his impending trading plans to his informational source, he is no longer liable for insider trading under Rule 10b-5 because he no longer is employing a "deceptive device," although he could still be liable under state law for breaching a duty of loyalty.[84] If *Chiarella* were analyzed under this theory, Chiarella likely could have been held liable for misappropriating confidential information relating to the tender offers from his employer as well as the parties to the tender offer.

6. Summary of Current Insider Trading Restrictions

In summary, under current insider trading law, liability can arise in three distinct ways. First, an insider is required to disclose his information prior to trading, or to abstain from trading, if he owes a fiduciary duty towards his trading partner. This restriction was held in *Texas Gulf Sulfur* and modified by *Chiarella*. A tippee can be held liable in the same way if his tipper has such a duty, as determined in *Dirks*. Second, Rule 14e-3 prohibits traders from buying or selling securities using inside information related to a tender offer, if the securities' companies have entered, or taken substantial steps towards, a tender offer. Finally, *O'Hagan* affirmed Rule 10b-5 liability when a trader misappropriates inside information without informing the information's source.

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[83] 521 U.S. at 652.
[84] 521 U.S. at 655.

B. The Applicability of Insider Trading Doctrine

If there is a commonality between the disclose or abstain rule and the misappropriation rule,[85] it is the requirement that some specific duty be violated. That duty can be a fiduciary one owed to a trading partner under the disclose or abstain theory, or one of loyalty or confidentiality under the misappropriation theory. In the case of Congressional insider trading, however, it is not clear that congressmen or their aides owe any party such a duty in more than a vague sense. Andrew George argues that congressmen already have a duty preventing them from trading on inside information.[86] The duty may be derived from three sources: common law relationships, agreements to maintain information in confidence, and a history of sharing confidences.[87] A violation of this duty through trading on inside information may leave a congressman open to prosecution under the misappropriation theory. However, even George acknowledges the need for confirmation of regulators' power to prosecute under this theory.[88] It is this ambiguity of duty and ability to prosecute that further regulation would ameliorate definitively by augmenting the Securities Exchange Act and the Commodity Futures Trading Act.

George is not the first to argue that congressmen possess a duty that might keep them from trading on inside information. Other observers believe that the basis for a fiduciary duty of congressmen to their constituents or to the country at large should

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[85] Rule 14e-3 is not particularly applicable to Congressional insider trading, as one imagines that legislators rarely come into possession of inside information related to a tender offer.

[86] Andrew George, Essay, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL'Y. REV. 161 (2008).

[87] *Id.* at 164.

[88] *Id.* at 172.

already be recognized, even without new legislation. Over thirty years ago, potential reformers such as Joseph Kalo were already observing that "The application of fiduciary duties to activities of government employees is not novel."[89] Besides pointing to some dicta that suggested a public office should be regarded as a trust,[90] Kalo suggested that "Deeply engrained in the American people is a belief that public office, and confidential information acquired as a result of holding such office, should not be used for private gain."[91] Years later, other observers picked up on similar threads. For instance, *The Fiduciary Duty of Former Government Employees*, a Yale Law Journal note, argues that a "general fiduciary duty" is necessary for former congressmen and other federal employees.[92] According to this argument, public office involves a relationship of trust, and as a trustee of the electorate, a public officer should have duties akin to those of trustees in the private sector.[93] Like Kalo's argument, this assertion seems to rely on the implicit expectations that Americans may have for their elected leaders. Americans are supposed to believe that those who hold public office have promised to subordinate their own private gain to the public good.

While this perception of Kalo may be true, it hardly offers a solid legal basis for liability based on the disclose or abstain rule or the misappropriation theory. Both Slaughter and the *Wall Street Journal* have quoted Thomas Newkirk, a former SEC official and current partner at Jenner and Block:

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[89] Joseph Kalo, *Deterring Misuse of Confidential Government Information: A Proposed Citizens' Action*, 72 MICH. L. REV. 1577, 1581 (1974).
[90] *Id.* at 1581-82.
[91] *Id.* at 1582.
[92] Note, *The Fiduciary Duty of Former Government Employees*, 90 Yale L.J. 189 (1980).
[93] *Id.* at 200.

> 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.[94]

One imagines that this lack of a concrete duty, rather than the vague sense that congressmen ought to place public interests first, might control if a congressman were sued for trading on material nonpublic legislative information under the current legal regime. If congressmen and others are to be barred from engaging in such activities, regulation appears necessary insofar as it overcomes legislators' lack of a well-defined duty.

C. Other Relevant Laws and Norms

1. The Speech or Debate Clause

One possible concern about regulation of congressmen's trading is its potential conflict with the Speech or Debate Clause of the United States Constitution. The Clause, which protects members of Congress from prosecution for legislative activities, has been a prominent consideration in other attempted ethics reforms.[95] For example, a report on the creation of an independent ethics commission in place of the current member-composed committees by the New York City Bar Association noted that opposition to the independent committees was frequently rooted in potential conflicts with the Speech or Debate Clause.[96] This section provides a brief overview of the type of activities covered

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[94] Mullins, *supra* note 1, at A1.
[95] *The Creation of an Independent Ethics Commission* 63 REC. OF THE ASS'N OF THE BAR OF THE CITY OF N.Y. 128, 141.
[96] *Id.*

by the Speech or Debate Clause, but concludes that regulation of Congressional insider trading would probably not conflict with the Clause.

The Speech or Debate Clause, in Article I of the Constitution, provides immunity to legislators for certain activities. The Clause reads: "The Senators and Representatives . . . shall in all Cases, except Treason, Felony and Breach of the Peace, be privileged from Arrest during their Attendance at the Session of their respective Houses . . . for any Speech or Debate in either House, they shall not be questioned in any other place."[97] The text of the provision was adapted from the English Bill of Rights of 1689, and was influenced by the "long struggle for parliamentary supremacy" in England.[98] Today, the Supreme Court views the Clause as an element of the balance of powers, and has said that "the legislative privilege, protecting against possible prosecution by an unfriendly executive and conviction by a hostile judiciary, is one manifestation of the 'practical security' for ensuring the independence of the legislation."[99]

The Speech or Debate Clause accordingly grants immunity to representatives for activities that promote legislative independence, but does not protect activity that does not have a legislative purpose. The Supreme Court has held that the Clause covers activity "generally done in a session of the House by one of its members in relation to the business before it,"[100] but "the Clause has not been extended beyond the legislative

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[97] U.S. CONST. art I., § 6.
[98] United States v. Johnson, 383 U.S. 169, 178 (1966).
[99] United States v. Johnson, 383 U.S. 169, 179 (1966). *See also* Gravel v. United States, 408 U.S. 606, 616 (1972) ("The . . . Clause was designed to assure a co-equal branch of government wide freedom of speech . . . without intimidation or threats from the Executive Branch.")
[100] Gravel, 408 U.S. 606, 624 (1972) (quoting Kilbourn v. Thomson, 103 U.S. at 204).

sphere."[101] Based on this understanding of the Clause, it does not protect activity "that is in no wise related to the due functioning of the legislative process."[102] However, beyond this general principle, the Clause also does not protect "all things in any way related to the legislative process," because of the concern that "there are few activities in which a legislator engages that he would be unable somehow to 'relate' to the legislative process."[103] Based on these limitations, the Speech or Debate Clause has been held inapplicable to a wide variety of conduct that the Courts have deemed insufficiently related to the legislative process, ranging from accepting bribes to speech outside of the legislative process.[104]

The Court's rulings on specific activities suggest that the Speech or Debate Clause would not generally cover the types of disclosures of information contemplated by the STOCK Act or similar legislation. Court precedents have held the Speech or Debate Clause inapplicable to the release of certain types of information. For example, the Court has denied immunity for information published in press releases.[105] Even more closely related to the provisions of trading regulation, the Court has held that private publication of classified documents is not protected speech or debate.[106] In *Gravel v. United States*, the Court considered whether Senator Mike Gravel was protected by the Speech or Debate Clause when he arranged with a publisher to release the Pentagon Papers. The

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[101] *Id*. at 624-25.
[102] Johnson, 383 U.S. at 172.
[103] United States v. Brewster, 408 U.S. 501, 516 (1972)
[104] *Id* at 526.
[105] Hutchinson v. Proxmire, 443 U.S. 111 (1979)
[106] Gravel v. United States, 408 U.S. 606, 622 (1972).

Court noted that "the heart of the Clause is speech or debate in either House,"[107] and that publishing the papers "was in no way essential to the deliberations of the Senate."[108] If conveying the information to third parties is not crucial to the deliberative process, personal use of the information would be even less related to the legislative process. Therefore, it seems unlikely the Speech or Debate Clause would conflict with attempts to formally regulate Congressional insider trading.

2. Internal Ethics Committees

Members of Congress are subject to internal investigations and sanctions even if they are not subject to existing insider trading laws. Both the House and Senate have ethics committees that have the authority to punish their colleagues.[109] If these internal standards prohibit insider trading by legislators, there may be no need to create further legislation to prohibit the activity. This section discusses current Congressional regulations that may ban trading on Congressional information by representatives, but suggests that the current regulations are vague and that enforcement of ethics regulations is infrequent.

a. Ethics Regulations in the House of Representatives and United States Senate

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[107] *Id.* at 625.
[108] *Id.* at 625.
[109] The House committee is called the Committee on Standards and Official Conduct, http://ethics.house.gov. The Senate committee is called the Senate Select Committee on Ethics, http://ethics.senate.gov. *See also Enforcement of Ethical Standards in Congress*, http://www.rules.house.gov/archives/jcoc2ac.htm (surveying internal ethics committees).

The Code of Ethics for Government Service contains a passage that may cover the use of confidential information for securities trading. The Code cautions that "[a]ny 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."[110] This language seems to apply directly to the issue of using confidential information for securities trading, and at least one Congressman's office has suggested that this provision currently bans insider trading by congressmen.[111] The House Ethics Manual further states that this provision is designed to eliminate conflicts of interest that arise from "a situation in which an official's conduct of his office conflicts with his private economic affairs."[112] This same regulation applies to the Senate as well, as the Senate concurred in the House Resolution establishing the guidelines.[113]

b. Potential Problems with Ethics Committee Enforcement

Although insider trading based on information that congressmen obtain from Congress may be prohibited by internal ethics regulations, the ethics committees prosecute legislators only infrequently. As a result, the threat of sanctions imposed by the ethics committee may not deter use of confidential information for securities trading in the same way the increased SEC enforcement contemplated by legislation like the STOCK Act would.

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[110] Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong. (1958), *reprinted in* 2008 HOUSE ETHICS MANUAL.
[111] *Kudlow & Kramer* (CNBC television broadcast Mar. 29, 2006) (reporting conversation with counsel to Representative David Dreier).
[112] HOUSE ETHICS MANUAL 187 (2008).
[113] Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong. (1958), *reprinted in* 2008 HOUSE ETHICS MANUAL.

Congressional documents show that House and Senate ethics committees rarely prosecute fellow legislators. In 1993, Congress published a report on the House and Senate Ethics Committees.[114] The report determined that "Actual disciplinary actions by the full Senate or House have, in fact, been relatively rare."[115] The Senate has censured only nine Senators in its history, and the House only twenty-two Representatives.[116] The web page for the House Committee on Standards of Official Conduct lists only five reports dating back to the 105th Congress.[117]

Several commentators in the media have noted ethics committee inaction in response to well-known Congressional scandals. One journalist remarked that although "Over the last two years, three Republican congressmen and two Democrats have been enveloped by ethical scandals . . . [t]hrough all of this muck and scandal, the Ethics Committee has accomplished nothing."[118] News reports suggest the prior year was no different. *The Washington Post* wrote that "[t]he House ethics committee, the panel responsible for upholding the chamber's ethics code, has been virtually moribund for the past year, handling only routine business despite a wave of federal investigations into close and potentially illegal relationships between lawmakers and lobbyists."[119]

The apparent ineffectiveness of the ethics committees may derive from several characteristics of the committees. Members of internal ethics committees must continue

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[114] Enforcement of Ethical Standards in Congress, *supra* note 115.
[115] *Id*.
[116] *Id.*
[117] U.S. Committee on Standards of Official Conduct, http://ethics.house.gov/Investigations/Default.aspx.
[118] Michael Scherer. *Paging the Ethics Committee*. SALON.COM, Oct. 6, 2006, http://www.salon.com/news/feature/2006/10/06/ethics/print.html.
[119] Jeffrey H. Birnbaum, *In a Season of Scandals, Ethics Panels are on the Sidelines*, WASH. POST, Dec. 5, 2005, at A02. The article specifically references inaction over the Randall "Duke" Cunningham bribery scandal.

to work with legislators they might sanction, providing an incentive not to investigate.[120] Furthermore, committee members will be reluctant to investigate activities in which they themselves might be participants.[121] Senator Barack Obama of Illinois criticized these elements of the ethics committees by stating: "There's some good reason for the American people to be skeptical of our enforcement system. After all, we in the Senate are our own judge, jury, and prosecutor."[122] When legislators are forced to judge their peers, they may forgo prosecution to preserve working relationships and to avoid setting precedents that may later be used against them.

For these reasons, the internal ethics committees are likely insufficient to obviate the need for legislation. Internal regulations, while vague, seem to proscribe using confidential information for private gain, and internal ethics committees have the authority to punish legislators. However, the structure and track record of ethics committees suggests that they would not vigorously prosecute such activity. The third-party SEC, with powers granted by the legislation like the STOCK Act, would be more likely to investigate and prosecute insider trading by members of Congress.

3. Informal Ethical Norms

Finally, even if existing regulations are weak or nonexistent, informal ethical norms could theoretically prevent legislators from trading on nonpublic information. We suspect that legislators may feel that trading on information obtained through their positions is inappropriate, even if they do not believe it is illegal. To investigate this

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[120] The Creation of an Independent Ethics Commission, *supra* note 101 at 136.
[121] *Id*.
[122] *Id*.

issue, we contacted the offices of many Senators and Representatives to ask about their confidentiality policies and their thoughts about trading on Congressional information. We ultimately communicated with two aides and one Representative who offered their opinions about the issue.

We first received an e-mail from a former legislative assistant describing both formal and informal constraints on legislators and their staff. The assistant emphasized that within a legislative office, "loyalty is to your boss, to his constituents, and to varying degrees, the party."[123] This suggests that people's actions are limited by informal constraints, but not in the same way as a traditional insider trading case, where there is a fiduciary duty to the source of the information. Regarding the likelihood of a legislator or staff member using information for private gain, the assistant noted: "It's an honor system—you're not there for personal gain, you're there to serve the people of district X. BUT, it's politics. People will play their hands when they can. Sometimes to benefit their boss, sometimes to benefit themselves."[124]

We discussed the same issues with the current chief of staff to a New York Representative. He also emphasized that legislators perceive duties to their constituents, and noted that these duties might compel disclosure of information the Representative deems crucial to the residents of his district.[125] Such a duty to represent constituents, if it exists, is not obviously violated by a congressman's insider trading. Nevertheless, the chief of staff emphatically suggested that the use of information for trading securities was

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[123] E-mail from a former legislative assistant, to Daniel J.L. Cohen (Mar. 25, 2008, 06:49:00 EST) (on file with authors).
[124] *Id*.
[125] Telephone interview with Paul Lipson , Chief of Staff to Rep. Jose E. Serrano (Apr. 8, 2008).

inappropriate. He noted: "Trading on any kind of information to enrich oneself is, in this job, absolutely verboten."[126]

Lastly, Representative John F. Tierney of Massachusetts contacted us by e-mail with his views on using Congressional information for trading. He wrote that he and his staff members do not trade on private Congressional information and that they are governed by a confidentiality agreement.[127] Contrary to the New York Representative's chief of staff's statements that most offices do not have a formal confidentiality agreement because constituent concerns may demand disclosure, Congressman Tierney wrote that: "[l]ike most Congressional offices and organizations, my office has a confidentiality agreement, in which no disclosure of confidential information is made to anyone except as required in the performance of work. No use of confidential information shall be made in my office for personal gain, advantage, or for harm of others."[128]

These discussions with legislative staff members suggest that, to the extent the opinions are representative of congressmen as a whole, legislators likely believe that using nonpublic information to benefit themselves through securities trading is wrong. However, disclosing such information is not always impermissible, especially when the information is critical to the interest of their constituents.

IV. Toward a Normative Perspective

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[126] *Id*.
[127] E-mail from John F. Tierney, Congressman from Massachusetts. (May 5, 2008, 3:54 PM EDT).
[128] *Id*.

To this point, we have focused our discussion on several positive issues related to regulation: the impetus for regulation, the provisions of the STOCK Act, and whether current regulations make regulation unnecessary. Now, we turn our attention to the normative side of the story. Congressional "insider" trading may not be currently prohibited, but should it be? Should congressmen be given the opportunity to earn abnormally high returns[129] by virtue of their service as elected officials? No citation is needed to assert that this result strikes many people as unfair. We proceed from the presumption that Congressional trading on material non-public information should be prohibited, and we seek to determine if any arguments can be made to justify the continued allowance of such trading.

As we have already discussed, Congressional trading is not insider trading in the traditional sense of the term. Still, a good place to begin looking for arguments in favor of Congressional insider trading is the extensive academic literature on the anti-regulation side of the traditional insider trading debate. After developing each of the arguments put forth against a prohibition on traditional insider trading, we will consider any significant counterarguments. We will not, however, enter the fray of the insider trading debate by passing judgment on the merits of each argument with respect to traditional insider trading. Instead, we will ask the following question: assuming these arguments have merit as defenses of traditional insider trading, do any of them apply to Congressional trading? If so, perhaps the presumption against the continued allowance of Congressional trading can be overcome.

[129] *See* Ziobrowski et al., *supra* note 22.

There are at least six distinct arguments put forth in favor of traditional insider trading that are worth considering. First, insider trading can be a useful component of employee compensation. Second, insider trading does not significantly harm long-term investors. Third, insider trading promotes efficient pricing in capital markets. Fourth, insider trading provides a more effective mechanism than traditional whistleblowing for exposing corporate fraud and malfeasance. Fifth, insider trading on negative information provides needed incentives for full disclosure of corporate problems. Finally, sixth, managers can use observations of insider trading by employees as signals for otherwise unobservable changes in their companies. Each of these arguments will be discussed in turn, first in terms of generic insider trading and then as they might apply to Congressional trading.

A. Insider Trading as Compensation

Like each of the first three arguments listed above, the argument for insider trading as compensation has its origin in Henry Manne's classic book *Insider Trading and the Stock Market*.[130] The heart of this first argument is that the allowance of insider trading as a component of employee compensation—just like the use of stock options as a component of compensation—enables the insider to benefit from productivity increases he causes the firm to experience.[131] Thus, replacing other forms of compensation with the allowance of insider trading incentivizes employees to engage in productivity-increasing behavior.[132] In fact, as Manne has pointed out, allowing employees to conduct

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130 HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).
131 *Id.* at 166.
132 *Id.* at 166.

insider trading is in many ways a better form of incentive-generating compensation than using stock options.[133] Insider trading does not produce situations where employees are left with worthless out-of-the-money stock options that were supposed to account for a significant percentage of their compensation; insider trading does not prevent employees from earning compensation when their behavior serves only to reduce an expected loss rather than to create a gain; insider trading does not allow employees to profit when their company's stock appreciates only in line with the market or industry; and insider trading does not result in disgruntled employees pushing for renegotiation every time their company's stock price declines significantly.[134] Stock options, on the other hand, suffer from all of these pitfalls.

Of course, as Manne has acknowledged[135] since the publication of his classic, the argument for insider trading as an efficient form of employee compensation is not without its faults. There is no guarantee that the people who first get the opportunity to invest on the basis of inside information will always be the same people responsible for the productivity increases that make the information valuable.[136] This problem is particularly apparent once one considers that the determining factor in who gets the first legitimate opportunity to invest on the basis of inside information might not be who is privy to the information first. Rather, the determining factor might be who possesses the wealth needed to capitalize on the information, who has the analytical ability to understand the implications of the information for the future of the stock price, or any of

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[133] Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 IOWA J. CORP. L. 167, 172-73 (2005).
[134] *Id.*
[135] *Id.* at 170-71.
[136] *Id.* at 173.

a number of other possibilities.[137] Moreover, and perhaps most obviously, the argument for insider trading as a useful form of compensation seems to overlook the fact that insiders may benefit just as easily from selling stock in the face of declining productivity as from buying stock when productivity is on the rise.[138] In fact, since it is arguably easier for most employees to generate decreases in productivity than increases in productivity,[139] the incentives created by insider trading as a form of compensation in fact seem quite perverse. It is possible that reputational consequences and other concerns about intentionally decreasing productivity outweigh the gains to be made via insider trading,[140] but this is an open empirical question.[141]

In addition to the various counterarguments levied against Manne's idea of insider trading as compensation, significant limitations to his argument have also been identified. For instance, Jonathan Macey and David Haddock have identified two factors that are crucially important in evaluating the desirability of insider trading as a form of compensation: the attitudes of insiders toward risk,[142] and the identities of the most informed non-insiders.[143] The value of the opportunity to conduct insider trading, as opposed to the value of many other forms of employee compensation, is a non-uniform random variable at the time the employment contract is created. Thus, in accepting

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[137] Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1455 (1967).
[138] Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149.
[139] Kristoffel Grechenig, *Positive and Negative Information – Insider Trading Rethought* 9 (Univ. of St. Gallen Law Sch. Law and Economics Research Paper Series, Working Paper No. 2007-28), *available at* http://ssrn.com/abstract=1019425.
[140] *Id.*
[141] *Id.*
[142] David D. Haddock & Jonathan Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1449, 1459-62 (1986).
[143] *Id.* at 1458-59.

insider trading as a form of compensation, employees are necessarily taking on some risk. Therefore, if employees are risk-averse, tradeoffs between insider trading and other forms of compensation with predetermined values in employment contracts will not be one-to-one on an expected value basis.[144] Employees will want a greater expected value increase from compensation via insider trading than they will be willing to sacrifice in decreases in other forms of less risky compensation. Insider trading, then, is likely a poor choice among forms of compensation if employees are risk-averse.[145]

Haddock and Macey's second observation is that the merits of insider trading as a form of compensation depend on whether market professionals or regular shareholders are the most informed non-insiders. In other words, it matters whether market professionals possess information not available to regular shareholders that would allow them to profit from trading with regular shareholders if insiders were not allowed to trade first on the same information. If market professionals possess such information, then allowing insider trading as a form of compensation prevents market professionals from profiting at the expense of regular shareholders.[146] On the other hand, if market professionals have no such information – if regular shareholders are the most-informed non-insiders – then market professionals could not profit at the expense of regular shareholders even in the absence of insider trading. The only possible result of allowing insider trading as a form of compensation in this case would be the prevention of

[144] *Id.* at 1462.
[145] This only fails to be true if those who bear the ultimate burden of paying employee salaries (presumably the shareholders) are risk-loving, which is almost certainly not the case.
[146] Haddock & Macey, *supra* note 146, at 1458-59.

shareholders from profiting on what could be seen as a corporate opportunity, presumably a negative outcome.[147]

Finally, it is unclear how a corporation could limit the compensation employees could expect to earn from insider trading, making insider trading practically difficult as a substitute for wage compensation. Whereas the amount of employee options and stock purchase plans can be dictated by the company, insiders' potential profit off trades seems limited only by the amount of credit they can access and the amount of shares they can purchase or sell before their information is incorporated into the stock price.

As was stated earlier, we do not intend to evaluate the merits of Manne's argument in the context of generic insider trading. Counterarguments and limitations are presented only to provide a better understanding of each argument before attempting to apply the argument to Congressional trading. In this case, it is fairly straightforward that—even assuming Manne's argument has merits for generic insider trading—Congressional trading cannot be justified by arguing that it is a useful form of compensation for congressmen. Insider trading would be a useful form of compensation for congressmen only if it provided them with favorable incentives. While it is desirable to provide a corporate employee with the incentive to partake in productivity-increasing behavior, it is not desirable to provide congressmen with the incentive to increase the value of one particular corporation as compared to others. In fact, as Stephen Bainbridge has explained, "Stock trading by congressmen . . . presents a double-edged conflict of interests. They may vote on the basis of their trading plans or trade on the basis of their

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[147] *Id*. at 1459-60.

voting plans."[148] Compensating congressmen via insider trading does not have the same potential benefits as compensating regular insiders in this manner. This first argument does not justify Congressional trading.

B. Lack of Harm to Long-term Investors

The second argument offered by Manne in *Insider Trading and the Stock Market* is that insider trading does not actually harm long-term investors.[149] It is helpful to approach this argument in two steps. First, consider any investor whose decisions about whether to trade in a stock are not affected by price movements that result from insider trading. Since insider trading causes changes in stock prices that would eventually happen anyway, such an investor who chooses to hold his position in a company whose insiders are trading should not be affected. If this investor chooses to change his position in the company and transact with the insiders, he would have been transacting in the same manner if the insider trading were not occurring. Thus, if he buys from an insider who is selling on negative information, he will actually get to pay a lower price since the insider trading is driving the stock price down. If he sells to an insider who is buying on positive information, he will sell at a higher price because the insider trading is pushing the stock price up. Our hypothesized investor actually benefits from the insider trading whether he's buying or selling! The second step of the argument is much simpler. "The long-term investor," Manne argues, "is much less likely than the trader to sell because of price

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[148] Stephen Bainbridge, *Insiders on the Hill*, TCS DAILY, Mar. 30, 2006, http://tcsdaily.com/article.aspx?id=033006D.
[149] Manne, *supra* note 134, at 93-103.

changes effected by insiders."[150] In other words, long-term investors are likely to very closely approximate our hypothesized investor and thus are unlikely to be harmed by insider trading. To quote Manne again, "no real damage is caused to a[] [long-term] investor who engages anonymously on an exchange in a trade with an insider on the other side of the transaction."[151]

The primary counterargument that has been put forth against this claim is that every participant in the stock market, long-term investors included, pays an "insider trading tax" on each transaction.[152] Market makers, the argument goes, systematically lose money when insiders trade,[153] so they will increase the bid-ask spread to cover this extra cost of conducting business.[154] The burden of insider trading is thus passed along from market makers to market participants generally, effectively creating a tax on transactions throughout the market. Because market participants are aware of this tax, they are inclined to purchase securities only at a lower price and sell at a higher price, increasing the cost of equity and reducing the profitability of new capital projects, perhaps even abandoning projects that would otherwise have a positive net present discounted value. This counterargument has been empirically challenged,[155] but it has not been conclusively rejected.

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[150] Manne, *supra* note 134, at 102.
[151] Manne, *supra* note 137, at 168.
[152] *Id.*
[153] Since market makers stand ready to trade with all partners and the decisions of some potential trading partners will be affected by price movements caused by insider trading, the trading of market makes will be affected by price movements caused by insider trading. Thus, market makers do not approximate our hypothesized investor and may (in fact, likely will) be harmed by insider trading.
[154] Manne, *supra* note 137, at 168.
[155] *See* Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U.L. REV. 83 (2004).

Assuming that Manne is correct that insider trading does not harm long-term investors, his argument should apply just as well to Congressional trading as to regular insider trading. Unlike with the compensation argument, the "no harm" argument has nothing to do with the identities of the people conducting the informed trades. If Manne's argument has merit for normal insider trading, it has merit for Congressional trading.

C. Pricing Efficiency of Markets

Manne's third argument against the prohibition of insider trading is that insider trading improves the pricing efficiency of markets. In other words, insider trading causes stock prices to reflect more accurately the true values of companies than they otherwise would. Such pricing accuracy is beneficial primarily because it results in a more efficient allocation of capital among companies,[156] but also because it decreases the volatility of stock prices.[157] No significant theoretical counterargument has been made against the claim that insider trading should lead to more efficient pricing; it seems fairly straightforward that allowing insiders to trade on their knowledge will cause stock prices to reflect information that would otherwise not be reflected. The empirical evidence on this point, however, has been cast in different lights by different scholars. Manne has recently claimed that "the argument for a strong positive relationship between market

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[156] Stephen M. Bainbridge, *Insider Trading: An Overview* 778 (SSRN Working Paper Series), *available at* http://ssrn.com/abstract=132529.

[157] *Id.* at 778-79. Bainbridge asserts that lower volatility is a positive because it "decreases the likelihood of individual windfall gains and increases the attractiveness of investing in securities for risk-averse investors."

efficiency and insider trading has proved to be very robust."[158] Stephen Bainbridge, on the other hand, asserts that the effects of insider trading on stock prices occur "slowly and sporadically,"[159] and thus that "the market efficiency justification for insider trading loses much of its force."[160]

Assuming that Manne's pricing efficiency argument is valid as applied to regular insider trading, it should also be valid as applied to Congressional trading. The pricing efficiency argument, like the "no harm" argument, has nothing to do with who conducts the informed trading. However, since opportunities for Congressional trading may be less common than opportunities for normal insider trading, one would think that Congressional trading would have a less significant—perhaps even statistically insignificant—effect on the pricing efficiency of American capital markets.

The limited available empirical evidence seems to support the view that Congressional trading does not have a significant effect on pricing efficiency. As can be seen in Figure 1, *infra* page 9, there is no marked increase in cumulative abnormal returns immediately following a purchase of the stock by Senators. Proponents of the pricing efficiency argument would argue that Senators are incentivized to credibly disseminate their inside information to the market, so that the stocks they have just purchased increase in price, resulting in profit. If such dissemination occurred, Senators' cumulative abnormal returns should increase rapidly in the days immediately following a purchase. However, abnormal returns do not start increasing until twenty-five days after purchase, and begin to increase significantly only 65 days after purchase, suggesting that Senators

[158] Manne, *supra* note 137, at 169.
[159] Bainbridge, *supra* note 160, at 780.
[160] *Id.*

are not significantly distributing their inside information, and thus that market efficiency is improved little by Congressional insider trading, if at all.

Even though Figure 1 includes all Senator purchases, and therefore a significant number of non-insider trades, we would still expect a rapid increase of cumulative abnormal returns in the days immediately following a purchase if Senators were circulating their information (assuming Senators were engaging in insider trading, which as already discussed is suggested by their high returns). This increase should occur because non-insider purchases, when averaged, should result in a horizontally-flat cumulative abnormal returns line—or perhaps a gradually-increasing line if Senators choose savvy investment brokers—and the inside purchases should have a sharp increase in cumulative abnormal returns immediately following the purchase. The average of the two types of purchases should still feature a marked increase.

D. Insider Trading as Whistleblowing

The fourth argument against prohibiting insider trading, and the first not developed originally by Henry Manne, is Jonathan Macey's argument that insider trading may provide a more effective mechanism for exposing corporate fraud and malfeasance than traditional whistleblowing.[161] Professor Macey takes the position that whistleblowing and insider trading on "whistleblower information"—information about corporate corruption, fraud, or other malfeasance—should be regulated similarly.[162] Both should be actively encouraged when the whistleblower or insider has a rightful property

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[161] Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899 (2004).
[162] *Id.* at 1902.

interest in the underlying information, and both should be illegal when no such rightful property interest is present.[163]

Macey claims that whistleblowing and insider trading on whistleblower information are "analytically and functionally indistinguishable,"[164] but he goes on to point out some pragmatic rationales for the superiority of insider trading. First, Macey argues that insider trading provides more credible evidence of fraud or corruption than does whistleblowing.[165] "[T]he talk involved in whistleblowing is cheap," Macey argues, "while the trading involved in short selling is costly to the short seller whose information about the underlying company is erroneous."[166] Essentially, since insider traders have to put their money where their mouths are, allegations of fraud and corruption brought to light via insider trading are more likely to be legitimate than similar allegations made by a whistleblower, who risks no finances. Second, Macey notes that whistleblowing relies on government officials "who are often poorly motivated or inept,"[167] while insider trading does not suffer from this pitfall. For these reasons, among others, Macey claims that insider trading is often preferable to whistleblowing as a mechanism for exposing corporate wrongdoing.

Even if Macey is right that insider trading on whistleblower information is often a better alternative than whistleblowing, his argument does not really apply to Congressional trading. This point is definitional, and not all that interesting. A whistleblower, per Professor Macey, is "an employee or other person in a contractual

[163] *Id.*
[164] *Id.*
[165] *Id.* at 1912.
[166] *Id.*
[167] *Id.* at 1915.

relationship with a company who reports misconduct to outside firms or institutions, which in turn have the authority to impose sanctions or take other corrective action against the wrongdoers."[168] Thus, there are no whistleblowers in Congress, so arguing that Congressional trading is a better alternative to whistleblowing for exposing material non-public information about corporate wrongdoing known by congressmen is a vacuous argument. This is not to say, however, that Congressional trading on negative information (including information about corporate wrongdoing) has no value as a mechanism for bringing such information to light. In fact, this is the next argument we consider.

E. Incentive to Disclose Negative Information

Kristoffel Grechenig has argued that insiders need incentives to disclose negative information in general, whether about corporate malfeasance or just poor earnings.[169] Insiders have strong incentives not to disclose such negative information, as such disclosures could result in less pay (particularly via the reduced value of stock options), less marketability when switching jobs, social sanctions, and other repercussions.[170] While disclosure duties may seem like a solution to this problem, Grechenig contends that allowing insiders to trade on negative information is a better solution in some cases because it entails no enforcement costs.[171] He does acknowledge that insider trading on negative information is not costless, as it may cause insiders as a whole to overinvest in

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[168] *Id.* at 1903.
[169] Grechenig, *supra* note 148.
[170] *Id.* at 4.
[171] *Id.* at 5.

the search for negative information.[172] Grechenig concludes that insider trading on negative information should not replace disclosure duties, but rather should serve as a supplement to them.[173]

Grechenig acknowledges that his argument is potentially susceptible to one of the critiques of Henry Manne's "insider trading as compensation" argument described earlier.[174] "If insiders were allowed to trade on bad news," Grechenig explains, "they would have incentives to produce this information in the first place. Clearly, producing negative information, and then trading on it, is fairly easy. . . . Incentives for a deliberate production of negative information results [sic] in inefficiencies."[175] Having stated this critique, Grechenig counters by listing the possible repercussions for an insider who intentionally creates negative information, from lost performance-based compensation to reputational harm and so on.[176] His intuition is that the repercussions outweigh the benefits, but he admits that it is an empirical question.[177] If his intuition proves wrong, Grechenig suggests that a rule allowing all insiders but the producer of the negative information to trade on it might be a good solution.[178] Such a rule would also solve the potential problem of insiders increasing risk in excess of investor preferences in order to increase their profits via trading in both directions,[179] yet it might be practically impossible.

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172 *Id.* at 6.
173 *Id.* at 6.
174 *See supra* Part IV.A.
175 Grechenig, *supra* note 148, at 9.
176 *Id.*
177 *Id.*
178 *Id.*
179 *Id.*

Grechenig's argument applies naturally in the context of Congressional trading. Like typical insiders, Congressmen also have potentially strong incentives not to seek out and disclose negative information they learn about corporations. As elected officials, they might not want to be the bearers of bad news. Moreover, earning a reputation for reporting negative corporate information to the public might be costly to congressmen in terms of corporate support and contacts. Congressmen are at risk of falling prey to overinvestment in the search for negative information, but such a possibility seems somewhat far-fetched in light of the wave of corporate corruption that Congress allowed to occur for most of the past decade.

Nevertheless, congressmen likely have more incentive to publicize negative information than corporate insiders do. They are not employed by the company to which the information pertains, and therefore do not risk losing their job and human capital if the company performs poorly. Furthermore, a congressman with his constituents' best interests in mind may also have incentive to reveal negative information early. Constituents will be better off if they can adjust their lifestyles and security holdings early, rather than waiting until the information is revealed only once the company enters bankruptcy as a result of desperate attempts to counteract whatever is causing the negative information. Thus, it is unclear whether congressmen need the extra incentive of insider trading to disclose negative information. The disadvantages to allowing their insider trading may outweigh any positive in increased disclosure that might result.

F. Insider Trading as a Signaling Mechanism

While the first three arguments we discussed were originally developed by Manne in 1966, Manne put forth this final argument only in 2005.[180] One of the key advantages of regular insider trading, Manne suggests, is that it causes changes in stock prices that managers can use as signals for problems in their companies that they otherwise might fail to observe.[181] For instance, imagine a scenario in which a division head of a company knows that a highly anticipated product within his division is not developing as had been hoped. The division head may not want to tell upper management this negative information, fearful that he will be replaced or otherwise disciplined. If the division head is not allowed to engage in insider trading, upper management will not learn about the negative information in a timely manner. On the other hand, if the division head is allowed to conduct insider trading based on the information, upper management will see the stock price falling due to the division head's selling of shares. Upper management will at least know that something is wrong, though they will still have to figure out the actual cause of the falling stock price. Manne acknowledges that this may sometimes be difficult, and he also acknowledges that upper management might even be hard-pressed to notice the decrease in stock price since other factors are simultaneously affecting the price.[182] In spite of these limitations, Manne argues that it is still better for managers to be given a chance to discover problems in a timely manner by watching stock price changes than for no such opportunity to exist at all.[183]

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[180] Manne, *supra* note 137, at 182-83.
[181] *Id.*
[182] *Id.* at 183.
[183] *Id.*

Manne's argument that normal insider trading provides helpful signals of corporate problems to managers is not applicable to the Congressional context. First, it is unlikely that congressmen would often know aspects of the inner workings of companies that the companies' managers would not already know. Second, while it is possible that a congressman would learn something through his work that would be useful information for a corporate manager, congressmen would not be disinclined to tell the corporate manager in the same way that the division head in the above hypothetical would be. If the information were not protected by a confidentiality duty, the congressman could simply talk to the corporate manager. Manne's manager signaling argument thus seems to provide very little, if any, justification for Congressional trading.

G. Summary of Six Traditional Arguments Against Restricting Insider Trading

Three of the arguments against the prohibition of traditional insider trading are applicable to the Congressional trading context, while three are not. Allowing Congressional trading will not significantly harm long-term investors; it may promote efficient pricing in capital markets; and it may give congressmen needed incentives to disclose negative information about corporations. On the other hand, Congressional trading is not a useful form of compensation; it is not an alternative to whistleblowing; and it will likely not produce stock price changes that can serve as useful signals to corporate management.

The three arguments applicable to the Congressional trading context highlighted above, although the most important, are not necessarily an exhaustive list of all possible justifications for Congressional trading. Other arguments in favor of Congressional trading may exist besides the ones that have been made for traditional insider trading.

H. An Additional Argument Against Restriction: Democratic Accountability

One possible additional argument in favor of allowing Congressional trading is that regulation is unnecessary because congressmen are democratically accountable to the public for their behavior. Congressmen have to publicly disclose their trading activity,[184] so perhaps people will pay attention to these disclosures and vote overly-opportunistic congressmen out of office. If this is the case, Congressional insider trading will be effectively punished without any need for intervening regulation. Definitive evidence of this possibility is not present, but the fact that Senators with less seniority earn higher returns than Senators with more seniority[185] could be seen as indirect evidence of accountability for insider trading. The interpretative story is that voters, aware of the perpetrators of opportunism, are not re-electing Senators who earn abnormally high returns. Thus, only Senators who do not make insider trades, and who thus earn more normal returns, are re-elected and become more senior. Of course, it could also be the case that newer Senators have greater incentives to earn abnormal returns, or that they are more likely to still retain corporate contacts from their not-so-far removed days in the private sector. Perhaps new Senators are simply younger and engage in more risky investments, with correspondingly higher returns, than older and more financially-conservative senators. However, given voter indifference and the costs associated with

[184] See Pub. L. No. 95-521, 92 Stat. 1824 (codified in scattered sections of 5 U.S.C.).
[185] Ziobrowski et al., *supra* note 22, at 674.

individually analyzing and monitoring congressmen's financial disclosures, it seems fairly unlikely that voters are systematically voting out of office those Senators who earn particularly high returns. While the evidence is inconclusive, democratic accountability probably does not hurt the case for regulation of Congressional trading. On the other hand, it probably does not provide a strong deterrent.

V. Final Recommendations and Modifications

In our experience, when presented with an explanation of the current legality of Congressional insider trading, most people are mildly appalled—or, in the case of a few securities analysts with whom we spoke, envious. Based on these attitudes and a sense that public policy should reflect the wishes of constituents, our initial presumption was against suggesting that Congressional insider trading be allowed to continue. To overcome this presumption, the traditional arguments for corporate insider trading would have to strongly support Congressional insider trading. In reviewing these arguments, though, this is not the case. Only half of the arguments usually offered for corporate insider trading are even weakly applicable to Congressional insider trading. The potentially significant costs associated with the perverse incentives of Congressional insider trading seem, on balance, to outweigh any benefits. Given that corporate insider trading is illegal, and that it remains easier to justify than Congressional insider trading, we cannot endorse Congressional insider trading.

Therefore, we suggest that Congressional insider trading should be regulated. We assess the current attempt to regulate congressmen's insider trading: the STOCK Act. If the STOCK Act were to regulate Congressional insider trading, we suggest that it should be modified in several important ways before being adopted. Broadly, the Act should be changed to improve disclosure, as well as to equalize restrictions applied to congressmen and federal employees, and to Senate and House members.

Currently, Senators and House Representatives, and certain other legislative employees, are required to file publicly-available financial disclosures of securities transactions under section 101 of the Ethics in Government Act of 1978.[186] These reports must be filed annually and must include a documenting of the dates and amounts of transactions greater than $1,000, although the disclosed transaction amount need only fall within a given range.[187] The STOCK Act, as proposed, would increase the frequency of filing to within 90 days after a securities transaction.[188] After the Sarbanes-Oxley Act of 2002, corporate insiders are now required to publicly disclose their securities transactions within two business days.[189] We see no compelling reason for the STOCK Act's filing period to be so long, and believe the Act would be more effective at disclosing insider trading and increasing congressional accountability if the filing period is considerably closer to the two-day period for corporate insiders.

The STOCK Act also places more restrictions on federal employee insider trading than on Congressional insider trading. We believe the Act should be equally restrictive towards both. The Act would prohibit federal employees from trading securities based on

[186] 92 Stat. 1824.
[187] The current ranges for transactions are: not more than $15,000; greater than $15,000 but not more than $50,000; greater than $50,000 but not more than $100,000; greater than $100,000 but not more than $250,000; greater than $250,000 but not more than $500,000; greater than $500,000 but not more than $1,000,000; greater than $1,000,000 but not more than $5,000,000; greater than $5,000,000 but not more than $25,000,000; greater than $25,000,000 but not more than $50,000,000; and greater than $50,000,000. See 5a U.S.C. §102(d)(1). *Id.* This rule is also embodied in Title XXXIV of the Standing Rules of the Senate, and Rule XXVI of the Rules of the House of Representatives of the 110th Congress.
[188] Stop Trading on Congressional Knowledge Act, H.R. 682 § 4(a)(1), 111th Cong. (2009).
[189] *See* 15 U.S.C. § 78p (2008).

material nonpublic information relating to the issuer of the securities,[190] while the analogous section for congressmen prohibits trading on inside information relating only to "any pending or prospective legislative action relating to such issuer. . . ."[191] It is unclear why the Act would restrict Congressional trading on only pending or prospective legislation relating to the stock issuer, rather than on *any* inside information related to the issuer. One could imagine a situation such as a briefing by the Department of Defense that alerts a congressman to an upcoming defense deal with a certain contractor, yet because such information is not related to "pending or prospective legislative action" concerning the contractor, the congressman is not restricted from trading the contractor's stock, whereas the federal employee would be.[192] We feel the section for congressmen should be changed to prohibit trading on inside information relating to the issuer of the securities, like the restriction for federal employees.

Next, the STOCK Act amends the Rules of the House of Representatives to prohibit disclosure of inside information related to pending or prospective legislation for a public company if the Representative believes the information will be used to buy or sell that company's securities.[193] This amendment is apparently aimed at stopping the spread of insider trading, and would presumably prevent Representatives from passing along information even when they derive no direct or indirect benefit—behavior that is permitted following *Chiarella*. Although it may be difficult to determine a situation in

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[190] Stop Trading on Congressional Knowledge Act, H.R. 682 § 2(a), 111th Cong. (2009).
[191] *Id*.
[192] Of course, insider trading could be prohibited in these situations by creating a contractual duty not to disclose. Nevertheless, it is puzzling why federal employees and congressmen would have different default rules against insider trading in these contexts.
[193] Stop Trading on Congressional Knowledge Act, H.R. 682 § 3, 111th Cong. (2009).

which Representatives do not derive *any* benefit from passing information (after all, they could always derive the benefit of building political capital or increasing their awareness among constituents), it is unclear why we would want a more restrictive rule for Representatives than for other potential inside traders, or how to resolve the apparent conflict between this amendment and the Supreme Court's holding in *Chiarella*.[194]

Additionally, just as with the different restrictions for congressmen and federal employees discussed previously, it is unclear why we would want to prevent Representatives from tipping information relating to only prospective or ongoing legislation. If a goal of the Act is to prevent the spread of insider trading, it would make more sense to restrict tipping information relating to the broader category of any inside information relating to the public company.

Furthermore, the Act includes no analogous provision for prohibiting Senators from tipping inside information. Such behavior does not appear to be already prohibited by the current Standing Rules of the Senate,[195] and we can think of no compelling reason to restrict Representatives, but not Senators, from tipping inside information. Instead, we feel both Representatives and Senators should be equally restricted from spreading inside information relating to public companies.

With these suggested amendments, the insider-trading restrictions of the STOCK Act is a strong piece of legislation worthy of endorsement. There is credible evidence that

[194] Having received direct or indirect benefit to be liable for tipping may not be the most exacting requirement. For instance, the SEC found a tipper benefited by tipping his adult film star girlfriend about upcoming mergers. *See also* Press Release, Sec. & Exch. Comm'n, Court Enters Final Judgment Against James J. McDermott And Kathryn B. Gannon SEC Bars McDermott from the Securities Industry (Jun. 7, 2005), *available at* http://sec.gov/litigation/litreleases/lr19250.htm (describing decision in an insider trading case).
[195] The current Standing Rules of the Senate are available at http://rules.senate.gov/senaterules/.

Congressional insider trading has occurred in the past, and that the current patchwork of laws and norms is inadequate to stop its future practice. There is also a presumption, based on the feelings of Americans and the obvious analogy to corporate insider trading, that Congressional insider trading is inequitable and should be illegal. The best arguments for corporate insider trading are not applicable enough to Congressional insider trading to overcome this presumption. Thus, the legality of Congressional insider trading constitutes an unfortunate gap in securities law—one that should be filled by an amended version of the STOCK Act, or some other similar regulation.