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at a Hearing Before the

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“INSIDER TRADING AND CONGRESSIONAL ACCOUNTABILITY”

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Chairman Lieberman, Ranking Member Collins and Members of the Committee:

I am honored to be invited by you, and will proceed directly to the point:

Are Members of Congress exempt from the insider trading laws? Can they sometimes engage in securities or commodities trading based on material non-public information, which trading would be unlawful (and potentially criminal) if engaged in by private citizens?

In a brief Executive Summary, my testimony will conclude:

(1) There are substantial ambiguities in the judge-made law on insider trading that would make it difficult to enforce the existing prohibition against Members of Congress in some settings. Although the Supreme Court could resolve these ambiguities in favor of liability, there is little certainty that they will, and public enforcers may hesitate in enforcing the law to its full extent in the interim. Hence, I believe there are good arguments for Congress to act to fill this possible loophole.

(2) While both S.1871 and S.1903 are well intentioned, they leave major loopholes that undercut their deterrent effect, because much material, nonpublic information that a Member of Congress receives does not relate to "pending or proposed legislation" (as these proposed statutes would require).

(3) A less drastic alternative to the proposed legislation is available: Congress could simply pass legislation declaring that a Member of Congress is a fiduciary for purposes of insider trading liability, and that no personal benefit or deceptive act is required to establish liability. This would enable Congress to sidestep the need to define terms such as "material" or "nonpublic" and instead rely on the existing case law. The one thing that Congress should not

attempt is a universal, comprehensive statute that defines all aspects of insider trading law. That risks a debacle.

(4) Members of Congress can rely on "Rule 10b5-1" plans so that the proposed extension of the insider trading prohibition to their trading should not render them illiquid. Congress could also instruct the SEC to give guidance in "no action" letters on a confidential basis to Members of Congress who are concerned about whether trading might violate the law. Opinions from private counsel would also provide substantial protection if all relevant details were provided to the counsel giving such opinion.

(5) Ultimately, "sunlight is the best disinfectant," and a requirement that Members of Congress disclose their trading within a brief period thereafter and that such information be made publicly available on a website could prove the most effective and least intrusive deterrent to improper use of material, nonpublic information by them.

I. The Legal Status of Trading by Members of Congress On Material, Non-Public Information

As you are no doubt aware, there has been a spirited debate among academics and journalists about whether Members of Congress can trade on the basis of material nonpublic information that they learn in the course of their duties.[1] Some have argued that they cannot be held liable (at least in most cases),[2] while others have replied, just as

[1] Compare Stephen Bainbridge, Insider Trading Inside the Beltway, 36 Iowa J. Corp. Law 281 (2011) with Donna Nagy, Insider Trading, Congressional Officials and Duties of Entrustment, 91 B.U.L. Rev. 1105 (2011). See also, Stephen Bainbridge, The Stop Trading on Congressional Knowledge Act (available at http://ssrn.com/abstract=1449744) (2011).

[2] See Bainbridge, supra note 1.

fervently, that they can.[3] I must note that the participants in this debate have all been respected academics, knowledgeable in this field, and nothing in my comments is meant to imply disrespect for either side in this debate. Rather, because insider trading is not defined by statute, the contours of unlawful insider trading are shaped by a maze of decisions, about which reasonable experts can disagree.

Nonetheless, I believe that there is a correct answer to the question whether Members of Congress can engage in what the public would consider to be insider trading. That answer is: SOMETIMES. In my judgment, Members of Congress could be successfully sued by the SEC in the following (but limited) instances:

(1) they traded on material non-public information relating to a tender offer;[4]

(2) they breached a duty of confidentiality that they voluntarily assumed (including by contract) that required them not to trade on that information;[5]

(3) they knowingly received a "gift of information" from an insider who would, himself or herself, be barred from trading;[6] or

(4) they have a defined family relationship or prior "history, pattern or practice of sharing confidences" with the person who confided the material, non-public information to them.[7]

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[3] See Nagy, supra note 1.

[4] Such trading is expressly prohibited by Rule 14e-3, which does not require that there be any breach of a fiduciary duty. See 17 C.F.R. § 240.14e-3.

[5] See Rule 10b5-2(b)(1) (specifying that such a "duty of trust or confidence" exists "whenever a person agrees to maintain information in confidence"). See 17 C.F.R. § 240.10b5-2. This rule was challenged and found unauthorized in SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) rev'd on other grounds, 620 F.3d 551 (5th Cir. 2010), but that court did uphold the idea that a contract can create a duty of confidentiality that bars trading if it is sufficiently explicit.

[6] See Dirks v. SEC, 463 U.S. 646, at 667 (1983) (discussing a "gift of confidential information to a trading relative or a friend" and finding it to be within the reach of Rule 10b-5).

[7] See Rule 10b5-2(b)(2).

It should be obvious that these examples cover only the minority of cases. Thus, I am in general agreement with those (including Professor Stephen Bainbridge[8]) who argue that Members of Congress are not clearly covered by the prohibition on insider trading.

Why is that? Certainly, no law or decision has expressly exempted Member of Congress from the insider trading prohibition. My answer is that there are at least three serious obstacles that interfere with attempting to apply the standard doctrine on insider trading to Members of Congress:

1. The Missing Fiduciary Duty. First, Members of Congress do not clearly owe a fiduciary duty (or any similar duty requiring them to be loyal and hold information in confidence) either to their trading partners in a securities (or commodities) transaction or to the source of the material, nonpublic information.[9] Since at least the Supreme Court's principal decision in 1983 on insider trading, Dirks v. SEC,[10] a prerequisite to insider trading has been a breach of a fiduciary duty (or a similar legal duty requiring the defendant to subordinate his self-interest to that of the beneficiary). This element of a required fiduciary breach is not a problem in most corporate cases because corporate directors, officers and employees do owe such a duty to the corporation and its shareholders. Similarly, other agents of the corporation – lawyers, investment bankers,

[8] See Bainbridge, supra note 1.

[9] To explore the full dimensions of the concept of fiduciary status would take an additional 100 pages. Very different conclusions are reached by courts depending on the context. In the enforcement context (civil or criminal), courts do not view the concept of fiduciary as expansively as they do in other, more aspirational contexts. Thus, in the leading case of United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), the Second Circuit (in an en banc decision) defined the term "fiduciary" in terms of two elements: (1) reliance, and (2) de facto control. Id. at 568. A fiduciary relationship, it said, involves "discretionary authority and dependency." Id. at 569. These critical elements of discretionary authority and dependency are not clearly present when, for example, an Executive Branch official confides confidential information in a Member of Congress.

[10] 463 U.S. 646 (1983).

and other advisers – are said to become "constructive insiders" who similarly owe such a duty to the corporation. The tippees of these persons are viewed as co-conspirators who share liability if they know that the information on which they traded was misappropriated from the corporation (much as the "fence" shares liability with the thief if the former receives the stolen property with knowledge).

Because Congressional staffers are employees of Congress, their liability seems clear if they trade based on material nonpublic information that they acquire as the result of their professional duties or status. But Members of Congress are different. They are neither employees nor agents of any larger entity. Some decisions have said that public officials "owe a fiduciary duty to the public to make governmental decisions in the public's best interest."[11] But it is particularly difficult to say that Members of Congress owe a duty to respect the confidentiality of nonpublic information that they acquire in the course of their work. Any Member of Congress is constitutionally entitled by the Speech and Debate Clause of the U.S. Constitution to reveal any information – including material nonpublic information – in Congressional debate. Of course, a distinction can be drawn between revealing information and trading on it, but the core duty applicable to most fiduciaries to protect the secrets entrusted to them does not apply to a Member of Congress.

[11] See, e.g., United States v. Woodward, 459 F.3d 1078, 1086 (11th Cir. 2006). I acknowledge that there is indeed some possibility that U.S. Attorneys could prosecute the misuse of material nonpublic information by Members of Congress under the mail and wire fraud statutes. See Carpenter v. United States, 484 U.S. 19 (1987). But the SEC lacks jurisdiction to enforce, or sue under, these criminal statutes. In addition, Carpenter applies when the employer owns the information in question and the employee in effect embezzles it for the employee's own use. But a Member of Congress is not an employee of the Treasury Department or the Defense Department when he or she trades on information obtained from or through them and thus does not clearly breach a duty owed to them.

2. The Personal Benefit Requirement. A second major barrier to imposing insider trading liability on Members of Congress is Dirk's personal benefit rule. Typically, the Member of Congress will be a tippee, rather than someone who owed a fiduciary duty. To hold the tippee liable, Dirks insisted that there must first be a showing that the tipper breached a duty in disclosing the information to the tippee and received a personal benefit for doing so. Specifically, the Dirks Court said:

> "Thus, the test is whether the tipper personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[12]

Typically, it will be hard to show that the tipper received anything of value in return for disclosing material nonpublic information to a Member of Congress. The tipper may more likely only want to earn the long-term goodwill of the Member of Congress. This personal benefit (which essentially requires a quid pro quo exchange) applies both to Dirks-based cases and to cases brought under the more recent "misappropriation theory."[13]

3. The Need to "Feign Fidelity to the Source." Finally, the most likely scenario in which a civil or criminal action could be brought against a Member of Congress arises under what is known as "misappropriation theory." Here, the defendant is said to have

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[12] 463 U.S. at 662-663.

[13] The SEC has resisted this interpretation that the "personal benefit" rule applies to misappropriation theory cases, but has been unsuccessful in convincing courts that the two theories have different elements. See SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003) (finding that same standards apply under "classical" theory and misappropriation theory because both are derived from same statutory language and same rule). The "personal benefit" requirement can be satisfied by a reputational benefit that translates into future earnings, and thus a tipper who exchanges material information in return for the Member's vote has not only bribed the Member of Congress but possibly engaged in insider trading as well. This is not, however, likely to be the typical case.

breached a duty not to the trading partner in a securities transaction, but to the source of the information (i.e., the person or entity disclosing the information to the Member of Congress). This more recent theory of liability, which the Supreme Court endorsed in United States v. O'Hagan,[14] vastly increased the scope of insider trading liability. But at the same time that the Court announced its acceptance of this theory, it also insisted that to satisfy the requisite element of deception under Section 10(b) of the Securities Exchange Act of 1934, the defendant must be shown to have engaged in "feigning fidelity to the source of the information."[15] This was easy enough on the facts of O'Hagan, where a partner in a law firm representing a bidder in a takeover elaborately contrived to learn the identity of the takeover target. But such feigning may not be present in a case where a Cabinet Secretary calls leading Members of Congress into an emergency meeting and advises them of major developments that will move the market. Absent some act of "feigning fidelity to the source," there may not be the requisite deception to support liability under Rule 10b-5.

Summary. These problems do not mean that it would be impossible for a court to find that Members of Congress owed a fiduciary duty that was breached when a member traded on confidential information. However, only the Supreme Court could definitively so rule, and in the interim I doubt that U.S. Attorneys would feel entitled to indict even in an egregious case, given the uncertain state of the law. Although I suspect that the SEC will disagree with my assessment and maintain that they do have adequate authority, they have long been in denial about the degree to which Dirks undercuts their traditional theory of insider trading. Moreover, the SEC has now lost a string of cases in the D.C.

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[14] 521 U.S. 642 (1997).
[15] Id. at 655.

Circuit Court of Appeals and seems no longer to receive Chevron deference from that Court.[16] My point is not that the SEC deserved to lose these cases, but that their views no longer command the deference that they once received from some courts.

The bottom line is simple: at worst, the proposed legislation is superfluous; at best, it is essential. In my judgment, there is no harm or risk in attempting to clarify a body of law that clearly has serious ambiguities. But Congress should not attempt a comprehensive statute defining all of insider trading law. Congress has attempted that before, only to give up. The moment Congress attempts a comprehensive statute, special interest groups will appear in droves, seeking safe harbors for their members. The result could give rise to even greater uncertainty.

II. An Analysis of the Proposed Legislation

I have reviewed two proposed bills: S.1871 (introduced by Senator Brown) and S.1903 (introduced by Senator Gillibrand and seven other Senators). They are closely similar. My comments relate only to their provisions on insider trading and not to their provisions on lobbying or related matters (where I am not an expert).

Although both bills appear well-intentioned, they are both subject to two major flaws that are likely to nullify their effectiveness. At the outset, let me hypothesize that the most likely (and profitable) form of insider trading by a Member of Congress will be trading based on nonpublic information relating to the budget, taxes, or broad economic legislation or regulation. For example, a Member of Congress might learn in advance of

[16] The most recent example of this lack of deference is Business Roundtable v. SEC, 647 F.3d 1144 (D.C. 2011) (invalidating SEC Rule 14a-11, the "proxy access" rule). See also, Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166, 167-168 (D.C. Cir. 2010). In the area of insider trading, the Government has also lost outside of the D.C. Circuit when it has attempted to stretch the law. See, e.g., United States v. Chestman, 947 F.3d 551 (1991) (en banc); SEC v. Yun, supra note 12.

proposed regulatory action by a major federal agency because that agency has learned (from experience) to advise the principal Congressional committees having oversight over it before it takes major action. Such information could have broad macro-economic effect (for example, a change in interest rates or indications about likely terrorist acts) that will affect much of the market. Clearly, such information is not firm-specific, because it will affect entire sectors of the economy, possibly with greater impact on some industries. The most efficient way to trade on such information would be to buy options – either put or call options – or futures or swaps on an index of securities. In short, if one learns negative news of broad scope, one may wish to bet on a decline in the S&P 500 index.

Against that backdrop, two provisions in both of the proposed bills undercut the intended impact of each bill:

First, Section 2(b) of both statutes instructs the SEC and the CFTC to adopt rules prohibiting any person from buying or selling securities or security-based swaps "while such person is in possession of material nonpublic information <u>relating to any pending or prospective legislation action relating to such issuer</u>." (emphasis added) (Section 2(a) does the same with respect to any commodity for future delivery or swap). This language is seriously underinclusive. It covers only information relating to "pending or prospective legislative action." Yet, Congress does much more than simply legislate. For example, the Senate confirms (or rejects) Presidential appointments and ratifies (or rejects) treaties. More importantly, both Houses of Congress have oversight functions. Thus, the Secretary of the Treasury (or the Federal Reserve Chairman) might tell leading Members of Congress that interest rates are about to go up (or down) significantly, and this information will move the market dramatically. Or, the Secretary of Defense could alert them to an impending war in the Middle-East or military developments or a specific defense contract that is to be awarded. In neither case does this information relate to "pending or prospective legislative developments." In both cases, such information could be traded on profitably (often by trading in futures, swaps, or options on some index).

Thus, the language of both Sections 2(a) and 2(b) needs to be revised and expanded. I suggest the simplest change would be to replace the words "while such person is in possession of material nonpublic information relating to any pending or prospective legislative action relating to such issuer" with the following words:

> "while such person is in possession of material nonpublic information (i) derived from such person's position as a Member of Congress or Federal employee or gained during the performance of such person's duties, or (ii) obtained, directly or indirectly, from a Member of Congress or Federal employee where the recipient of such information knows, or should have known, that the information was so obtained."

This language would cover both (i) trading by a Member of Congress or Federal employee or (ii) trading by a tippee thereof (who knew, or should have known, that the information was so obtained). This language would not cover tipping by either a Member of Congress or Federal employee, but such a prohibition could (and should) be added by an additional section that stated:

> "Not later than _ days after the date of enactment of this Act, the Commission shall, by rule, prohibit any person from communicating any material nonpublic information (other than by means of a statement communicating such information to the public generally), with the intent to enable another person, directly or indirectly, to purchase or sell any [security] [security-based swap] [commodity] based on material, nonpublic information originally communicated to a Member of Congress or Federal employee."

This language would reach not only the Member of Congress or Federal employee who tips material nonpublic information but also intermediate links in the chain (as sometimes the information may be passed through multiple tippees).

The second major problem lurks in the existing language of proposed Section 2(b): both S.1871 and S.1903 only prohibit the purchase or sale of "securities or security-based swaps <u>of</u> <u>any</u> <u>issuer</u>." This overlooks that most options are issued by third parties (i.e., securities dealers). In order to maximize his or her profits, the insider who trades on material nonpublic information will typically buy put or call options from such dealers. It is also important that any statute not define the material nonpublic information so that it must relate to any specific issuer. Macro-economic information about a pending financial crisis, an oil shortage, or the prospect of war or terrorism someplace does not relate to specific issuers, but to the market generally. The above suggested language makes this deletion so that the language would cover options issued by third parties.

III. <u>Safe Harbors And Less Drastic Alternatives</u>

Concern has been expressed by some that a statute extending the insider trading prohibition to Members of Congress would overreach; that is, if poorly drafted, it could prove a trap for the unwary, snaring relatively innocent mistakes by busy Members of Congress. Or it could impose illiquidity on Members of Congress who would not dare to trade.

Nonetheless, Members of Congress can find considerable reassurance in the protections afforded by Rule 10b5-1, adopted by the SEC under the Securities Exchange Act of 1934.[17] This provision immunizes trading pursuant to a "written plan for trading

[17] See 17 CFR § 240.10b5-1.

securities” that empowers another person – a trustee or broker, typically – to trade for him pursuant to detailed instructions. Such a plan does “not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales” (see Rule 10b5-1(a)(1)(i)(3)). However, Rule 10b5-1 plans allow the person creating them to give very detailed instructions as to what should be done under various contingencies; they are thus not the same as “blind trusts.” Such plans are today widely used by senior management of public companies who know that they will from time to time come into possession of material nonpublic information. Thus, a Member of Congress could instruct a broker entrusted with trading discretion over his or her portfolio to sell if stock prices fell below defined levels or if other market tests were triggered.

Still another possibility is that the draft legislation could instruct the SEC to give guidance (possibly through “no action” letters) to Members of Congress who are uncertain as to whether they possessed material nonpublic information and whether, if so, it restricted them from carrying out specific trading plans. Such a no-action letter would immunize the Member from any enforcement action by the SEC, at least if the Member did in fact disclose all material information in his possession to the SEC. The one drawback with this approach is that the SEC could prove to be overly conservative and decline to grant permissions, even in appropriate cases, out of an excess of caution.

In this light, a Member of Congress could also rely on an opinion of counsel, given in advance of the trade by an attorney with experience in securities law and regulation, that the information possessed by the Member was not material or did not apply to specified securities. The Commission has long recognized the “reliance on counsel" defense and would be unlikely to challenge a Member of Congress who had received such an opinion from experienced counsel.

Finally, Members of Congress do have one unique protection that they alone could sometimes utilize. Rule 10b-5 is often said to impose a duty to "disclose or abstain" with respect to securities trading. Many corporate officials may not disclose confidential and possibly material information because it would breach a duty owed by them to their corporation to maintain its confidentiality. But Members of Congress have an absolute and Constitutionally-protected right to disclose information under the Speech and Debate Clause.[18] If a Member of Congress disclosed such information on the floor and then, after a decent interval for the market to absorb it (at most until the next trading day), he could then trade, because the information would no longer be non-public.

I have been asked: what would be the minimum intervention that could satisfactorily resolve the status of Members of Congress, without Congress having to potentially disturb the elaborate judge-made law on insider trading. From such a minimalist perspective, I believe the least drastic intrusion would be a one sentence statute that defined a Member of Congress as a fiduciary for purposes of insider trading liability. Such a statute might simply provide:

> "Members of Congress [and their staffs] shall be deemed fiduciaries with respect to material, nonpublic information that they receive in the course of performing their duties or as a result of their status, regardless of whether they exchange anything of value for such information or engage in any deceptive act, and they may not purchase or sell or otherwise trade in securities, commodities, security-based swaps, or other financial instruments based upon such information, unless such trading is specifically exempted or permitted by rules adopted by either the

[18] U.S. Const., art I, § 6, ch. 1. This protection also applies to Congressional staffers working for a Member of Congress. See Gravel v. United States, 408 U.S. 606, 622 (1972).

> Securities and Exchange Commission or the Commodities Futures Trading Commission."

This language would work to cover all the problems previously noted and does not require Congress to define what "material" or "nonpublic" means, as courts could rely on the existing case law. Indeed, a sentence could be added instructing courts to use the existing case law in interpreting this provision.

Finally, "sunlight is the best disinfectant" (to borrow from Justice Brandeis), and this remedy could also be better structured to increase the sunlight focused on Congressional trading. Section 4 of both bills would require reporting of the purchase or sale of certain securities within 90 days after such event. (It would be highly advisable to include the term "option" in Section 4's list of securities that must be reported). The report would be made to the Clerk of the House of Representatives or the Secretary of the Senate, respectively. This 90 day delay seems unusually long, given that similar reports of purchases and sales must be made under Section 16 of the Securities Exchange Act of 1934 by corporate directors and senior executives within two business days. Although a two business day test seems overly confining, some intermediate period, possibly such as 10 days, would be preferable.

More importantly, because "sunlight is the best disinfectant," such reports should be publicly available on a website so that journalists and others could easily access them. A compromise here may be necessary if the Member has adopted a Rule 10b5-1 trading plan. Obviously, if disclosure is made to the world only days after the trade, the blind trust is no longer blind. The person who created the Rule 10b5-1 trading plan would know what was in his portfolio and might be able to exercise a low visibility influence.

Hence, in the case of a Rule 10b5-1 trading plan, it may be advisable to delay reporting the trade for some longer period (say 30 to 60 days).

Today, the one thing that we know for certain is that trading by Members of Congress is attracting media attention. That probably is as it should be. If a Member of Congress buys 10,000 shares of the common stock of a defense contractor five days before it receives a multi-billion dollar defense contract, the press will be suspicious and even the existence of a Rule 10b5-1 plan will not assuage their skepticism. In the long-run, public disclosure of trades may prove to be the most effective deterrent of suspicious trading behavior.

To sum up: there is little downside in Congress legislating and considerable upside, both to fill the void in the law and to restore public confidence in Congress. But Congress should pursue a narrow, surgically targeted statute and not take on the very complex problem of codifying the entire law of insider trading. That could prove a disaster.