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The Stop Trading on Congressional Knowledge Act

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***Abstract*:** A 2004 study of the results of stock trading by United States Senators during the 1990s found that that senators on average beat the market by 12% a year. In sharp contrast, U.S. households on average underperformed the market by 1.4% a year and even corporate insiders on average beat the market by only about 6% a year during that period. A reasonable inference is that some Senators had access to—and were using—material nonpublic information about the companies in whose stock they trade.

Under current law, it is uncertain whether members of Congress can be held liable for insider trading. The proposed Stop Trading on Congressional Knowledge Act addresses that problem by instructing the Securities and Exchange Commission to adopt rules intended to prohibit such trading.

This article analyzes present law to determine whether members of Congress, Congressional employees, and other federal government employees can be held liable for trading on the basis of material nonpublic information. It argues that there is no public policy rationale for permitting such trading and that doing so creates perverse legislative incentives and opens the door to corruption. The article explains that the Speech and Debate Clause of the U.S. Constitution is no barrier to legislative and regulatory restrictions on Congressional insider trading. Finally, the article critiques the current version of the STOCK Act, proposing several improvements.

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The Stop Trading on Congressional Knowledge Act

Stephen M. Bainbridge*

Over time, nobody beats the market. This basic premise of efficient capital markets theory has been confirmed in numerous academic studies.[1] The only important exception to the rule traditionally has been corporate insiders trading in their own corporation's stock.[2] The obvious and generally accepted explanation for insiders' results is their access to and use of material nonpublic information about the company.[3]

A 2004 study of the results of stock trading by United States Senators during the 1990s, however, found that that senators on average beat the market by 12% a year.[4] In sharp contrast, U.S. households on average underperformed the market by 1.4% a year and even corporate insiders on average beat the market by only about 6% a year during that period.[5] A reasonable inference is that some Senators had access to—and were using—material nonpublic information about the companies in whose stock they trade:

> Looking at the timing of cumulative returns, the senators also appeared to know exactly when to buy or sell their holdings. Senators would buy stocks just before the shares suddenly would outperform the market by more than 25%. Conversely, senators would sell stocks that had been beating the market by about 25% for the past year just when the shares would fall back in line with the market's performance.
>
> The researchers say senators' uncanny ability to know when to buy or sell their shares seems to stem from having access to information that other investors wouldn't have. "I don't think you need much of an imagination to realize that they're in the know," says Alan Ziobrowski, a business professor

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[1] Bob Ryan, Corporation Finance and Valuation 84 (2006) ("The empirical evidence is absolutely solid, fund managers cannot out perform the market ….").

[2] Hasan Nejat Seyhun, Investment Intelligence From Insider Trading 312 (2000).

[3] Id. at 74.

[4] Alan J. Ziobrowski et al., Abnormal Returns from the Common Stock Investments of the U.S. Senate, 39 J. Fin. & Quant. Anal. 661 (2004).

[5] Jane J. Kim, U.S. Senators' Stock Picks Outperform the Pro's, Wall. St. J., Oct. 26, 2004, available at http://tinyurl.com/nrwm6r.

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> at Georgia State University in Atlanta and one of the four authors of the study.[6]

Members of Congress can obtain material nonpublic information in many ways. They can learn inside information when, for example, a company confidentially discloses it during the course of a Congressional hearing or investigation. In most cases, however, members of Congress likely trade on the basis of market information. "'Market information' refers to information that affects the price of a company's securities without affecting the firm's earning power or assets. … Examples include information that an investment adviser will shortly issue a 'buy' recommendation or that a large stockholder is seeking to unload his shares or that a tender offer will soon be made for the company's stock."[7] In the present context, examples of market information readily available to members of Congress include knowing that "tax legislation is apt to pass and which companies might benefit," being aware "that a particular company soon will be awarded a government contract or that a certain drug might get regulatory approval …."[8]

Analysis of the legality of such trading must begin by recognizing that the term "insider trading" is a misnomer in two relevant senses. First, trading on the basis of either inside or market information is a potential breach of the federal securities laws. The mere fact that information may have originated outside the company is irrelevant, so long as the information is material to the company's stock price.[9] Second, the federal securities laws' prohibition of so-called "insider" trading in fact extends to many corporate outsiders.[10] Accordingly, Congressmen,

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[6] Id. The extent of Congressional trading on material nonpublic information is uncertain. "Just over a third of the senators bought or sold individual stocks in any one year in the study, and the vast majority of stock transactions were less than $15,000." Id.

[7] U.S. v. Chiarella, 588 F.2d 1358, 1365 n.8 (2d Cir. 1978), rev'd on other grounds, 445 U.S. 222 (1980).

[8] Kim, supra note 5.

[9] See Chiarella v. U.S., 445 U.S. 222, 240 n.1 (1980) (Burger, C.J., dissenting) ("Academic writing in recent years has distinguished between 'corporate information'—information which comes from within the corporation and reflects on expected earnings or assets—and 'market information.' … It is clear that § 10(b) and Rule 10b-5 by their terms and by their history make no such distinction."); see also Dirks v. S.E.C., 463 U.S. 646, 656 n.15 (1983) (citing Chief Justice Burger's dissent approvingly).

[10] See S.E.C. v. Tome, 638 F. Supp. 596, 616 (S.D.N.Y. 1986) ("The term 'insider trading' actually is a misnomer, only imperfectly describing the proscribed conduct, since liability under the securities laws can extend to those who are not insiders, as that term is commonly understood …").

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their staffers, and other government officials and employees are not exempt from liability for trading on the basis of material nonpublic information simply because they are not corporate insiders.

Under current law, however, although Congressional staffers and other government officials and employees could be prosecuted successfully for insider trading under the federal securities laws, the quirks of the applicable laws almost certainly would prevent members of Congress from being successfully prosecuted.[11] To address that anomaly, Congressmen Louise Slaughter (D-NY) and Brian Baird (D-WA) have introduced The Stop Trading on Congressional Knowledge Act (the "STOCK Act" or "Act").[12] If adopted, the Act "will prohibit Members of Congress and their staff from using nonpublic information they are able to obtain through their official positions to enrich their personal portfolios."[13]

Part I of this Article explains why members of Congress are effectively immune from insider trading liability under the current federal securities laws. Part II sets out the policy justifications for extending those laws to include members of Congress. Part III argues that there is no constitutional barrier to such an extension. Finally, Part IV critiques the STOCK Act's approach to banning Congressional insider trading.

I. Current Law

Although the modern insider trading prohibition technically is grounded in the federal securities statutes and regulations, most notably Rule 10b-5[14] promulgated by the SEC pursuant to the authority granted it by Section 10(b) of the Securities Exchange Act,[15] the prohibition in fact is the product of a series of judicial

[11] Insider trading potentially can give rise to both civil and criminal actions. The SEC is authorized by Section 21A(a)(1) of the Securities Exchange Act to bring a civil action against insider traders in a United States district court, seeking a variety of civil penalties, including disgorgement and fines of up to three times the defendant's profits. 15 U.S.C. § 78u-1(a)(1). Under Section 32 of the Exchange Act, the Department of Justice may bring felony criminal charges against those who willfully violate, inter alia, the rules against insider trading. 15 U.S.C. § 78ff(a). Unless the context requires otherwise, the term "prosecute" will be used herein, for purposes of semantic convenience, to refer to both SEC civil and DOJ criminal proceedings.

[12] H.R. 682, 111th Cong., 1st Sess. (2009).

[13] Press Release, Brian Introduces Legislation to Prohibit Insider Trading on Capitol Hill (Jan. 27, 2009), available at http://tinyurl.com/ne77mw.

[14] 17 CFR § 240.10b-5.

[15] 15 U.S.C. § 78j(b). Other bases of insider trading liability, such as Rule14e-3's restrictions on the use of information about a tender offer, 17 C.F.R. § 240.14e-3, or the

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decisions creating a quasi-common law in the interstices of Rule 10b-5.[16] As the prohibition evolved, two conceptually distinct theories emerged pursuant to which liability for insider trading can be imposed:

> [T]he Supreme Court has recognized two theories of insider trading liability: the "classical theory" and the "misappropriation theory." The classical theory generally only imposes liability when a trader or tipper is an insider of the traded-in corporation. The classical insider-trader thus breaches a fiduciary duty owed to the corporation's shareholders. The misappropriation theory, however, creates liability when a tipper or trader misappropriates confidential information from his source of the information. The misappropriator thus breaches a fiduciary duty owed to the source.[17]

As we shall see below, in the vast majority of cases only the latter theory will be relevant to insider trading by members of Congress and other governmental officials.

A. The Classical Theory

The modern federal insider prohibition began taking form in *S.E.C. v. Texas Gulf Sulphur Co.*[18] The *TGS* opinion rested on a policy of equality of access to information. The court contended that the federal insider trading prohibition was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material information." Put another way, the majority thought Congress intended "that all members of the investing public should be subject to identical market risks." Accordingly, under *TGS* and its progeny, virtually anyone who possessed material nonpublic information was required either to disclose it before trading or abstain from trading in the affected company's securities. If the would-be trader's fiduciary duties precluded him from disclosing the information prior to trading, abstention was the only option.

In *Chiarella v. U.S.*,[19] the United States Supreme Court rejected the equal access policy. Instead, the Court made clear that liability could be imposed only if the defendant was subject to a duty to disclose prior to trading. In turn, the requisite duty to disclose arises out of a fiduciary relationship between the inside

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federal mail and wire fraud statutes, 18 U.S.C. § 1341 and 1343, are outside the scope of this article.

[16] S.E.C. v. Cuban, 2009 WL 2096166 (N.D. Tex. 2009) (noting that insider trading generally is "defined by judicial opinions construing Rule 10b-5").

[17] S.E.C. v. Rocklage, 470 F.3d 1, 5 (1st Cir. 2006).

[18] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[19] 445 U.S. 222 (1980).

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trader and the persons with whom he trades. *Chiarella* thus made clear that the disclose or abstain rule is not triggered merely because the trader possesses material nonpublic information. When a securities fraud action is based upon nondisclosure, there can be no fraud absent a duty to speak, and no such duty arises from the mere possession of nonpublic information.[20] As the court explained in its subsequent decision in *Dirks v. S.E.C.*:[21]

> We were explicit in Chiarella in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "[depart] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[22]

The substantial limitation on the scope of insider trading liability imposed by *Chiarella* posed the question whether anyone other than classical insiders such as directors, officers, and perhaps large shareholders could be held liable for dealing on the basis of insider information. *Dirks* confirmed that the classical theory reached at least two other categories of potential defendants. First, certain outsiders with especially close relationships with the issuing corporation can become constructive insiders:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. … For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.[23]

Second, the *Dirks* court held that the insider trading applies not only when an insider—whether classical or constructive—trades, but also when such an insider

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[20] Id. at 232.

[21] 463 U.S. 646 (1983).

[22] Id. at 254-55.

[23] Id. at 655 n.14.

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tips inside information to an outsider who then trades.[24] The court held that a tippee's liability is derivative of that of the tipper, "arising from [the tippee's] role as a participant after the fact in the insider's breach of a fiduciary duty."[25] A tippee therefore can be held liable only when the tipper breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.[26]

What *Dirks* proscribes thus is not merely a breach of confidentiality by the insider, but rather the breach of a fiduciary duty of loyalty to refrain from profiting on information entrusted to the tipper.[27] Looking at objective criteria, courts must determine whether the insider-tipper personally benefited, directly or indirectly, from his disclosure.[28] The most obvious example of a benefit is the outright sale of information for cash. Non-pecuniary gains by the insider can also qualify, however.[29] Liability could be imposed, for example, on a corporate CEO discloses information to a wealthy investor not for any legitimate corporate purpose, but solely to enhance his own reputation.[30] Likewise, liability could be imposed where the tip is a gift, because that transaction is regarded as analogous

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[24] Id. at 659-60.

[25] Id. at 659 (quoting *Chiarella*, 445 U.S. at 230).

[26] Id. at 660.

[27] See Kevin V. Haynes, Insider Trading Under Rule 10b-5, in Fundamentals of Securities Law, WL SP057 ALI-ABA 411 ("In *Dirks* the Court alludes to the inherent unfairness of insiders' trading on information that was intended to be available only for corporate purposes. This suggests that the insider breaches a fiduciary duty to refrain from self-dealing when he trades on inside information."); see also Keith Valory, Comment, The Misappropriation Theory of Insider Trading: What Constitutes a "Similar Relationship of Trust and Confidence?," 39 Santa Clara L. Rev. 287, 296 (1998) ("It is clear from the Court's rulings on the Classical Theory of insider trading that it is most concerned with curtailing deceptive self-dealing in material, non-public corporate information.").

[28] See *Dirks*, 463 U.S. at 663 (stating that the test of whether a disclosure by an insider amounts to a breach of fiduciary duty focuses on "objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure").

[29] See S.E.C. v. Yun, 327 F.3d 1263, 1275 (11th Cir. 2003) (holding that "the gain does not always have to be pecuniary. A reputational benefit that translates into future earnings, a quid pro quo, or a gift to a trading friend or relative all could suffice to show that the tipper personally benefitted.").

[30] Id.

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to the situation in which the tipper trades on the basis of the information and then gives the tippee the profits.[31]

Cases in which members of Congress or other government officials qualify as classical insiders or constructive insiders present no enforcement difficulties under current law. Nothing in the existing rules precludes their application in such cases. Such cases, however, presumably are quite rare. According to the House Ethics Manual, for example, members of Congress and their senior staff may not, *inter alia*, "serve for compensation as an officer or member of the board of an association, corporation, or other entity."[32] Opportunities to serve as a classical insider thus are unlikely to arise.

In contrast, it seems plausible that Congressmen or other government officials might sometimes receive tips from corporate insiders. Such a tip would be the functional equivalent of a bribe. Nothing in current law would prohibit prosecution of both tipper and tippee in such cases. Instead, it would be treated the same way as gifts of information.

Suppose the insider claimed that he gave the tip not for personal benefit, however, but so that the company would benefit. In effect, the tipper claims, he bribed the Congressman so the Congressman would do a favor for the company. The logic of *Dirks* suggests there could be no insider trading liability in such a case.[33]

B. The Misappropriation Theory

As defined by the Supreme Court in *U.S. v. O'Hagan*,[34] in which the Court endorsed the misappropriation theory as a valid basis for insider trading liability, the misappropriation theory is another misnomer. It does not deal with theft of inside information—or, at least, not directly—but rather holds that a fiduciary's undisclosed use of information belonging to his principal, without disclosure of such use to the principal, for personal gain constitutes fraud in connection with the purchase or sale of a security and thus violates Rule 10b-5.[35]

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[31] Id.

[32] Committee on Standards of Official Conduct, Restrictions on Outside Employment Applicable To Members and Senior Staff, available at http://tinyurl.com/mz3eyv.

[33] Cf. 65 Fed. Reg. 51,716 n.7 (2000) (SEC release acknowledging how selective disclosures to analysts was viewed as protected from insider trader liability because tipper received no personal benefit but rather provided the tip so as to benefit corporation).

[34] 521 U.S. 642 (1997).

[35] Id. at 652.

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The Court acknowledged that misappropriators have no disclosure obligation running to the persons with whom they trade.[36] Instead, it grounded liability under the misappropriation theory on deception of the source of the information; the theory addresses the use of "confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[37] Under this theory, "a fiduciary's undisclosed, self serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[38] So defined, the Court held, the misappropriation theory satisfies § 10(b)'s requirement that there be a "deceptive device or contrivance" used "in connection with" a securities transaction.[39]

Where a member of Congress, a Congressional staffer, or other government information obtains material nonpublic information in the course of their duties and then uses it to trade in the stock of the relevant issuer, their conduct could be colloquially described as a theft of the information, but any potential insider trading liability under the misappropriation theory would require proof of a fiduciary duty between the official and the source of the information. To be sure, two recent cases hold that a fiduciary relationship is not essential to misappropriation liability. In *S.E.C. v. Cuban*,[40] a district court held that a non-fiduciary who had agreed contractually both to keep information confidential and not to use the information for personal gain could be help liable for misappropriation-based insider trading liability. In *S.E.C. v. Dorozhko*,[41] the Second Circuit held that an alleged computer hacker supposedly broke into the computer system of a company called IMS Health, Inc., and used the information he learned in doing so to purchase put options on the company's stock had committed a deceptive act in connection with the purchase or sale of a security. Because the case purportedly involved a material misrepresentation (namely, the hacker's disguising of his identity in breaching the company's computer network), the court opined that showing of a fiduciary duty is unnecessary.

The *Cuban* case seems more important for present purposes. If government ethics rules banning the use of nonpublic information for personal gain are deemed to constitute the requisite agreement, the Cuban case provides a precedent

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[36] Id. at 653.

[37] Id. at 652.

[38] Id.

[39] Id. at 656-57.

[40] Civil Action No. 3:08-CV-2050-D (N.D. Tex. July 17, 2009).

[41] No. 08-0201-cv (2d Cir. July 22, 2009).

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for imposing liability. The *Cuban* decision, however, is inconsistent with the well-accepted proposition that a fiduciary relationship is required.[42]

Assuming that the misappropriation theory in fact requires a breach of a duty of disclosure arising out of a fiduciary relationship or similar relationship of trust and confidence, an important distinction arises between members of Congress and other government officials. The Standards of Ethical Conduct For Employees of the Executive Branch provide that: "Public service is a public trust, requiring employees to place loyalty to the Constitution, the laws and ethical principles above private gain."[43] Accordingly, an employee of the Executive Branch should be deemed an agent of the government or, at least, to stand in a similar relationship of trust and confidence with the government.[44] The Standards further provide that: "An employee shall not engage in a financial transaction using nonpublic information, nor allow the improper use of nonpublic information to further his own private interest or that of another, whether through advice or recommendation, or by knowing unauthorized disclosure."[45]

Turning to Congress, both members of a Congressman's staff and Committee staffers are employees of their respective houses.[46] They are subject to an ethical obligation never to "use any information received confidentially in the performance of governmental duties as a means for making private profit."[47]

These employment relationships should suffice for Congressional staffers to be deemed to have an agency or other relationship of trust and confidence with their employing agency. In *S.E.C. v. Cherif,*[48] for example, the court held that "a

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[42] See, e.g., Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007) (holding that "the [Supreme] Court . . . has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure").

[43] 5 C.F.R. § 2635.101.

[44] Joseph Kalo, Deterring Misuse of Confidential Government Information: A Proposed Citizens' Action, 72 Mich. L. Rev. 1577, 1581 (1974) ("The application of fiduciary duties to activities of government employees is not novel.").

[45] 5 C.F.R. § 2634.703(a). Nonpublic information is defined for this purpose as "information that the employee gains by reason of Federal employment and that he knows or reasonably should know has not been made available to the general public." Id., § 2634.703(b).

[46] Email from Mary Baumann, U.S. Senate Historical Office, to Jenny Lentz, UCLA School of Law Library, Friday, July 31, 2009 (copy on file with author).

[47] House Ethics Manual 249 (2008).

[48] 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).

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person violates Rule 10b-5 and Section 10(b) by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment."[49] Put into *O'Hagan*'s terminology, "a [staffer's] undisclosed, self serving use of [Congressional] information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the [Congress]."[50]

Of whom are members of Congress agents or fiduciaries, however? With whom do they have the requisite relationship of trust and confidence out of which the requisite duty to disclose before trading arises? The only logical candidate is the electorate. Although there is some precedent in other contexts for the proposition that "a public official … owe[s] a fiduciary duty to the public to make governmental decisions in the public's best interest,"[51] the predominant view, as stated by former SEC enforcement official Thomas Newkirk, is that "[i]f 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."[52] To be sure, if the *Cuban* decision discussed above[53] becomes widely accepted, and the Congressional ethics manuals' prohibition of insider trading by members is deemed to provide the requisite agreement, liability might be imposed on members who violate that obligation.[54] As we have seen, however, that decision remains highly controversial.[55]

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[49] Id. at 410. See also SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990) ("[A]n employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10b-5.").

[50] U.S. v. O'Hagan, 521 U.S. 642, 652 (1997). See generally Andrew George, Public (Self)-Service: Illegal Trading on Confidential Congressional Information, 2 Harv. L. & Poly' Rev. 161, 165-66 (2008) (concluding that staffers can be held liable either for trading on or tipping of material nonpublic information learned on the job).

[51] United States v. Woodard, 459 F.3d 1078, 1086 (11th Cir. 2006).

[52] Brody Mullins, Bill Seeks to Ban Insider Trading by Lawmakers and Their Aides, Wall St. J., Mar. 28, 2006, at A1.

[53] See supra text accompanying notes 40-42.

[54] See George, supra note 50, at 166-68 (arguing that the House and Senate ethics manuals constitute the requisite agreement).

[55] See supra text accompanying note 42.

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An apt precedent for treating stock trading by Congressional staffers and members of Congress differently is provided by *U.S. v. Carpenter*.[56] R. Foster Winans wrote the widely read "Heard on the Street" column for the Wall Street Journal, which provides investing information and advice. Because that column apparently had a short lived effect on the price of the stocks it covered, someone who knew the column's contents in advance could profit by trading in the affected stocks. Although Wall Street Journal policy stated that prior to their publication the contents of columns were the Journal's confidential property, Winans, before publication, disclosed the contents of his columns to several friends who then traded in the affected stocks. Winans and his friends were convicted of mail and wire fraud and insider trading under Rule 10b-5 pursuant to the misappropriation theory.[57]

In *Carpenter*, the Second Circuit held that Winans and his fellow conspirators committed illegal insider trading by "secreting, stealing, purloining or otherwise misappropriating material non-public information in breach of an employer-imposed fiduciary duty of confidentiality," on the basis of which they then traded in the stock of issuers mentioned in Winans' columns.[58] In dicta, the court indicated that the Wall Street Journal could have traded on the basis of the information in question:

> Appellants argue that it is anomalous to hold an employee liable for acts that his employer could lawfully commit. Admittedly, … the Wall Street Journal or its parent, Dow Jones Company, might perhaps lawfully disregard its own confidentiality policy by trading in the stock of companies to be discussed in forthcoming articles. … Although the employer may perhaps lawfully destroy

[56] 791 F.2d 1024 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987).

[57] The Supreme Court affirmed on all counts, but the securities fraud convictions were affirmed only by an evenly divided Court (4-4). 484 U.S. 19 (1987). By long standing tradition, a decision by an evenly divided court affirms the lower court result but has no precedential or stare decisis effect, which left the legitimacy of the misappropriation theory uncertain until the O'Hagan decision validated it.

The federal mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, respectively prohibit the use of the mails and "wire, radio, or television communication" for the purpose of executing any "scheme or artifice to defraud." The mail and wire fraud statutes protect only property rights, McNally v. U.S., 483, U.S. 350 (1987), but confidential business information is deemed to be property for purposes of those statutes. Carpenter v. U.S., 484 U.S. 19, 25 (1987). Hence, the Supreme Court held, the Wall Street Journal owned the information used by Winans and his co-conspirators and, moreover, that their use of the mails and wire communications to trade on the basis of that information constituted the requisite scheme to defraud.

[58] *Carpenter*, 791 F.2d at 1032.

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> its own reputation, its employees should be and are barred from destroying their employer's reputation by misappropriating their employer's informational property. … Here, appellants, constrained by the employer's confidentiality policy, could not lawfully trade by fraudulently violating that policy, even if the Journal, the employer imposing the policy, might not be said to defraud itself should it make its own trades.[59]

Nothing in *O'Hagan* is inconsistent with the distinction drawn in *Carpenter*. The misappropriation theory bans undisclosed trading by an agent or other fiduciary in breach of a duty of loyalty to the principal; it does not ban trading by the principal in the same information, even if the agent in question developed the information for the principal. As an employer, a member of Congress is free to trade; as an employee, the staffer is not.

II. Policy

Over 40 years ago, Henry Manne observed that "the federal government is the largest producer of information capable of having a substantial effect on stock-market prices."[60] To the extent the government does not itself generate such information, vast amounts of information must be disclosed to the federal government before it becomes public.[61] Congressman are especially well-positioned to receive nonpublic information, Manne argued.[62] In addition to their direct interactions with nongovernmental information sources, they are also "focal points for receiving information produced or learned in all the various executive departments and agencies" that report to them.[63]

The argument for prohibiting insider trading by members of Congress and other government employees is straightforward: "the ability of elected officials to profit on the basis of material nonpublic information creates perverse incentives for these officials, and introduces innumerable distortions and the potential for immeasurable harm in a legal system in which public trust and confidence is critical."[64] As Larry Ribstein observes:

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[59] Id. at 1033-34.

[60] Henry G. Manne, Insider Trading and the Stock Market 171 (1966)

[61] Id. at 172.

[62] Id. at 179.

[63] Id.

[64] Jonathan R. Macey and Maureen O'Hara, Regulation and Scholarship: Constant Companions or Occasional Bedfellows?, 26 Yale J. on Reg. 89, 108 (2009).

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> Congress's insider trading is bad because it gives our lawmakers the wrong incentives. Do we really want to give Congress more reasons to hurt and help particular firms?
>
> In fact, Congress's trading is worse than trading by corporate insiders, which at least might be rationalized as a way to let employees cash in on their productive efforts. It's far worse than the usual trading on non-public information by outsiders without any breach of duty, which may encourage socially productive investigation and monitoring ....[65]

Congressional insider trading thus is undesirable, in the first instance, because it creates incentives for members and staffers to steal proprietary information for personal gain. The massive increase in federal involvement in financial markets and corporate governance as a result of the financial crisis of 2008 has made opportunities to steal such information even more widely available to government officials. Second, it gives members and staffers incentives to game the legislative process so as to maximize personal trading profits. Indeed, some members of Congress are so prominent that their pronouncements could move the market, allowing them to profit even further from trading on undisclosed information. Third, inside information can be utilized as a pay-off device."[66] Fourth, it gives members and staffers incentives to help or hurt firms, which distorts market competition.

In sum, the point hardly requires belaboring. There is no plausible justification for allowing members of Congress or other governmental actors to use material nonpublic information they learn as a result of their position for personal stock trading gains. To the contrary, the policy arguments all come down on the side of banning such trading.

III. A Constitutional Barrier?

The only plausible barrier to regulating insider trading by members of Congress is the Speech and Debate Clause of the U.S. Constitution, which provides that "for any Speech or Debate in either House, [the Senators and Representatives] shall not be questioned in any other Place."[67] This provision was intended by the Founders to ensure that "legislators are free to represent the

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[65] Larry E. Ribstein, Congress' Insider Trading, Ideoblog, Mar. 29. 2006.

[66] Manne, supra note 60, at 184.

[67] U.S. Const., art. I, § 6, cl. 1. Note that the Clause applies solely to members of Congress and their employees. Other government officials can be regulated without regard to it. See Gravel v. U. S., 408 U.S. 606, 622 (1972) (refusing "to distinguish between Senator and aide in applying the Speech or Debate Clause").

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interests of their constituents without fear that they will be later called to task in the courts for that representation."[68] Accordingly, "legislators engaged 'in the sphere of legitimate legislative activity,' should be protected not only from the consequences of litigation's results but also from the burden of defending themselves."[69]

Although the Speech and Debate Clause confers absolute immunity on members of Congress and their staffers, it does so only within the limited sphere of legislative action. The Supreme Court has thus explained that:

> Legislative acts are not all-encompassing. The heart of the Clause is speech or debate in either House. Insofar as the Clause is construed to reach other matters, they must be an integral part of the deliberative and communicative processes by which Members participate in committee and House proceedings with respect to the consideration and passage or rejection of proposed legislation or with respect to other matters which the Constitution places within the jurisdiction of either House. As the Court of Appeals put it, the courts have extended the privilege to matters beyond pure speech or debate in either House, but "only when necessary to prevent indirect impairment of such deliberations."[70]

How would banning members of Congress or their staffers from using material nonpublic information learned on the job for personal trading profit impair Congressional deliberations? Obviously, it would not. To the contrary, by removing the perverse incentives such trading opportunities create, the legislative process would be enhanced. The Speech and Debate Clause therefore should not bar regulation of Congressional insider trading.

IV. The Stop Trading on Congressional Knowledge Act

Congressmen Brian and Slaughter introduced versions of the STOCK Act in the 109th,[71] 110th,[72] and now the 111[1th] Congresses.[73] According to Congressman Brian, the current version of the Act would:

- Prohibit Members or employees of Congress from buying or selling stocks, bonds, or commodities futures based on nonpublic information they obtain because of their status;

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[68] Powell v. McCormack, 395 U.S. 486, 503 (1969).

[69] Dombrowski v. Eastland, 387 U.S. 82, 85 (1967) (citation mitted).

[70] Gravel v. U.S., 408 U.S. 606, 625 (1972) (citations omitted).

[71] H.R. 5015, 109th Cong., 2d Sess. (2006)

[72] H.R. 2341, 110th Cong., 1st Sess. (2007).

[73] H.R. 682, 111th Cong., 1st Sess. (2009).

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- Prohibit Executive Branch employees from buying or selling stocks, bonds or commodities futures based on nonpublic information they obtain because of their status;
- Prohibit those outside Congress from buying or selling stocks, bonds, or commodities futures based on nonpublic information obtained from within Congress or the Executive Branch;
- Prohibit Members and employees from disclosing any non-public information about any pending or prospective legislative action obtained from a member or employee of Congress for investment purposes;
- Require Members of Congress and employees to report the purchase, sale or exchange of any stock, bond, or commodities future transaction in excess of $1,000 within 90 days. Members and employees who choose to place their stock in holdings in blind trusts or mutual funds would be exempt from the reporting requirement ….[74]

A. The Prohibition on Trading and Tipping

The STOCK Act is not self-executing. To the contrary, it mostly dumps the problem into the SEC's lap by directing the Commission to undertake a number of rulemaking proceedings.

For present purposes the key operative provision is Section 2(a), in which the SEC is directed to adopt a rule prohibiting:

> [A]ny person from buying or selling the securities of any issuer while such person is in possession of material nonpublic information, as defined by the Commission, relating to any pending or prospective legislative action relating to such issuer if—
>
> (1) such information was obtained by reason of such person being a Member or employee of Congress; or
>
> (2) such information was obtained from a Member or employee of Congress, and such person knows that the information was so obtained.[75]

A rule comporting with this provision would ban members of Congress and Congressional staffers from trading on the basis of material nonpublic information obtained by virtue of their position. It also would ban the tippee of a member or staffer from trading so long as the tippee knew the information was obtained from a member or staffer. The provision thus solves the doctrinal problems associated

[74] Press Release, supra note 13.

[75] H.R. 682, 111th Cong., 1st Sess. § 2(a) (2009).

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with prosecuting members of Congress who commit insider trading. Other provisions of the Act do likewise with respect to federal government employees generally.

Note, however, that there is a key limitation on the scope of the prohibition authorized by the Act; namely, the information must relate to a "pending or prospective legislative action," which action in turn must relate to the issuer of the securities traded. As to the former aspect, how broadly will "legislative action" be interpreted? As to the latter, information about one issuer may often allow one to profit by trading in the securities of another company.

Consider the following cases:

- After Congress defeats proposed legislation that would have sharply increased Acme's costs of doing business, Acme's CEO gives a key Congressman a hot tip on Acme stock as a pay off. There was a legislative action, but it was in the past and, accordingly, is neither pending nor prospective.
- A member of Congress learned from a Cabinet member that a government agency was about to enter a large procurement contract. There is no "pending or prospective" legislative action, but there is valuable material nonpublic information on which the member could trade.
- The CEO of Acme is an avid hunter. Congress is considering legislative action that would ban hunting of the CEO's favorite game animal. The CEO of Acme gives a key Congressman a hot tip on Acme stock as a bribe to oppose the hunting law. This is perhaps the most egregious form of Congressional insider trading, yet it would not seem to relate to "such issuer" and thus would not be prohibited.
- During a confidential committee investigation, a member of Congress learns that Acme is about to announce a major new discovery. The member infers that Ajax—Acme's major competitor—will take a serious hit. The member shorts Ajax stock. Technically, the member has not traded in the stock of "such issuer."

Three other problems with the present statutory language deserve mention. First, the Act applies only to "the securities of any issuer." The rulemaking authorized by the Act thus could not proscribe trading in third-party derivatives, such as options. Second, while the Act authorizes a ban on tippee trading, it does not expressly authorize a regulatory ban on tipping by members or staffers.[76]

[76] The Act does amend the Congressional ethics rules to ban tipping with respect to pending or prospective legislative action. H.R. 682, 111th Cong., 1st Sess. § 3 (2009).

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There is no reason members and staffers should be allowed to tip with impunity. Finally, Rule 14e-3 prohibits tippees from trading on the basis of material nonpublic information about a tender offer not only if the tippee knows the information came from one of the specified sources, but also if the tippee "has reason to know" that it came from a proscribed source. The STOCK Act should do likewise with respect to information obtained from a member or staffer.

Congress could solve these problems by broadening the grant of rulemaking authority given the SEC by the Act even further, so as to allow the SEC to address harms related to those to which the Act is addressed. We have known about the need to address Congressional insider trading at least since Manne's 1966 book, however, and the SEC has been "happily complicit with" the failure to address it.[77] Accordingly, it seems safe to assume that the SEC will be loath to bite the hand that feeds it budget by taking an aggressive stance in the Act's mandated rulemaking proceedings. Where there are known gaps, such as those identified here, Congress therefore should fill them expressly.

B. Reporting Provision

The STOCK Act would require that a member of Congress disclose to the Clerk of the House or Secretary of the Senate, as the case may be, transactions of $1,000 or more in "any stocks, bonds, commodities futures, or other forms of securities that are otherwise required to be reported under" the Ethics in Government Act.[78] A member has up to 90 days after the transaction is effected to disclose it.[79] This compares quite unfavorably with the two days corporate insiders have to report transactions covered by Section 16 of the Securities and Exchange Act.[80] A shorter disclosure window is in order.

V. Conclusion

Insider trading by corporate insiders has been banned for over 4 decades.[81] Throughout that period, we have known that insider trading by members of Congress was a potential problem that arguably presented even more serious

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[77] Macey & O'Hara, supra note 64, at 109.

[78] H.R. 682, 111th Cong., 1st Sess. § 4 (2009).

[79] Id.

[80] See 15 U.S.C. § 78p(a) (setting out disclosure rules for specified corporate insiders).

[81] The modern federal insider trading prohibition is generally regarded to have originated with SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

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policy concerns than trading by classic insiders. Congressional insider trading creates perverse legislative incentives and opens the door to serious corruption. Yet, both Congress and the SEC have turned a blind eye.

The STOCK Act would fix the doctrinal obstacles to prosecuting members of Congress who commit insider trading. If passed, it also might finally give the SEC political cover to actually bring such cases. Although the present Act still needs work, it is long over due.

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