The STOCK Act - Dispelling a Legal Perception

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“Few practices, short of manipulation, have as deleterious an effect on the investing public’s confidence in corporate institutions and the securities markets as the selective disclosure of and misuse of so-called inside information, i.e., material nonpublic information.”¹

Insider trading harms investor confidence in the markets which makes it more difficult for firms to raise capital and decreases liquidity.² Further, insider trading harms the issuing corporation as it creates an incentive for management to direct the company to maximize their personal monetary gain rather than the corporation’s.³ Finally, insider trading hurts a non-issuer employer, such as a law firm or financial planner, as the insider trading employee harms the reputation of the employer.

Congress is well aware of the harmful effects of insider trading. The House Committee on Energy and Commerce stated, “[i]nsider trading damages the legitimacy of the capital market and diminishes the public’s faith... [The] small investor will be… reluctant to invest in the market if he feels it is rigged against him.”⁴ Yet, Securities Exchange Commission (“SEC”) enforcement official Thomas Newkirk stated, “[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

³ William Wang, Mark Steinberg; Insider Trading, pg.29-31 (2010)
to anybody." This widely held legal perception, as espoused by Mr. Newkirk, allowed Congress to take a public stand against insider trading while they reaped substantial profits from trading on material non-public information. Congress had to enact a law which essentially says that they are subject to the same laws as their constituents, a systemic failure.

This article discusses traditional federal securities laws as well as the newly enacted Stop Trading on Congressional Knowledge Act ("STOCK Act" or "Act") and their effect on members of Congress. Prior to the enactment of the STOCK Act many presumed that insider trading laws did not apply to members of Congress. This Article will first discuss how members of Congress capitalize on their access to material non-public information. Next, it will consider whether traditional theories of insider trading, pre STOCK Act securities laws, would apply to members of Congress. The third section discusses whether the STOCK Act is sufficient to curb Congressional insider trading, and further discusses potential shortcomings of the Act. Finally, this article will offer several alternatives to the STOCK Act which could be more effective at limiting Congressional insider trading.

I. Introduction: Cashing In on Congressional Knowledge

President Obama signed the STOCK Act into law April 4, 2012, in part to prohibit members of Congress from trading on material non-public information. Previously, Congress operated under a fog of uncertainty as to whether federal securities laws applied to them. This fog has burned off.

Congressman Brian Baird and Congresswoman Louise Slaughter introduced the original version of the STOCK Act on March 28, 2006, but it quickly died in Committee. Baird and

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6 Public Law 112-105
7 H.R. 5015 (109th)
Slaughter re-introduced this legislation in 2007\textsuperscript{8} and in 2009,\textsuperscript{9} but both bills failed to make it out of committee. The purpose of the STOCK Act is “[t]o prohibit Members of Congress and employees of Congress from using nonpublic information derived from their official positions for personal benefit...”\textsuperscript{10} Congress has a substantial conflict of interest in limiting their own ability to trade on non-public information due to their success in trading securities. United States Senators outperformed the market by 12.3\% between 1993-1998.\textsuperscript{11} During roughly that same period 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.\textsuperscript{12} Thus either Congress is consistently outperforming the market and even corporate insiders based on their talent and skill, or there is a significant information imbalance.\textsuperscript{13}

Congressman Spencer Bachus provides a quintessential example of the evils of Congressional insider trading. On September 18, 2008, with a financial crisis on the horizon, Alabama Republican Spencer Bachus received a closed-door briefing from then Treasury Secretary Hank Paulson and then Federal Reserve Chairman Ben Bernanke.\textsuperscript{14} Congressman Bachus received sensitive information regarding the perilous state of the financial industry, and, specifically that Lehman Brothers was on the verge of collapse.\textsuperscript{15} The very next day the Congressman placed heavily leveraged short trades on financial companies including General

\begin{footnotes}
\item[8] H.R.2341 (110\textsuperscript{th})
\item[9] H.R.682 (111\textsuperscript{th})
\item[10] Public Law 112-105
\item[12] Stephen M. Bainbridge, Insider trading Inside the Beltway page 1
\item[15] Id.
\end{footnotes}
Electric, essentially betting on a financial meltdown. Congressman Bachus profited tremendously on the downfall of our economy because he was armed with privileged information. While Bachus is currently under investigation for this trade, he is now the chairman of the House Financial Services Committee. The Congressman has since been promoted.

The appeal of trading on non-public information spans across the aisle. On January 3, 2009, Democrat Dianne Feinstein, a California Senator, introduced legislation to grant 25 billion dollars to the FDIC. Senator Feinstein first offered the FDIC this money October 30, 2008, days before the FDIC awarded a highly competitive and equally lucrative contract to CBRE. Senator Feinstein’s husband, Richard Blum, was the chairman of the board of CBRE. Around this same time, Blum’s private investment firm purchased more than 10 million new shares in CBRE.

Senator Feinstein is one of the wealthiest members of Congress, mainly from her husband’s holdings. Together they are worth over $52.3 million according to her 2007 personal financial disclosure forms. This high ranking Senator and her security trading husband formed a lucrative power couple under the pre-STOCK Act legal perception. In 2007 Senator Feinstein stepped down from the Senate Military Construction Appropriations Subcommittee after accusations surfaced that she was funneling government contracts to corporations that her

16 Id.
17 http://www.washingtonpost.com/politics/rep-bachus-faces-insider-trading-
20 Id.
21 Id.
22 Id.
23 Id.
24 Id.
husband owned.\textsuperscript{25} Despite these substantial conflicts of interest, Senator Feinstein remains a Senator and her husband was never investigated for insider trading related to CBRE.

Congress was content with the status quo. Few members were proactive in changing the legal perceptions that enabled them to achieve significant profits. Congress was not going to act on its own; something had to change the political climate with respect to Congressional insider trading. Enter Steve Kroft, of CBS’s 60 Minutes. Steve Kroft shed light on Congressional insider trading on national television,\textsuperscript{26} surmising, as many others did, that members of Congress are not liable under insider trading laws.\textsuperscript{27} Soon after, President Obama in his 2012 State of the Union Address, said, “send me a bill that bans insider trading in Congress and I will sign it tomorrow.”\textsuperscript{28} Congressional insider trading was front and center in the national news cycle at a time when only 10% of Americans approved of the job Congress was doing, an all-time low.\textsuperscript{29} Thus there was a perfect storm for sweeping reform on Congressional insider trading.

The most recent version of the STOCK Act was introduced January 26, 2012, and passed through both houses by March 22, 2012.\textsuperscript{30} Congressmen were tripping over one another to come out publicly in support of this legislation, which is conceptually the same bill that was originally introduced 6 years prior. This is evident in that Representative Bachus, the often-cited shining example of Congressional corruption, became the Republican sponsor for the Bill.\textsuperscript{31} The Bill passed 93-2 in the Senate and 417-2 in the House.\textsuperscript{32} This unheard of bi-partisan support to get legislation through both houses in less than three months in an era of political entrenchment is

\textsuperscript{25} http://www.metroactive.com/metro/01.24.07/dianne-feinstein-0704.html
\textsuperscript{26} http://www.cbsnews.com/video/watch/?id=7388130n
\textsuperscript{27} Id.
\textsuperscript{28} http://www.whitehouse.gov/state-of-the-union-2012
\textsuperscript{29} http://www.gallup.com/poll/152528/congress-job-approval-new-low.aspx
\textsuperscript{30} Public Law 112-105
\textsuperscript{31} http://www.cnbc.com/id/45612773/Why_Is_Eric_Cantor_Blocking_the_Congressional_Insider_Trading_Act
\textsuperscript{32} http://www.govtrack.us/congress/bills/112/s2038
further evidence of the significant change of the political climate surrounding this piece of legislation. This was a chance for Congress to show their constituents that they are literally not above the law, any more at least.

The portion of the STOCK Act which is immediately relevant to this paper is Sec. 4. The pertinent portion of §4 is as follows.

SEC. 4. PROHIBITION OF INSIDER TRADING:
(a) Affirmation of Nonexemption. Members of Congress and employees of Congress are not exempt from the insider trading prohibitions arising under the securities laws, including section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.
(b) Duty.-
   (1) Purpose. The purpose of the amendment made by this subsection is to affirm a duty arising from a relationship of trust and confidence owed by each Member of Congress and each employee of Congress.
   (2) Amendment. Section 21A of the Securities Exchange Act of 1934 (15 U.S.C. 78u-1) is amended by adding at the end the following:

II. Dispelling the Perception: Applying pre-STOCK Act Insider Trading Laws to Members of Congress.

Rule 10b-5\textsuperscript{34} was promulgated pursuant to a Congressional grant of authority to the SEC in Section 10(b) of the Exchange Act.\textsuperscript{35} The core of Rule 10b-5 is the implementation of the

\begin{footnotesize}
\textsuperscript{33} Public Law 112-105
\textsuperscript{34} Rule 10b-5 -- Employment of Manipulative and Deceptive Devices
\end{footnotesize}

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,
\begin{itemize}
\item To employ any device, scheme, or artifice to defraud,
fundamental purpose that all investors should have equal access to the rewards of participation in security transactions.\textsuperscript{36} It was the intent of Congress that all members of the investing public should be subject to identical market risks.\textsuperscript{37} Courts use rule 10b-5 as a means to attach liability to those that trade on material nonpublic information.\textsuperscript{38}

However, the language of the rule does not entail the full scope of a 10b-5 claim, many of the elements of 10b-5 were judicially created, such as scienter,\textsuperscript{39} the requirement that the claimant be a purchaser or seller,\textsuperscript{40} and that there must be a breach of a fiduciary duty.\textsuperscript{41} One of the main discussions of this paper focuses on the fiduciary duty element, which is now a widely accepted requirement of an insider trading violation.\textsuperscript{42} For the SEC to sanction a member of Congress for insider trading they will have to show that the Congressman traded on material non-public information in breach of a fiduciary duty.

Whether Congress is subject to the pre STOCK Act federal securities laws is unclear because the SEC has never alleged insider trading against a Congressman. There is substantial dispute as to whether the SEC could successfully bring insider trading charges against a

\begin{itemize}
  \item 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
  \item 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.
\end{itemize}

\textsuperscript{36} \textit{Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 847-48 (2d Cir. 1968)
\textsuperscript{37} Id. at 851
\textsuperscript{38} Id. at 852
\textsuperscript{39} \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185 (1976)
\textsuperscript{40} \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723 (1975)
\textsuperscript{42} Id.
Congressman without the STOCK Act, mostly due to a lack of a traditional fiduciary duty.\textsuperscript{43}

There are two theories of insider trading, the classical theory and the misappropriation doctrine.

a. Classical Theory

The Classical theory, also referred to as the special relationship theory or the traditional theory, imposes liability when a corporate insider trades in his corporation's securities on the basis of material, confidential information obtained by reason of his position.\textsuperscript{44} This theory of liability requires an issuer, a corporate insider who is directly or indirectly employed by the issuer, and an innocent third party who trades with the insider.\textsuperscript{45} Pursuant to this “classical theory,” persons who owe duties of trust and confidence to an issuer’s shareholders must either disclose all material nonpublic information in their possession or abstain from trading in the issuer’s shares.\textsuperscript{46} The relevant breach of fiduciary duty is to the other side in the transaction, the innocent third party.\textsuperscript{47}

The Supreme Court expanded the scope of liability under the classical special relationship doctrine to those deemed constructive insiders. Thus the classical special relationship theory is not limited to traditional corporate executives or board members. In SEC v. Dirks, the Supreme Court described constructive insiders as follows:

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

\textsuperscript{43} Stephen M. Bainbridge, \textit{Insider trading Inside the Beltway} page 18
\textsuperscript{44} \textit{United States v. O'Hagan}, 521 U.S. 642, 643, (1997)
\textsuperscript{45} \textit{Id.}, at
\textsuperscript{47} William Wang, Mark Steinberg; \textit{Insider Trading}, pg.424 (2010)
relationship at least must imply such a duty. 48

Finally, tippers and tippees can also be liable under the classical theory. A tipper, an insider who provides material non-public information to a non-insider, breaches a fiduciary duty by receiving a personal benefit from the disclosure. 49 Personal benefit can be shown though 1) pecuniary gain, 2) an enhancement of reputation that will translate into future earnings, 3) an expectation of reciprocal tips or other items of value, and 4) even a good feeling when gifting confidential information to a friend or relative. 50

The tippee could be liable if he knew or should have known of the tipper’s breach. Absent an initial breach by the tipper, there is no derivative liability for the tippee. 51 Someone who is neither an insider of the issuer, a constructive insider, nor a tippee of an insider, will escape liability under the special relationship theory. 52

i. Application of the special relationship doctrine to Congress.

It is unlikely that a member of Congress would ever be prosecuted under the classical special relationship doctrine as either a direct insider or a temporary insider. Members of Congress are restricted from serving for compensation as an officer or member of the board of a corporation or other entity. 53 Thus they cannot be classic insiders of a corporation.

It is also unlikely that members of Congress would be considered temporary insiders under footnote 14 from the Dirks opinion. 54 A Congressman would have to be in a special confidential relationship with the issuer, and the information would have to come into the

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49 Id. at 667
50 William Wang, Mark Steinberg; Insider Trading, pg. 390 (2010)
52 Id. at 661
53 COMMITTEE ON STANDARDS OF OFFICIAL CONDUCT, RESTRICTIONS ON OUTSIDE EMPLOYMENT APPLICABLE TO MEMBERS AND SENIOR STAFF
Congressman’s possession in the furtherance of a business objective. The House Ethics Manual specifically states that “no public official should take on a private obligation that conflicts with the individual’s primary duty to serve the public interest.”

However, if a situation did arise where a Congressman traded on confidential information intended to serve the interest of the business while he was a temporary insider then the Congressman would be liable under 10b-5. There is no explicit Congressional exception from insider trading liability.

Finally, it is possible for a Congressman to become a tippee and assume liability. If a corporate insider provides a Congressman inside information, in breach of a duty owed to their shareholders, and receives a personal benefit from the Congressman, then the Congressman could be liable if he knew or should have known of the insider’s breach. Much of the focus on the inability of members of Congress to face liability under traditional securities laws is the lack of a fiduciary duty. However, as a tippee, the Congressman would assume the insider’s fiduciary duty to the shareholders of the insider’s corporation. A congressman would be liable as a tippee under the following hypothetical scenario.

Jefferey Snelling, CEO of Henron, divulges material non-public information to Texas Senator Conryn while the two friends are playing a round of golf.

Here, both parties could be liable under the classical tipper/tippee theory. The insider Snelling breached a duty to the shareholders of Henron by divulging the corporation’s information to an outsider, and as long Snelling received a personal benefit and the Senator knew or should know of this breach, then the Senator would also be liable. The benefit running to Snelling requires a low standard; simply a good feeling for giving information to a friend.

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55 House Ethics Manual, 2009
56 Id.
57 Stephen M. Bainbridge, Insider trading Inside the Beltway page 19
It is also likely that a Senator knows that a corporate insider should not divulge inside information to non-insiders, or at least he should know. This situation is highly probable given the power US Senators wield, and the substantial success they have had in the financial markets.

It is unknown whether a member of Congress ever became a temporary insider or a liable tippee because the SEC has not been willing to investigate Congressional trades. With the significant returns made by Congress in the securities markets it is rational to assume that they received substantial non-public information. It is further rational to assume that at some point a corporate insider tipped a member of Congress in violation of traditional securities laws. The SEC failed in their regulatory capacity by allowing members of Congress to operate under a legal perception that federal securities laws did not apply to them. At a minimum this perception should have been tested.

b. Misappropriation Doctrine

There is another source of liability for insider trading known as the misappropriation theory. The Supreme Court endorsed the misappropriation theory in US v. O’Hagan, recognizing that liability could stem from trades made in breach of a duty to the information source.\(^\text{60}\) One misappropriates material nonpublic information by breaching a duty arising out of a relationship of trust and confidence and uses that information in a securities transaction, regardless of whether there is a duty to the shareholders of the stock traded.\(^\text{61}\)

In O’Hagen, an attorney traded on information regarding his client’s possible tender offer for Pillsbury Corp.\(^\text{62}\) The Supreme Court found this to be a violation of 10b-5 under the

\(^{59}\) William Wang, Mark Steinberg; Insider Trading, pg.390 (2010)
\(^{61}\) SEC v. Clark 915 F.2d 439, 443 (9th Cir. 1990)
misappropriation doctrine. O’Hagen misappropriated material non-public information from two information sources, his direct employer, the law firm, and his law firm’s client. O’Hagen met the deceptive device or contrivance element because he did not disclose his intention to use the information. Under the classical theory, fraud is perpetrated on the third party who trades with the insider, whereas under the misappropriation theory the fraud is perpetrated on the information source.

It is well settled that traditional fiduciary duties will suffice under the misappropriation doctrine such as an employment relationship. However, the misappropriation doctrine does not require a traditional fiduciary duty but will accept a duty of trust and confidence. Although the Supreme Court has not expressly defined a duty of trust and confidence, this standard is consistently applied by lower courts.

In US v. Chestman, the 2nd Circuit defined both a fiduciary duty and its functional equivalent, a duty of trust and confidence:

A fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. What has been said of an agent's duty of confidentiality applies with equal force to other fiduciary relations: “an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency.” Restatement (Second) of Agency § 395 (1958). These characteristics represent

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63 Id.
64 Id.
65 Id. at 655
66 William Wang, Mark Steinberg; Insider Trading, pg. 424 (2010)
67 Id. at 653
68 Id. (In O’Hagen, the traditional employer relationship sufficed for fiduciary duty)
69 See: SEC v. Falbo, 14 F. Supp. 2d 508, 522-24 (S.D.N.Y. 1998) (holding that although he was not a traditional fiduciary, an electrical contractor nonetheless was placed “in a position of trust and confidence.”); S.E.C. v. Yun, 327 F.3d 1263 (11th Cir. 2003).
70 Id.
71 United States v. Chestman, 947 F.2d 551, 567-570 (2d Cir. 1991)
the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.\textsuperscript{72}

The Chestman court further held that in the absence of a pre-existing fiduciary relationship, a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.\textsuperscript{73} Merely telling someone that certain information is confidential is not enough to find a pre-existing fiduciary duty, there has to be a fiduciary duty prior to the disclosure of the confidential information.\textsuperscript{74} While “duty of trust and confidence” jurisprudence is governed by district and circuit court case law, the principles discussed in this paper are widely accepted.\textsuperscript{75}

i. Application of the Misappropriation Doctrine to members of Congress

It is likely that the SEC had more opportunities to bring insider trading claims against members of Congress under the misappropriation doctrine. The difficulty in bringing a 10b-5 claim against Congress under the classical special relationship theory is proving a certain employment relationship, or that the Congressman knew or should have known of an insider’s breach of a fiduciary duty; neither of which are pre-requisites to congressional liability under the misappropriation doctrine.

The SEC only has to prove the elements of insider trading by a preponderance of the evidence.\textsuperscript{76} The SEC showed a complete lack of interest in reigning in the blatant use of non-public information by members of Congress. A major impediment to alleging insider trading against members of Congress under the misappropriation doctrine prior to the STOCK Act is the

\begin{itemize}
\item \textsuperscript{72} Id at 569
\item \textsuperscript{73} Id. at 567
\item \textsuperscript{74} Id.
\item \textsuperscript{75} Id.; United States v. Kim, 184 F. Supp. 2d 1006 (N.D. Cal. 2002); S.E.C. v. Yun, 327 F.3d 1263, 1273 (11th Cir. 2003)
\item \textsuperscript{76} See DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS page 13 (2d ed. 2008).
\end{itemize}
perceived lack of a confidential relationship with the information source.\textsuperscript{77} Professor Stephen Bainbridge, in an article discussing the inability to use traditional securities laws to hold members of Congress liable for insider trading, argues as follows:

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,” such a duty would be irrelevant to the problem at hand. What is needed under insider trading law is either a duty to the person with whom one trades or to the source of the information, not some generalized duty to members of the public in the abstract.\textsuperscript{78}

This analysis is from the perspective of current corporate case law, but this cannot be the same analysis under insider trading claims against elected officials. An analysis of fiduciary duty with regards to members of Congress is markedly different then a discussion of the fiduciary duty of a corporate executive or other standard insider. Liability against a Congressman would require a completely different analysis, dissimilar to any prior analysis of insider trading.

The SEC is very aggressive in going after individuals who come into possession of material non-public information.\textsuperscript{79} The SEC consistently took the position that possession of material inside information creates an affirmative duty to disclose or refrain from trading.\textsuperscript{80} Even though the Supreme Court expressly held there was no affirmative duty to disclose non-public information,\textsuperscript{81} the SEC attempted this argument again in \textit{Dirks}.\textsuperscript{82} This aggressive frontal assault on corporate insider trading was curiously absent in Congressional enforcement. The SEC

\begin{itemize}
\item \textsuperscript{77} Stephen M. Bainbridge, \textit{Insider trading Inside the Beltway} page 19
\item \textsuperscript{78} Id.
\item \textsuperscript{79} See; \textit{Dirks v. S.E.C.}, 463 U.S. 646 (1983)(Where the SEC alleged insider trading against a market analyst who exposed a corporation of fraudulent asset pricing and did not personally benefit from any trades based on the information.)
\item \textsuperscript{81} \textit{Chiarella v. U. S.}, 445 U.S. 222, 223 (1980)(“Here, petitioner had no affirmative duty to disclose the information as to the plans of the acquiring companies.”)
\item \textsuperscript{82} \textit{Dirks v. S.E.C.}, 463 U.S. 646, 656, 103 S. Ct. 3255, 3262, 77 L. Ed. 2d 911 (1983)(“Here, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.”)
\end{itemize}
consistently argued that those who possess inside information have a duty to disclose or refrain from trading, yet was unwilling to make this argument with regards to members of Congress.

It is difficult to surmise how a court would have viewed a Congressional fiduciary duty under traditional securities laws, but there are valid arguments that a motivated SEC could have made.

First, employer relationships are sufficient to establish a traditional fiduciary duty. As held in U.S. v. O'Hagen, O'Hagen’s position as an employee of a law firm created a fiduciary duty to the law firm, and a breach of that duty created liability under 10b-5. An O'Hagen argument could have been made by the SEC that members of Congress are employees of their constituency. They are elected, or hired, as well as paid by a specified group of constituents. Thus in the traditional employment sense they have a fiduciary duty to their electorate, and if they received information from a member of the electorate they had a duty to that individual not to misappropriate the information. Trading on such information without disclosing the intent to do so would be a violation under O'Hagen.

However, even if the SEC would not argue a classic employment relationship exists between Congress and their constituents, then the SEC could have argued a relationship of trust and confidence existed between members of Congress and those that provide them information. A Congressman owes a fiduciary duty to the public to make governmental decisions in the public’s best interest, and this general duty should suffice for insider trading liability. A similar

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84 United States v. O'Hagen, 521 U.S. 642 (1997)
85 Id.
86 Id.
88 See; United States v. Woodard, 459 F.3d 1078, 1086 (11th Cir. 2006) (“John Woodard owed a fiduciary duty to the public to make governmental decisions in the public's best interest; and John's misuse of his office for private gain constitutes fraud.”)
argument was successful in 1995 in a criminal proceeding in the Southern District of West Virginia in United States v. ReBrook. William Edward ReBrook was hired as an attorney for the West Virginia Lottery Commission. He learned that VLC, a lottery machine manufacturer, was going to receive the state’s contract to sell lottery tickets and he traded and tipped based on that information. The court held that the “defendant could be found guilty of insider trading under misappropriation theory based on breach of duty to his employer, the state lottery, and citizens of state, regardless of fact that he did not have relationship with the company in whose stock he traded.” The court stated that ReBrook owed a duty to the citizens to provide them with honest services when he accepted a position in their employ. It should be noted that United States v. ReBrook was later overturned by the 4th Circuit on the grounds that the court did not recognize the misappropriation doctrine, but this doctrine is now a well-established theory of liability. United States v. ReBrook is valid precedent for arguing a duty to an electorate.

A ReBrook argument could be made with respect to members of Congress, advocating that they owe a duty to the citizens of the entire country. If a state employee owes a duty to the citizens of the state, then a federal employee should owe a duty to the citizens of the country. This holding dispels both Professor Brainbridge’s and Thomas Newkirk’s theory that a general duty to citizens would not suffice under 10b-5.

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90 Id. at 893
91 Id.
92 Id. at 894
93 Id.
94 United States v. ReBrook, 58 F.3d 961 (4th Cir. 1995)
95 William Wang, Mark Steinberg, Insider Trading, pg. 442.
97 Id.
98 Id.
99 Stephen M. Bainbridge, Insider trading Inside the Beltway page 19
Additionally, a circuit split on the interpretation of a duty of trust and confidence led the SEC to promulgate rule 10b5-2 on August 24, 2000.\(^{101}\) There are numerous arguments that the SEC could have made under rule 10b5-2.

Section 1 was invalidated as a sole means to require disclosure under the misappropriation theory.\(^ {102}\) So a Congressman merely agreeing to maintain material nonpublic information in confidence is not enough, in and of itself, to sustain insider trading liability. Regardless, section 2 of rule 10b5-2 has the potential to expose members of Congress to liability as a breach of trust and confidence to the party disclosing the information.\(^ {103}\)

Section 2 could apply to the Representative Bachus scenario, where the highest-ranking Republican on the House Financial Services Committee received a closed door briefing about highly sensitive information regarding the United States financial industry.\(^ {104}\) It is likely that the House Financial Services Committee, Hank Paulsen, and Ben Bernanke have a history of sharing confidences, such that Bachus knew or should have known that he was expected to keep the information confidential. Further, while section 1 is not a sole means for liability, an agreement to keep information confidential is additional evidence in establishing a relationship of trust and confidence. This infamous briefing was not disclosed in a Congressional hearing, but under a

\(^{101}\) 15 U.S.C. § 78a rule 10b5-2

A duty of trust or confidence exists in the following circumstances, among others:

1) whenever a person agrees to maintain information in confidence

2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material non-public information expects the recipient will maintain its confidentiality; or

3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling;

\(^{102}\) S.E.C. v. Cuban, 634 F. Supp. 2d 713, 730 (N.D. Tex. 2009)

\(^{103}\) 15 U.S.C. § 78a rule 10b5-2

\(^{104}\) JASON ZWEIG, A Perk of Power: Trading in Companies You Oversee (http://online.wsj.com/article/SB10001424052702304703104575174124009720464.html)
shroud of secrecy.\textsuperscript{105} This briefing was likely closed door to keep the information quiet until those privy to the information could decide on a plan of action. These meetings were so sensitive that cell phones and BlackBerrys were confiscated.\textsuperscript{106} These facts, while viewed with the benefit of hindsight, are likely sufficient for the SEC to at least launch an investigation of Senator Bachus’ trades under rule 10b5-2.

Further, the SEC has successfully brought insider trading claims even where there is a complete lack of a fiduciary duty. In \textit{SEC v. Blue Bottle Ltd. & Stokes}, the court, in an unpublished opinion, granted the SEC’s request for a temporary restraining order freezing the defendant’s assets, who obtained information through hacking insider’s computers.\textsuperscript{107} “As a complete stranger to the source of the information, a computer hacker could not be said to have been entrusted with confidential information.”\textsuperscript{108} Thus the misappropriation doctrine, as put forth in \textit{O’Hagen},\textsuperscript{109} would not apply to the computer hacker. The SEC was unwilling to implicate members of Congress for insider trading due to a lack of a fiduciary duty,\textsuperscript{110} yet a lack of fiduciary duty was not enough to prevent the SEC from going after computer hackers.

The most substantial hurdle to overcome in prosecuting members of Congress under traditional securities laws would be finding a fiduciary duty or similar relationship of trust and confidence. Even if the fiduciary duty element is met, the SEC must prove the other elements of 10b-5, including that the information was non-public. In a situation such as Senator Bachus’s closed door briefing this would not pose a problem.\textsuperscript{111} However, Congressmen often come into

\textsuperscript{105} \textit{Id.}
\textsuperscript{106} \texttt{http://www.cbsnews.com/video/watch/?id=7388130n}
\textsuperscript{108} \textit{Id.}
\textsuperscript{111} \textit{JASON ZWEIG, A Perk of Power: Trading in Companies You Oversee (http://online.wsj.com/article/SB10001424052702304703104575174124009720464.html)
possession of information at public hearings. Those who argue that Congress could not be liable under insider trading laws often point to the fact that they receive information at public hearings.\(^{112}\)

Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public.\(^{113}\) In \textit{SEC v. Texas Gulf Sulfur}, the Supreme Court found that Coates, an insider who traded on material information immediately after a news release, was guilty of insider trading because the news release was merely the “first step in the process of dissemination.”\(^{114}\) The court further stated that all investors must have an “equal opportunity to make informed investment judgments.”\(^{115}\) The Supreme Court held that the information must appear over the Dow Jones broad tape, meaning the market must have an opportunity to react to the information.\(^{116}\)

Once the market reacts to the information, under the efficient capital market hypothesis, there is no longer a benefit to the information because the price already reflects all public information.\(^{117}\) Therefore, if Congress truly followed established securities laws, as put forth by \textit{Texas Gulf Sulfur}, there would be no benefit in receiving information at a public hearing under the assumptions of a semi-strong efficient capital market hypothesis.\(^{118}\) Yet, judging by the


\(^{113}\) \textit{Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 854 (2d Cir. 1968).

\(^{114}\) \textit{Id.} at 854

\(^{115}\) \textit{Id.}

\(^{116}\) \textit{Id.}

\(^{117}\) \textit{Basic Inc. v. Levinson}, 485 U.S. 224, 241 (1988)

\(^{118}\) \textit{Id.}
substantial success that U.S. Senators have in the financial markets,\textsuperscript{119} Congress is rarely following the mandate under \textit{Texas Gulf Sulfur}.\textsuperscript{120}

Finally there is a pragmatic argument that public policy demands Congressional liability for insider trading. A Federal judge would likely not hold certain Federal laws do not apply to members of Congress. The Congressman would have to make an argument that the type of information they receive and their lack of duty to their constituents makes Federal securities laws inapplicable to them. Such an argument would likely fail under public policy, and would be political suicide for the Congressman. If a court did find that Congress cannot be liable under 10b-5, this would create such public controversy that the STOCK Act would likely have been passed soon after. Forcing the judicial system’s hand in interpreting 10b-5 in regards to members of Congress would have banned Congressional insider trading sooner.

A brief prepared by the SEC which highlights the aforementioned arguments could be strong enough to impose liability on Senator Bachus, as well as many other Congressional insider traders, without using the STOCK Act. What is certain is the SEC’s unwillingness to attempt any such argument allowed Congress to operate under a legal perception for far too long.

\textbf{III. The STOCK Act in Application: Round Peg in a Square Hole}

Even though the STOCK Act was introduced numerous times over the last six years it spent very little time in committee.\textsuperscript{121} There was not enough debate over the effects of the law, or the potential for superior alternatives. Once the bill became political gold it went through both

\textsuperscript{119} Alan J. Ziobrowski, PhD, Ping Cheng, PhD, James W. Boyd, PhD, and Briggitte J. Ziobrowski, PhD, "Abnormal Returns from the Common Stock Investments of the U.S. Senate," \textit{Journal of Financial and Quantitative Analysis}, Dec. 2004
\textsuperscript{120} \textit{Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 854 (2d Cir. 1968).
\textsuperscript{121} H.R. 5015 (109\textsuperscript{th}); H.R.2341( 110\textsuperscript{th}); H.R.682 (111\textsuperscript{th})
houses in less than three months.\textsuperscript{122} This is hardly enough time to fully consider this law’s acquiescence into current insider trading jurisprudence.

The Stock Act expressly states that Members of Congress are not exempt from the insider trading prohibitions arising under the securities laws, including section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.\textsuperscript{123} Essentially, members of Congress will be treated the same as anyone else under securities laws, yet members of Congress exhibit unique qualities. A corporate insider is likely to only receive information about his company. However, the type of information that members of Congress receive is markedly different, virtually limitless in its breadth. Instead of creating new laws to address the type of information that Congress obtains, the STOCK Act forces Congress into the current structure of insider trading, and along with it the current judicial precedent. There should be a new set of statutes which discuss Congressional liability. They are not exposed to the same type of information as traditional insiders, thus they should not be governed by the same rules.

The STOCk Act is a step in the right direction toward limiting Congressional insider trading. This act assuredly serves the function of dispelling the perception that Congress is not liable under Federal securities laws. Further, it addresses the concern expressed by Professor Bainbridge\textsuperscript{124} and others regarding an absence of fiduciary duty or similar relationship of trust and confidence. The STOCK Act establishes that Congress owes an expansive fiduciary duty to all US citizens, eliminating any debate over the fiduciary duty element of a 10b-5 claim.\textsuperscript{125} Finally, the most significant benefit of this law is that it provides the SEC a political cover to begin investigating members of Congress for insider trading. There are clear conflicts of interest

\textsuperscript{122} S. 2038 112\textsuperscript{th} Congress
\textsuperscript{123} Public Law 112-105
\textsuperscript{124} Stephen M. Bainbridge, Insider trading Inside the Beltway page 19
\textsuperscript{125} Public Law 112-105Sec. 4
where the SEC has to investigate and bring charges against those on whom they depend for funding. The political firestorm created by Steve Kroft and his 60 minutes investigation\textsuperscript{126} created an environment where the SEC should now feel more comfortable regulating Congressional insider trading, if not pressured into doing so. With the STOCK Act, there is less concern that the SEC will not be motivated to investigate Congress.

While the STOCK Act is a significant stride toward reigning in Congressional insider trading, it likely did not go far enough and it could create more problems than it solves.

A major problem with the STOCK Act is the lack of guidance; it places an additional burden on the SEC to formulate rules with respect to Congressional trading. This added responsibility came at a time when the SEC is still trying to comply with the demands of the Dodd Frank Act\textsuperscript{127} and the recently passed Jumpstart Our Business Startups Act.\textsuperscript{128} At this point it is unclear how the SEC will frame allegations of insider trading under the STOCK Act, or how the precedent will develop. One thing that is certain is that this piece of legislation will spark litigation due to the unique fiduciary duty Congress now has. Forcing elected officials into three decades of corporate insider trading case law will not be a smooth transition. The SEC will have to frame their theories of liability around existing insider trading law, either under the classical theory or the misappropriation doctrine.

For the SEC to argue a violation of a classical special relationship, they would likely have to label members of Congress classic insiders, similar to a board member of a corporation. The SEC could point to similarities, noting that both Congressmen and corporate insiders receive material non-public information due to their positions. Dirks states that the court does not want to deter those who ferret out information, such as a market analyst, implying that their intent is to

\textsuperscript{126} \url{http://www.cbsnews.com/video/watch/?id=7388130n}
\textsuperscript{127} 12 U.S.C. § 25b
\textsuperscript{128} H. R. 3606
only impose liability on those that come into possession of information due to their positions.129 A rational argument could be made that by simply being a Congressman you are going to receive material non-public information.

However, the Congressman will have representation as well, and will point to the deficiencies of classifying members of Congress as insiders. Congress receives a significant amount of information in public hearings, vastly dissimilar to the type of information a corporate insider receives. A Congressman would likely argue that the information they receive in a public hearing is not non-public information. Further, a Congressman’s method of retrieving information is more akin to a market analyst then a corporate executive. Congressmen hold hearings, interview individuals, and extensively research issues. Both market analysts and members of Congress are attempting to ferret out information. If the SEC brings an insider trading claim against a Congressman under the classical theory, the Congressman will likely assert a defense indicating that they are not typical corporate insiders.

Another major problem with the classical theory is showing that the Congressman came into possession of the information in his official capacity. One defense to classic corporate insider trading is that information was not received while working in an official capacity of corporate responsibilities.130 Under general agency principles, a director acts within the scope of his employment when his act (1) “is of the kind he is employed to perform”; (2) occurs “substantially within the authorized time and space limits”; and (3) “is actuated, at least in part, by a purpose to serve the master.”131 There will likely be substantial litigation over Congressional claims that they received information while not acting within their official capacity.

131 RESTATEMENT (SECOND) OF AGENCY § 228
A final problem is that under the classical theory the insider has to trade in his own company’s stock.\textsuperscript{132} It is going to be difficult for a court to define the scope of a Congressman’s own stock. The SEC will likely advocate a broad definition of own stock, such as all securities, due to the expansive nature of Congressional information. The Congressman will likely argue that this term, “trades in own stock,”\textsuperscript{133} is not applicable to a member of Congress as there is no Congressional stock. If the SEC determines that Congress is substantively the same as corporate insiders, and chooses to frame the theory of liability on the classical special relationship doctrine, there are going to be considerable issues for courts to determine.

The SEC could also frame Congressional liability under the misappropriation doctrine. Again, under the misappropriation theory a duty is owed to the source of the information.\textsuperscript{134} The difficulty under this approach is determining the source of information. In the Senator Bachus scenario the source of the information is clear, it was Bernanke and Paulson.\textsuperscript{135} However, typically Congress receives a broad range of information from a myriad of individuals. Finding a specific source of information to whom the fiduciary duty is owed will be one basis of litigation under the misappropriation doctrine.

The most expansive theory of liability, one which the SEC will likely advocate, is that information that a Congressman receives while working in his official capacity belongs to the public. The Act explicitly states that Congress has a fiduciary duty to the citizens of the United States.\textsuperscript{136} Thus the SEC will likely argue that US citizens own Congressional knowledge. If the public is the source of the information then when Congress trades on it, without authorization

\textsuperscript{133} Id.
\textsuperscript{134} Id. at 647
\textsuperscript{135} JASON ZWEIG, A Perk of Power: Trading in Companies You Oversee (http://online.wsj.com/article/SB10001424052702304703104575174124009720464.html)
\textsuperscript{136} Public Law 112-105 Sec. 4, subsection G
from the public, they misappropriate that information and violate their fiduciary duty. This would be a powerful interpretation of the information source under the STOCK Act.

This theory of the source of Congressional knowledge will have a substantial effect on curbing Congressional insider trading, but will not avoid litigation due to the breadth of information a Congressman receives. It will difficult to define a Congressional source of information in many instances. Consider the following hypothetical.

Senator Stewart, in a Congressional hearing, receives an expansive amount of information from over 30 individuals, spanning multiple issues and industries, and pieces the information together into a trading strategy.

Who is the source of the information in this scenario? Senator Stewart will likely advocate that he is his own source of information as he was responsible for formulating the strategy based on fragmented information. If you are your own source of information then there is no liability under the misappropriation doctrine.\textsuperscript{137} The courts will likely have to painstakingly review Congressional records to determine exactly what information the Congressman received and who that information specifically came from.

Another approach to the aforementioned Congressional hearing would be for SEC to argue that the Congressman breached a duty to the aggregate information source, the culmination of the 30 individuals, which is the public. The courts will then have to address whether there can be a duty to an aggregate source of information, and if so, would the Congressman breach his fiduciary duty to every person that provided any information? These are difficult questions that a court will have to address due to the expansive nature of Congressional information.

While this discussion is abstract and theoretical, it highlights the reality that Congress created by drafting a STOCK Act which does not account for the vast differences between a Congressman and the CFO of a public corporation. The 34 Act and rule 10b-5 were not written

from the perspective of Congressional insider trading, and there is no judicial precedent for a court to look to for guidance. It is not certain how the SEC will frame theories of liability for Congressional insider trading.

Aside from framing the conceptual theory of liability under the STOCK Act, there are issues with applying the statutory language of the Exchange Act to members of Congress. Rule 10b5-1 states that 10b “restricts the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence.”\(^\text{138}\)(emphasis added). It is possible that this restriction will not reach the broad range of information that Congress receives. As previously mentioned, prior to the financial collapse of 2008 certain members of Congress received a closed door briefing in which they received inside information regarding the financial condition of Lehman Brothers. Senator Bachus received information about Lehman Brothers and traded in General Electric shares. Such a trade avoids the plain language of the rule, to refrain from trading in a security based on non-public information about that security or issuer.

This exemplifies the idea that Congress is exposed to broad, wide reaching information that has impacts across companies and industries. They do not receive the same type of information as corporate insiders, thus they should not be governed by the same rules. While current insider trading case law will have a significant impact on claims against Congressmen, the STOCK Act jurisprudence will also have a significant impact on existing corporate insider trading law.

In the STOCK Act, one Congressman has a fiduciary duty to other Congressmen.\(^\text{139}\) However, many circuits require fiduciary like superiority, dominance and control to characterize

\(^{138}\) Securities Exchange Act Rule 10b5-1
\(^{139}\) Public Law 112-105 Sec. 4 sub g
a relationship of trust and confidence. In US v. Kim, the court found that there was no
fiduciary duty between CEOs of different companies because both parties had similar levels of
expertise and knowledge. The court in US v. Cassese echoed this principal finding that no
fiduciary duty existed between the President of a company and the CEO of another company due
to a lack of “de facto control and dominance.” Members of Congress are similar to two CEOs,
in that between two Congressmen there is no one party with superior expertise and knowledge.
Thus it is possible that a court applying this statutorily created fiduciary duty will begin to erode
the existing theories relied on in Cassese and Kim.

Further, it is unclear whether the STOCK Act goes far enough to curb the problem of
insider trading. Assuming what Senator Feinstein and her husband were alleged to do is true, and
assuming that it occurred again today, it is unclear whether this would be a violation of 10b-5
under the STOCK Act. Again, it is alleged that Senator Feinstein helped direct funds to the
FDIC, in exchange for the FDIC awarding a lucrative contract to CBRE which was headed by
her husband Blum. It is further alleged that Blum’s private equity company purchased a
substantial amount of stock in CBRE around this same time. The premise is that the Senator’s
husband was privy to non-public information about CBRE before the FDIC contract was
awarded. If Blum received this information due to his position as chairman of the board of
CBRE then this is a violation of 10b-5 under the classical special relationship theory because he
is a classic insider who traded in his company’s own stock based on material non-public
information.

140 Kim, 184 F. Supp 2d. at 1011
141 Id.
142 Cassese 273 F. Supp. 2d at 485
144 Id.
145 Id.
However, if Blum received this information from his wife then there would be no violation under the misappropriation doctrine if his wife is considered the source of the information. Senator Feinstein communicated her plans to appropriate funds to the FDIC while Congress was not in session, months before actually introducing the bill on the first day of the 111th Congress.\textsuperscript{146} Further, Feinstein’s intervention on behalf of the FDIC was unusual because she is not a member of the Senate Committee on Banking, Housing and Urban Affairs who has jurisdiction over the FDIC.\textsuperscript{147} Her plan to put together a piece of legislation nearly four months prior was likely her own information. It would be difficult to argue that the thoughts of a Congresswoman three months before presenting legislation is Congressional knowledge. Blum is not exposed to liability because under \textit{Chestman}, a husband and wife relationship does not create a pre-existing duty.\textsuperscript{148} Further, it is assumed from the \textit{O’Hagan} dissent that the source of information can grant permission allowing others to trade on it.\textsuperscript{149} Thus under the misappropriation theory, assuming Senator Feinstein was the source of information at the time of her talks with the FDIC, there is no liability even with the STOCK Act.

Likely, the only way to hold Feinstein or Blum liable under 10b-5 would be through the classical theory. It is possible this would fail under the classical theory on the grounds that she was not acting in her official capacity. Again she is not a member of the committee with jurisdiction over the FDIC, she was making plans while Congress was not in session, and the allegations indicate that the purpose was to benefit her and her husband,\textsuperscript{150} all indicating that she was not acting within the scope of her official duties. The SEC could argue that a plan to enact legislation in the future is acting within her official duties as a legislator, but it would be difficult

\textsuperscript{146} Id.
\textsuperscript{147} Id.
\textsuperscript{148} \textit{United States v. Chestman}, 947 F.2d 551, 567 (2d Cir. 1991)
\textsuperscript{150} \url{http://www.washingtontimes.com/news/2009/apr/21/senate-husbands-firm-cashes-in-on-crisis/?page=all}
to prove under agency law.\textsuperscript{151} While it is unclear how a court will rule on this egregious use of non-public information, it is not an easy case for the SEC to make even under the guise of the STOCK Act.

Another significant shortcoming of The STOCK ACT is the failure to include amendment 1493 proposed by Senator Grassley.\textsuperscript{152} This amendment was included in the Senate’s version of the STOCK Act, but taken out by the House.\textsuperscript{153} Amendment 1493 sought to amend the Lobbying Disclosure Act of 1995 to include the phrase “or political intelligence activities” after all instances of the phrase lobbying activities.\textsuperscript{154} The purpose of the amendment was to treat those who gather and trade political intelligence the same as any other lobbyist and require disclosure of specifically how they earn their income.

The political intelligence industry involves hundreds of lobbyists, analysts and insiders who sell their tips, knowledge and interpretations of congressional activities to hedge funds and other Wall Street investors.\textsuperscript{155} Some political intelligence brokers simply act as intermediaries between Wall Street and Congress, such as Paul Equale, who connects Wall Street investors hungry for information with Washington insiders who possess it.\textsuperscript{156} Other times, it is the lobbyist themselves who obtain information from their lobbyist positions then sell that information to hedge funds.\textsuperscript{157} One lobbyist stated, "I have information from doing my day job as a lobbyist, that information has value on Wall Street, so I sell it."\textsuperscript{158}

\textsuperscript{151} RESTATEMENT (SECOND) OF AGENCY § 228; (a director acts within the scope of his agency when his act (1) "is of the kind he is employed to perform"; (2) occurs “substantially within the authorized time and space limits”; and (3) "is actuated, at least in part, by a purpose to serve the master.")
\textsuperscript{152} 158 Cong. Rec. S290-02
\textsuperscript{153} H.R. 2038 (112\textsuperscript{th} Congress)
\textsuperscript{154} 158 Cong. Rec. S290-02
\textsuperscript{155} http://online.wsj.com/article/SB10001424052970204059804577225572815851652.html
\textsuperscript{156} Id.
\textsuperscript{157} Id.
\textsuperscript{158} Id.
The fact that a large part of the political intelligence trade involves lobbyists highlights the symmetry between the two industries, yet they are presently treated differently under the law.\textsuperscript{159} The law should not distinguish between those that are paid to meet with Congress to influence legislation and those that meet with Congress to obtain information to sell. Both are only meeting with Congress to obtain financial benefit, and they should both be required to disclose their arrangements. Political Intelligence should not be allowed to operate under a cloud of secrecy. Senator Levin, in a floor debate stated:

The House amendment also removes a provision of the Senate bill that would have required political intelligence consultants to register in a way similar to how lobbyists are required to register currently. Instead, the House amendment, like the version of the Senate bill that was reported by the Homeland Security and Governmental Affairs Committee, requires the Comptroller General of the United States to study the role of political intelligence in financial markets and report back to Congress. It is corrosive of open government for political intelligence consultants to sell their access to officials. Before Congress acts to address this issue, we must learn more about it, which is why I support this study.\textsuperscript{160}

This is an impressive showcase of political skill. Senator Levin took a stand against a “corrosive” practice while killing an amendment to shed light on it in the same statement. It is unclear exactly what further information is necessary to require these individuals to register. They are functionally the same as lobbyist, profiting on their access to legislators. Further, who is harmed by disclosure? This is simply evidence of the power Wall Street has in Congress. Information on proposed legislation is valuable to hedge funds, and they are willing to pay significantly for it.

One argument often made by those opposed to this amendment is that it will stymie the willingness of Congress to discuss matters with their constituents.\textsuperscript{161} Congress should be able to

\textsuperscript{159} H.R. 2038 (112\textsuperscript{th} Congress)
\textsuperscript{160} STOP TRADING ON CONGRESSIONAL KNOWLEDGE ACT OF 2012, 158 Cong. Rec. S1977-01, S1979, 2012 WL 967170, 5
\textsuperscript{161} http://www.grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=39909
discuss potential legislation with their constituents who would likely be affected by the legislation. This ability to ferret out information and influence legislation is a fundamental part of our democracy, but it is unclear how mere registration hinders these objectives. Lobbyists appear to be doing just fine operating in the open.

Further it is unlikely that the STOCK Act will have an effect on the prevalence of this industry. It is possible that members of Congress who provide information to political intelligence dealers could face liability under the special relationship doctrine as tippers. Assuming members of Congress are framed as classical insiders, they would be the tippers, the insiders with the information, and the tippees would be the political intelligence firms. Under the classical special relationship doctrine, the critical issue is the purpose of the disclosure by Congress to the political intelligence firms, and whether the Congressman received some personal gain. Even with a broad definition of personal gain, is unlikely that Congressmen receive any personal gain from such disclosure because they have an obligation to meet with their constituents to get an idea of how legislation will affect them. Thus it is possible that political intelligence firms, even under the STOCK Act, will be free to trade on material non-public Congressional knowledge, demonstrating a greater reason for these firms to register.

There is an argument that this is the type of activity Dirks seeks to protect. Political intelligence firms ferret out information to trade on, which Dirks argues makes the markets more efficient. Thus it is possible that these firms provide a service to the financial markets; yet this is not a valid reason to avoid registration.

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162 Id.
164 Id.
166 Id.
In summation, there are substantial issues with forcing members of Congress into current security law jurisprudence, both conceptual and textual. Courts and SEC rules are going to shape how this Act will be applied. Further, this act passed on an opportunity to bring legitimacy to political intelligence dealers, allowing them to continue to operate in the shadows. This Act is certain to lead to litigation, and if the goal is to eradicate Congressional insider trading then there are far more effective measures that Congress could have taken.

IV. Alternatives: We’ll Do Better Next Time

If the STOCK Act is not effective in curbing Congressional insider trading, or more likely this Act creates more problems than it solves, then there are options that Congress can take to assure that the purpose of this Act is carried out.

One possibility is a statutorily mandated 10b5-1 plan. Rule 10b5-1(c) creates an affirmative defense to claims that insider trading laws were violated.167 “[T]he existence of a Rule 10b5–1 Trading Plan is an affirmative defense that must be pled and proved.”168 Rule 10b5-1(c) trading plans are a means for corporate officers to purchase or sell company shares steadily and thereby avoid suspiciously timed trades.169 These plans could have a substantial impact on Congressional insider trading while avoiding litigation. However, corporate insiders continue to post substantial returns, thus 10b5-1 plans likely have not done enough to curb corporate insider trading.

Another option is the use of blind trusts, which takes control of the investments completely away from the legislators and places control in a third party trustee. Congressman could be statutorily required to create a blind trust in which the trustee makes all decisions regarding financial investments. John Boener, in Steve Kroft’s 60 minutes special, expressly

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167 Securities Exchange Act Rule 10b5-1
169 William Wang, Mark Steinberg; Insider Trading, pg. 831 (2010)
stated that he does not handle his own investments indicating that he might already use a blind trust.\textsuperscript{170} The downside to this alternative is that it denies Congressman and their staffs the opportunity to control their own investments.

Further, the SEC could defer to The Office of Congressional Ethics to investigate possible violations of insider trading laws. This will alleviate many of the conflict of interest issues that coincide with the SEC investigating Congress. Recently, the Office of Congressional Ethics, an independent investigative agency, notified Representative Bachus that he is under investigation and that they have found probable cause to believe insider-trading violations have occurred.\textsuperscript{171} This is the first time the Office of Congressional Ethics has investigated a member of Congress for insider trading.\textsuperscript{172} One benefit to allowing this agency to handle Congressional insider trading is that they are not restraining by federal securities laws. The Office of Congressional Ethics is also investigating whether Bachus violated congressional rules that prohibit members of Congress from using their public positions for private gain.\textsuperscript{173} The obvious downside to this alternative is the lack of expertise that this investigative agency has with regards to insider trading. The SEC is going to be more efficient and knowledgeable in their investigations with regards to insider trading. Further, there is also a significant conflict of interest in relying on Congress to police itself. This is likely not a superior alternative, but could be an additional tool to curb Congressional insider trading if the two agencies can work together.

Finally, Congress could amend the STOCK Act to deal with the differences between Congressional inside information and typical corporate inside information. As previously stated, it is unclear how the courts will analyze traditional case law with regards to members of Congress.

\textsuperscript{170} \url{http://www.cbsnews.com/video/watch/?id=7388130n}
\textsuperscript{171} \url{http://www.washingtonpost.com/politics/rep-bachus-faces-insider-trading-investigation/2012/02/09/glQQA21Ui2Q_story.html}
\textsuperscript{172} Id.
\textsuperscript{173} Id.
Congress, and there is no statutory law for the courts to consider. Thus an express statute which outlines which type of trading is prohibited will create more certainty when members of Congress violate insider trading laws and inevitably come before the courts. The Following is a hypothetical statute which will take the uncertainty out of applying traditional insider trading law to members of Congress:

**Stop Trading On Congressional Knowledge Part 2; We Mean It This Time**

It shall be a violation of Sec. 10(b), and Rule 10(b)(5) thereunder, for any active member of Congress or any Congressional employee to:

1. Purchase or Sell Securities while in possession of material non-public information related, directly or indirectly, to that specific purchase or sale; or
2. Disclose information to any person where the member of Congress or their staff knows, or should know, that the information will be traded on prior to public dissemination.

This hypothetical legislation requires Congress and Congressional staffs to revert back to the Cady, Roberts era\textsuperscript{174} where there was an affirmative duty to disclose or refrain from trading on material non-public information. There could be an issue of an overly broad statute as Congress is constantly in possession of material non-public information which would restrict all trading regardless of the type of information. This is remedied by the language in this hypothetical statute, “related to that specific purchase or sale,” meaning Congress can trade while in possession of material non-public information as long as the information does not give them an advantage in that specific trade. Therefore this law is not as restrictive as creating a blind trust as a Congressman can still control his own trades.

In Dirks, the court was dismissive of the affirmative duty to disclose or refrain from trading noting that such a duty could have an inhibiting influence on the role of market analysts,

\textsuperscript{174} In re Cady, Roberts & Co., 40 S.E.C. 907 (1961)
which the SEC itself recognizes as necessary to the preservation of a healthy market.\footnote{Dirks v. S.E.C., 463 U.S. 646, 658 (1983)} Placing an affirmative duty on Congress to disclose or refrain from trading will not have an impact on the efficiency of the market, as this will not affect the true market analysts.

This statute further stands for the concept that Congress should be treated differently statutorily in order to avoid the inevitable problems of analyzing such a broad fiduciary duty under existing case law, as well as to account for the broad range of Congressional non-public information. As previously discussed, forcing members of Congress into existing inside trading jurisprudence is going to cause legal dissonance. This law would have an immediate impact on Congressional insider trading, and a bright line rule would avoid substantial litigation.

The downside to this statute is that even if a Congressman does their own research and obtains material non-public information they would not be able to trade on it. Essentially members of Congress would be prohibited from acting as the true market analyst that Dirks seeks to protect.\footnote{Id.} The statute could include a provision such as, “material non-public information obtained while acting within official responsibilities,” but this would just lead to litigation. A bright line rule prohibiting any trades based on material non-public information would eliminate litigation, and substantially curb Congressional insider trading. This could just be one of the perils of becoming a Congressman, a small price to pay to ensure the public’s confidence.

Another potentially harmful effect is that under this hypothetical statute Congress could not provide information to political intelligence dealers if they know or should know the dealers are going to trade on the information. Political dealers likely provide some benefit in ensuring efficient markets due to their willingness to ferret out information, and if Congress has to
publicly disclose the information before giving it to the political intelligence dealers then the dealers will lose their motivation to seek out information. However, this again is a small price to pay for ensuring public confidence in elected officials as well as the markets. Further, market analysts can still perform this function on their own; this will only stymie the blatant sale of Congressional access to hedge funds.

Instead of simple, highly effective measures such as a blind trust or an affirmative duty to disclose or refrain, Congress created a grey area where neither the SEC nor members of Congress can be certain how the theories of liability will evolve. Through the STOCK Act Congress chose a path consisting of SEC rules and years of litigation to develop precedent. Congress assuredly did not choose the path of least resistance.

V. Conclusion: The SEC’s Perpetual Struggle- Biting the Hand that Feeds Them

The legal perception that members of Congress could not be liable under the pre-STOCK Act securities laws never evolved into a tangible legal principal because it was never tested. It was, and remains today, nothing more than a theory. The theory served its purpose as it created an opportunity for Congress to publicly condemn insider trading while making significant returns on material nonpublic information. It further gave the SEC a political shield to forgo any investigation on members of Congress; a truly convenient perception.

It is difficult to surmise why the SEC never investigated members of Congress for insider trading, especially given the substantial success that Congress has in the financial markets and the aggressive history of the SEC. There is a level of self-preservation in the SEC’s prior approach to Congressional insider trading. First, such inaction only impacted a small subset of traders, members of Congress who actively traded on material nonpublic information. Thus it was likely not a major concern of the SEC who is still trying to comply with the requirements of
now three recently enacted laws. Further, it is reasonable that the SEC did not want to make it a priority to begin investigating the individuals who control their budget. This paper does not serve as an indictment on the SEC, but merely tries to explain how such egregious use of non-public information went unchecked.

It appears that the SEC was simply unwilling to enforce Federal securities laws on members of Congress, yet there were substantive arguments that could have been made. A member of Congress was investigated under Federal securities laws by the Office of Congressional Ethics before the SEC, proving their lack of concern for the issue. Even with the tacit permission to begin investigating Congress under the STOCK Act, there remains a substantial conflict of interest between the SEC and members of Congress which could continue to inhibit investigations. In June 2011, the House of Representatives appropriations committee cut the SEC’s fiscal 2012 budget request by $222.5 million, limiting the SEC’s budget to the same amount as the previous year even though the SEC’s responsibilities were vastly expanded under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

It is unclear why the Appropriations Committee was unwilling to expand the SEC’s budget. The SEC is not financed by tax revenue, but rather by fees levied on those it regulates. Thus it is puzzling why the House Appropriations Committee would want to cut the budget request. The Dodd-Frank act mandates that the fees cannot exceed the SEC’s budget. This is likely further evidence of the significant effect Wall Street has in Washington. Not only does a lower budget hurt the SEC’s enforcement capability, but now regulated entities, Wall

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177 12 U.S.C. § 25b (Dodd Frank); H. R. 3606 (JOBS Act); Public Law 112-105 (STOCK Act)
180 http://www.reuters.com/article/2012/03/06/us-sec-budget-idUSTRE8250VG20120306
181 Id.
Street, have a smaller cap on potential SEC fees. The SEC predicted that this year regulated entities will pay $136 million less in fees than they did the prior year.\textsuperscript{182} Thus the STOCK Act might not create enough incentive for the SEC to begin investigating members of Congress due to the perpetual struggle for funding.

While Congress should be applauded for taking such swift action once the issue was exposed, they could have created a stronger law. Corporate insider trading remains prevalent, as corporate insiders beat the market by over 6\%\textsuperscript{183}. Thus 10b-5 jurisprudence has not eradicated the problem. If Congress truly was concerned with completely foreclosing their ability to trade on Congressional knowledge they could have done a more effective job.

It is curious that it was necessary to pass a statute to expressly hold members of Congress accountable for the same laws as their constituents. This concept is astounding. Further, members of Congress will benefit from the many grey areas created by the Act as there are substantive arguments that insider trading laws still do not apply in certain instances despite the use of material non-public information. The SEC will now have to navigate unchartered waters without a compass. There is no guidance from Congress or prior case law for the SEC to rely on. The enactment of the STOCK Act is simply the first step in addressing the problem, but SEC rules and judicial decisions will shape Congressional insider trading jurisprudence. The STOCK Application of the STOCK Act is now up to the SEC and the Federal Courts, but at least we can count on Steve Kroft if this piece of legislation does not fulfill its stated purpose. In Steve Kroft we trust.

\textsuperscript{182} Id.
\textsuperscript{183} Stephen M. Bainbridge, \textit{Insider trading Inside the Beltway} page 1