

**H.R. 1148, THE STOP TRADING ON  
CONGRESSIONAL KNOWLEDGE ACT**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**  
ONE HUNDRED TWELFTH CONGRESS  
FIRST SESSION

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DECEMBER 6, 2011  
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## H.R. 1148, THE STOP TRADING ON CONGRESSIONAL KNOWLEDGE ACT

Tuesday, December 6, 2011

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Manzullo, Jones, Biggert, Capito, Garrett, Neugebauer, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Stivers; Frank, Waters, Maloney, Ackerman, Sherman, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Moore, Ellison, Perlmutter, Donnelly, and Carney.

Chairman BACHUS. The hearing will come to order. The Committee on Financial Services has been convened.

Today, we will examine an issue that has received a significant amount of attention in recent weeks. The American people deserve an answer to questions that have been raised about whether insider trading laws apply to Members of Congress and their staffs. They also have an absolute right to demand that the people they elect to represent them in Congress conduct themselves according to the highest ethical standards and do not seek to profit from their positions.

During this hearing, we will address this concern. We will seek to learn whether a Member of Congress or any citizen is exempt from the law, and we will discuss H.R. 1148, the Stop Trading on Congressional Knowledge Act (the STOCK Act). Accordingly, we will hear from several witnesses today, including: the sponsors of H.R. 1148, our colleagues; the Director of Enforcement at the Securities and Exchange Commission; and other experts on the subject.

I thank all the witnesses for appearing today and I look forward to hearing their testimony. I especially want to thank Representatives Slaughter, Walz, and Jones for joining us to talk about the bill they sponsored.

I will now recognize Mrs. Maloney for 1 minute for an opening statement.

Mrs. MALONEY. Thank you.

I am very pleased to welcome our witnesses today: Mr. Jones; Ms. Slaughter; and Mr. Walz. And I look forward to your testimony.

I am particularly proud of my New York colleague, Louise Slaughter, who was the first person to introduce this bill, when she discovered a staffer was making trades from his office based on inside information. And I am proud to be a sponsor of H.R. 1148, as I was in the last Congress. I am pleased to see that we are moving with great speed to address this issue and hopefully pass it into law.

Elected officials really should be like Caesar's wife in avoiding the appearance of impropriety. The potential for trading on inside information within these halls is undeniable, and we need to move to address it.

While the SEC has said recently that existing insider trading laws apply to Members, I can't remember the last prosecution under any existing laws. In addition, the House Ethics Committee guidance has been that House rules prohibit Members and their staff from entering into personal transactions that trade on confidential information, and we need to ban this. It remains clear to me that the need to expressly prohibit this activity in statute cannot be overstated. This bill is needed, and action on it is long overdue.

I have a series of editorials from across the country that I would like to place in the record, all of which support this bill and say we should have passed it yesterday.

I thank my colleagues, and I look forward to your testimony.

I yield back. Thank you.

Chairman BACHUS. Thank you.

Mr. Hensarling for 1½ minutes.

Mr. HENSARLING. Thank you, Mr. Chairman, for calling this hearing. And I thank my colleagues on the panel for their leadership in this area.

Before we debate any given policy, I think it is critical that we first get right the principle, and I would suggest that two principles apply here: first, with the exception of statutory compensation, the American people have to have confidence that Members of Congress will not profit from their office; and second, with the exception of the Speech or Debate Clause enshrined within our Constitution, our constituents deserve to know that Members of Congress are going to be living under the same laws that apply to them, and people need to know that these principles are inviolate.

Now, it is clear that "60 Minutes" still enjoys pretty good ratings, since I heard about this issue over the weekend on several occasions, but our constituents also deserve the facts. Let me quote from one of our witnesses from the Congressional Research Service: "I think it is now fairly clear to everyone following this issue that Congress did not exempt itself from insider trading laws." I also note that under our House ethics rules, Members are expressly prohibited from "using their official positions for personal gain."

The subject matter of today's hearing is very, very important, but before we prescribe a remedy, let's ensure we have identified the right problem. The challenge may be lax enforcement. The problem may be inadequate disclosure. It may lie in vague statutory definitions. It does not appear to lie with a Congressional exemption. But wherever it lies, the American people rightfully demand accountability, and we owe it to them to provide it.

I yield back the balance of my time.  
 Chairman BACHUS. I thank the gentleman.  
 Mr. Scott for 3 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I want to just commend our fellow Members of Congress who have taken the bold leadership on this legislation: Mr. Jones; Ms. Slaughter; and Mr. Walz. You are certainly to be commended.

And I want to thank you, Mr. Chairman, for holding this hearing today on the Stop Trading on Congressional Knowledge Act.

It is very important that we honor the trust that the American people placed in Members of Congress, and the STOCK Act would bar Members of Congress and Federal employees from profiting from information that is not publicly available that they obtain by means of their elected positions. The STOCK Act would also direct the Commodity Futures Trading Commission to prohibit someone from buying or selling a commodity for future delivery or swap while in possession of material information that is not public—very important and should be the case.

Currently, as a matter of fact, insider trading is not forbidden by law. However, there have been reports that Members of Congress and their staffs have been engaging in day trading of securities, and I find this very, very troubling. I believe that my House colleagues and I, as well as staff, should be subject to the very same rules as those that are not directly associated with Congress.

Although there seems to be a consensus on this fact, some have questioned the legislation's narrow scope. I think that this deserves a particular mention, and that is, namely, its application to only material that is nonpublic information relating to pending legislation and the omission of tipping by Congress or employees of the Executive Branch.

So I will be very interested in finding out today from our witnesses how our witnesses view the legislation under discussion, and then what should be done to increase this narrow focus, the focus of it, the effectiveness of it, if we feel it is necessary.

So I look forward to this hearing. Thank you very much, Mr. Chairman. And, again, the American people are depending upon us to do the right thing and play by the same rules that all the other American people are playing by when it comes to trading on the exchanges.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

I want to see us strengthen the law as it applies to insider trading as it can be practiced by Members of Congress.

I think that many people look at the government today and see that it has entered into every facet of the economy. We have massive Federal spending now. We have taxation policy that is not uniform. We have the government intervening in the economy on behalf of some firms and not others. And with that increased size and increased influence, there is a heightened sense that political pull and insider knowledge are enriching a select few. It is that perception of crony capitalism which threatens our free enterprise system and our republic.

And it is that perception that we have to address here in Congress. Washington must be held to a higher standard. And whether this is achieved through the STOCK Act or Mr. Duffy's legislation, of which I am a cosponsor, I believe that, at the end of the day, now is the time to act. After this hearing, we should mark up legislation.

And I look forward to hearing the witnesses, their testimony here this morning.

Thank you. I yield back, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

And I want to express my admiration for the efforts of my colleagues.

I will now acknowledge that during the 4 years I chaired the committee, it was during that period that I think this first surfaced, and I did not see it, apparently incorrectly, as an issue. It, frankly, seemed to me inconceivable that Members of Congress would be doing that. But I now accept the fact that it has been happening, and it is both a matter of right and a matter of what we owe the country to correct it. So I thank my colleagues for persevering.

I still think the best thing for Members of Congress to do is to be very cautious. To some extent, there are going to be elements of knowledge we have that are going to be hard to capture under the law. Our prediction about how a vote may go, if you don't have all the commitments signed in your pocket, probably wouldn't be inside information, but it is something that ought not to be there.

I will say, this had occurred to me some time ago as a potential issue, and I think I have resolved it the best way I can. Almost all of my investments are Massachusetts municipal bonds, which also have done pretty well lately because the rating agencies underestimate the commitment of the States. And, in fact, if anything, I have acted against interest because I have been urging the rating agencies to reduce the risk component that they impute to municipal bonds, which would make the interest rate go down.

I acknowledge the fact that I am getting an unduly high return because of the nonexistent possibility that they are going to default. But I also thought that owning the bonds of the State I am enjoined to represent would minimize any argument of conflict of interest. To the extent that I oppose anything that would undermine the fiscal soundness of the State I represent, I would assume that would be considered to be okay.

But to go back, there is an area of ambiguity. And no matter what we do, I think it is important that we pass this legislation, and I thank my colleagues for doing it. I must say, I am skeptical of the blind trust. I gather we got a last-minute entry into this derby to talk about mandatory blind trusts. I think there are problems with trusts being more or less blind and supervising who the trustee is. I believe that the approach my colleagues are taking is a very thoughtful one, and I will be working to sharpen the legislation. I understand there are obviously some ambiguities.

Let me just say, for those who might argue it is not necessary, I will rely on my most important legislative principle: Redundancy



is clearly preferable to ambiguity when you are passing laws, especially since we know that some of those who are telling us that this is unnecessary, if hired to represent one of us, would immediately argue that it was too ambiguous. So let's clear this up.

Thank you.

Chairman BACHUS. Thank you.

Mr. Duffy for 2 minutes.

Mr. DUFFY. Thank you, Mr. Chairman.

I think there is a cloud over Members of Congress and the trades that they make. Whether that is just perception or whether there is really wrongdoing I don't know. But I would commend Ms. Slaughter and Mr. Walz for introducing this bill, the STOCK Act. I think it is a first step in the right direction.

But I think we have to go a step further. We can't take a half step here. I think we should take the full step and leave no gray area with what Members of the House, Members of the Senate, the President, or the Judicial Branch do in regard to their trades. And that is why I have introduced H.R. 3550, the RESTRICT Act.

What we do there is we mandate that each Member have a blind trust, and if they opt out of the blind trust, they can opt for disclosure of trades within 3 business days of that trade. And I think if we do that, it will shed light on any trades that go on with Members or senior staff. And if there was a meeting with a high-ranking business official and 3 days later or 2 days later a Member is trading, we will be able to see that. I think that kind of transparency, the immediate transparency, is imperative.

If we are going to introduce legislation, this can actually get the job done. My fear is that if we only take half a step, there will still be too much gray out there for members of the public to see that Members could skirt around the new rule. I think my bill goes the distance and makes sure that there will be no doubt within the minds of the American people that Members of Congress, the Executive Branch, or the Judiciary are not going to use insider information to trade.

And, with that, I would yield back.

Chairman BACHUS. All right. Thank you, Mr. Duffy.

Mr. Lynch for 1 minute.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank our distinguished panel and sponsors of this legislation for coming forward.

I certainly think that recent revelations have created doubt in the integrity of the whole process here, whether or not Members are capitalizing on inside information that they get through the legislative process. So I certainly—I am a cosponsor of Mr. Walz's bill. I think it needs to be addressed, and I think we need to do it quickly and in a fashion that I think restores America's confidence that we are operating aboveboard here and not taking undue advantage of our positions.

So, with that, I want to congratulate the sponsors of this bill and Mr. Jones, Ms. Slaughter as well. Thank you very much.

I yield back the balance of my time.

Chairman BACHUS. Thank you, Mr. Lynch.

If there are no further Members—Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman.

While today's hearing focuses on a specific piece of legislation, I feel the greater discussion revolves around the public's perception of Washington and the current lack of trust that voters across the country have in their elected leaders. I think it is pretty clear that if a Member of Congress trades off of material, nonpublic information, as it is defined for private citizens who trade off of such information, there should be penalties and there should be accountability.

But we also must keep in mind that innuendo and bad research do not make for justifiable allegations against Members of Congress. To this end, I feel that the STOCK Act offers a completely unworkable solution to these allegations. The bill would likely lead to political witch hunts and, judging by language in Section 3, could disallow a Member of Congress from ever getting in front of a camera again to discuss pending legislation. This would have the perverse effect of decreasing transparency and further eroding the public's trust in Washington.

I feel there are better ways to address this issue, and that is why I have introduced House Resolution 480, which would amend House rules and require that every Member of Congress either place their assets in a blind trust or disclose all of their trading activity on a monthly basis for the public to see. The resolution bars insider trading by Members of Congress and grants enforcement power to the House Committee on Ethics, thereby avoiding the Constitutional problem of having an Executive Branch agency investigating the Legislative Branch. I feel this would be an important step toward Washington regaining some of the trust of the American people.

With this in mind, I look forward to discussing these very important issues at today's hearing, and I yield back the balance of my time.

Chairman BACHUS. Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

In the 1960s, when Americans were asked in polls if they believed that government officials, their government officials, could be counted on to do the right thing or at least try to do the right thing, they overwhelmingly said "yes." They might not agree with their decisions, but they didn't question the motives. They thought that the people who held responsible positions in their democracy came from the people and wanted to do the right thing by their country. They were patriotic Americans, just like other Americans.

That trust is now gone. In polling now, overwhelmingly, Americans do not think that of people who hold positions of government. That is toxic for our democracy. We cannot survive this democracy unless there is more confidence in our elected officials than there is now.

Part of that has been the result of the conscious effort to discredit government, to discredit everything that government does. Part of that is the result of the financial crisis and what happened. Most Americans think that everything done in the financial crisis was done to help specific institutions and specific people, not to help the economy. And there is too much truth to that.

Part of that is the result of another story on "60 Minutes," although it has been widely reported, on the failure to prosecute in

the face of what appears to be clear evidence of criminal misconduct. Certainly, in a democracy, no one can be too big to prosecute. And then, finally, this: There has to be an understanding that people have to believe, and it has to be true that people in responsible positions are not using their positions to enrich themselves.

We have to restore the trust of the American people in their democracy, and the first step to restore their trust is to be trustworthy.

I yield back the time I don't have.

Chairman BACHUS. Thank you, Mr. Miller.

We have completed opening statements.

We have three of our colleagues here to testify: Representative Walter Jones; Representative Louise Slaughter; and Representative Tim Walz. And you are free to make an opening statement at this time.

Walter, we will start with you.

**STATEMENT OF THE HONORABLE WALTER B. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA**

Mr. JONES. Thank you, Mr. Chairman.

We are living in a time when the American people do not trust Congress. Since the bailout of Wall Street, the Bernie Madoff scandal, and other indiscretions, the American people have been frustrated and disappointed in their elected officials concerning financial issues.

"60 Minutes" recently escalated speculation and raised more questions about those in power not playing by the same rules as the American people. According to many experts, those at the top of the financial world manipulated information to the detriment of the American taxpayer and investors, big and small.

As Members of Congress, it is our job to follow a strong honor code and to hold those accountable who are profiting from positions of power. The American people should never, ever have the slightest perception that we are using our office to pad our own pockets. That is why I believe in and I support the STOCK Act. It is a proper first step in maintaining the integrity of Congress.

The introduction of H.R. 1148 states its purpose: "To prohibit commodities and securities trading based on nonpublic information relating to Congress, to require additional reporting by Members and employees of Congress of securities transactions, and for other purposes." While there may be some technicalities to this legislation that need to be addressed, I believe that H.R. 1148 is a great starting point for this Congress.

Mr. Chairman, too many people today think that financial markets are a rigged casino in which regular investors cannot win and where insiders virtually cannot lose. And why shouldn't they think that, Mr. Chairman? Here are three headlines from the last 2 weeks. Bloomberg: "Secret Fed Loans Gave Banks \$13 Billion." The second Bloomberg report: "How Henry Paulson Gave Hedge Funds Advance Word of 2008 Fannie Mae Rescue." Mr. Chairman, this is why the American people are so disenchanted with Congress. And

the third, the Economic Times: “MF Global Proves Enron-Era Accounting Lives On.”

Three years after the financial crisis, the too-big-to-fail banks are even bigger, phony accounting still is being used, and back-door bailouts of favorite financial institutions still continue. Just yesterday, I was asked by a constituent why the banks that received a bailout continue to give millions of dollars in bonuses to their employees. It simply makes no sense.

That is why H.R. 1148, the STOCK Act, is so important. This legislation proves to the American people that if there is a problem, those of us in Congress will fix it. It is of the utmost importance that Members of Congress maintain the integrity of this institution. We in Congress are given a privilege and an opportunity to serve the American people. They deserve to trust those whom they elect to represent them in Washington.

And, Mr. Chairman, I hope this committee will use this bill, the STOCK Act, as the vehicle to expand and build the American people’s confidence in this institution, confidence which they have totally lost.

With that, Mr. Chairman, I am pleased and honored to be with my colleagues Tim Walz and Louise Slaughter. Ms. Slaughter has been fighting for this for the last 3 or 4 years. Mr. Walz has picked up the ball and is running. Let’s join him and let’s score a touchdown for the American people.

Thank you, Mr. Chairman. I yield back.

Chairman BACHUS. Thank you, Mr. Jones.

Representative Slaughter?

**STATEMENT OF THE HONORABLE LOUISE M. SLAUGHTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK**

Ms. SLAUGHTER. Good morning, everybody. Thank you, Chairman Bachus, and Ranking Member Frank, for holding this hearing this morning.

To Ranking Member Frank, I want to thank you for acknowledging the need for this legislation. Your leadership will certainly be missed when you retire at the end of this term, but I look forward to working with you and Chairman Bachus to get this bill passed, and another historic financial reform will be added to this committee’s legacy.

I thank the committee, as I said, for taking this up.

The STOCK Act has been around, as you know, for 5 years. It never gained more than 14 cosponsors, never had a Senate sponsor or anybody to notice. Brian Baird and I introduced it after increasing reports that Members of Congress and staff were abusing their official status for private gain, and the rise of national political intelligence firms—which, to me, is one of the most important parts of this bill that never gets mentioned, but I want to talk about that a little more later—using Congressional nonpublic information to gain an advantage in the stock market. In addition, the academic field had developed a study on whether Members of Congress performed better than average in the stock market in the 1980s and the 1990s.

The bill was reintroduced in the 110th and again in the 111th Congresses. I testified in 2009 before this committee's Oversight and Investigations Subcommittee at a hearing on this topic, but the bill never advanced at all.

The bill is supported by a broad base of groups: Public Citizen; Citizens for Responsibility and Ethics in Washington; Common Cause; Democracy 21; the League of Women Voters; the Project on Government Oversight; the Sunlight Foundation; and U.S. PIRG.

Leading up to the "60 Minutes" report, we only had, as I said, nine cosponsors—a typical amount, although we did have Walter Jones, for which I am extremely grateful, and I thank him for the support that he has given us in this legislation. We now have 171 cosponsors and counting. Every day brings four or five more. It is truly a bipartisan bill. There are not one but two Senate counterparts, as you know, and the Senate has already held their hearing.

Now, to make up for lost time—the Senate held the hearing and committed to the markup of this bill before the end of the year—I encourage the members of this committee to work in concert with the other five House committees of jurisdiction.

Congressional approval, as we all know, is at 6 percent. And it is hinted at that those are only 6 percent of the people who know and love us personally. Thousands of people across the country have been peacefully protesting to break the intimate relationship between Wall Street and Washington.

Enacting the STOCK Act will prove that Congress is capable of reforming its internal operations and will help to ensure that Members are held to at least the same standards as everyone else when it comes to insider trading. Failing to pass it, I am afraid, will send a clear signal to the American people that we have no interest in gaining their approval or in reforming a broken system.

Members of Congress, Congressional staff, and Federal employees have the unique opportunity and means to make profound changes in our economy and the country and the world, but that comes with a great obligation that we do not betray our principles for private gain.

I sincerely do believe that a vast number of Members of Congress and their staffs serve the best interests only of their constituents and the public, and they do not come here, obviously, to line their pockets. This bill is not about individuals; it is about reforming the institution as a whole. By explicitly prohibiting the improper use of sensitive information, we will be taking an enormous step in providing transparency, while preserving and strengthening the public faith in our government and the democratic process.

I understand some people don't believe this is necessary. They might argue that, in theory, the current ethics rules and the SEC rules could be applied to cases of trading using Congressional material and nonpublic information. However, in practice, we have never seen these rules applied to Congress. This has made the public rightly question the adequacy of the rules that we have today. And that is why the STOCK Act has a multi-pronged effort to address Congressional insider trading and remove any current ambiguity about the issue.

The STOCK Act requires the SEC, the Commodity Futures Trading Commission, and House Ethics to explicitly ban such trading

and provides two new enforcement rules. The bill requires timely financial disclosures, similar to what is required of Wall Street insiders. And I cannot emphasize this piece enough: It requires the registration of political intelligence firms, similar to what is required by lobbyists.

And as the author of this bill, I have sincerely regretted that this part of this legislation has been totally ignored. Let me tell you something about the importance of this bill. This is a whole group of people who survive on political intelligence.

Now, throughout this current economic crisis and, indeed, since their creation in the 1970s, the so-called political intelligence firms have operated quietly in the background without any regulation or oversight. Recently, the size of this industry has grown considerably, bringing in an estimated \$100 million a year. These firms are not influencing Congress but, rather, using Congressional information to influence their clients' stock portfolios.

For example, let me read to you the Web page for one such group—this is terribly important to me, so if you will give us a second on this one, and open up your ears: “Providing this service for clients who do not want their interest in an issue publicly known is an activity that does not need to be reported under the Lobbying Disclosure Act, thus providing an additional layer of confidentiality for our clients.”

How can we possibly allow that to continue? When we pass the STOCK Act, we will be requiring all such lobbying firms to sign up with both the House and the Senate, and for the first time since the 1970s, we will have some idea of what it is that they are up to. Now, the STOCK Act does not ban political intelligence firms but just requires that they be as transparent as the rest of the lobbying industry.

As I said, I deeply regret that part of the bill has gotten so little attention because, to me, it is one of the major, if not the major, part of it that we need to pass.

So, again, Chairman Bachus and Ranking Member Frank, I thank you for holding this hearing. It is a very important step forward. I look forward to working with you and all the people of this wonderful committee and any other interested parties to enact this critical legislation in a timely fashion.

Thank you for your time.

[The prepared statement of Representative Slaughter can be found on page 70 of the appendix.]

Chairman BACHUS. Thank you.

Representative WALZ?

**STATEMENT OF THE HONORABLE TIMOTHY J. WALZ, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA**

Mr. WALZ. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee for having us here on this important issue. A special thank you to Congresswoman Slaughter and Congressman Jones for being so engaged in this.

Prior to coming to Congress, I was a high school social studies teacher and an enlisted soldier in the Army National Guard. And I came to Congress for the same reason all of you did: to make a

difference, to try and serve our country, and to try and make things better, coming and talking about the issues that the American public was frustrated about—not just policy, but how the system worked. And the rampant cynicism that all of us recognize, the idea of a 9 percent approval rating, that is a disgrace to not only all of us, it is a disgrace to those who have worked so hard to build the democracy. And it is our responsibility to restore faith.

So as I got here and started talking about things like disclosing earmarks online, and that became a common practice, those types of things, I was approached by Louise Slaughter and Brian Baird, and they said, “We have something you might be interested in.” And they started explaining to me about the idea of trading on knowledge.

I think, like most Americans, I could not believe it. It seemed like it would be impossible there would be a loophole there. It seemed impossible that anyone would do it. But the facts and the studies that were done seem to show that, lo and behold, Members of Congress outperformed the stock market by about 6 to 10 percent on a regular basis. Now, that may be due to the infinite wisdom that resides in these halls or it could be something different: luck; smart, savvy trading; or the possibility that there was insider knowledge. I don’t know.

My point on this was, the idea of serving in Congress is the single greatest honor that your neighbors can bestow upon you. And our responsibility back to them is not to have them agree with every political decision we make, but to have them believe we are doing it in their best interest, everything we do. We could be 100 percent wrong in their opinion, but if they believe we are doing it for the right reasons and the system is not gamed, the faith in the democracy is solid.

So I got on to this bill and spent countless hours with the SEC, with professors of law, with Louise, and with our esteemed retired colleague, Brian Baird, talking about ways to make this work.

I do it with no pleasure, because this is about restoring faith. It is not about individuals, it is not about singling out. I don’t know if it has ever been done before, but the perception that it was being done is strong. Go home to the grocery store, all of you who were at Thanksgiving, tell me how that conversation went at the dinner table, and I will tell you that they are talking about this because their faith in the system is not there.

So I think trying to restore this and trying to get it right, any suggestions are welcome, but I agree with my colleague, Ms. Slaughter, that we need to move something. And I can tell you, if you think a 9 percent approval rating is bad, don’t pass anything on this. Drag it out and don’t do anything, and watch what happens. And that is not about political reelections, it is not about ideology; it is about the American people becoming so cynical in the greatest system of governance in the world that it is putting things at risk.

So, with that, I encourage you to take a look at this STOCK Act. I will be the first to tell you that this is the bare minimum. But for those of who you say, take another step, I am with you, I agree on this. The problem was, the first step took 6 years to take that

half-step, with seven cosponsors. We need to get something done now. We need a mechanism that does it.

And I agree with Louise, the problem of the tippers and the tippees has to be addressed in this also. For those who say this is already there, that may hold true in a theoretical argument, but in the American public's perception, it is not there. Something must be done. If it is transparency, I believe the STOCK Act is the most thoughtful, and the unintended consequences have been looked at in a greater nature.

And I will give you just a quote here. This is from former SEC Chairman Levitt: "Our markets are a success precisely because they enjoy the world's highest level of confidence. Investors put their capital at work and their fortunes at risk because they trust that the marketplace is honest. They know that our securities laws require free, fair, and open transactions." I would substitute this for the American public's. Our market is a success, our democracy is a success because people believe they are open, fair, and transparent. And that is what we are asking to do.

I can tell you that newspapers in my district—the Mankato Free Press said, this is a no-brainer. The Minneapolis Star Tribune: "This bill is smart politics and policy and is a dose of what is needed to start reversing voters' rapid cynicism."

That is what this is about. It is not a witch hunt. It is not about trying to get involved too deeply in the SEC's responsibility. It is trying to clarify for the American public that their public servants are held not just to the same law; I would argue we need to hold ourselves to a higher standard. We need to make it perfectly clear so that when they hear our debates, they may differ with us on the substance of the debate, but not on our motives.

So I am thankful, Mr. Chairman and Mr. Ranking Member, that you are taking this up. I look forward to working with each and every Member on improving and perfecting this bill. But I can't stress enough that we have a Senate counterpart, and I would like to thank Senators Gillibrand, Tester, and Brown. They have already moved forward; they have promised us a markup. I think it is one of those rare occurrences where, as Congresswoman Slaughter said, we now are nearly approaching that magic number of 218—we should get there hopefully soon—that we have the momentum to move this.

With that, I thank you, and I look forward to any questions you may have.

[The prepared statement of Representative Walz can be found on page 73 of the appendix.]

Chairman BACHUS. Thank you. That was a very articulate and effective statement. Thank you.

And I think it expresses a lot of our own views. It is absolutely essential that we do restore the public's trust. There have been some very serious allegations; I think we all are aware of that. I am personally aware of them. And if this is the answer, so be it.

And we will—I can't speak for the committee, but after this hearing, I am perfectly willing to schedule a markup.

Mr. FRANK. Mr. Chairman, if you would yield briefly?

Chairman BACHUS. Yes.



Mr. FRANK. In my experience, when it comes to scheduling a markup, yes, you can speak for the committee.

Chairman BACHUS. Well, then I will schedule a markup. I usually have to consult the ranking member. So you are with me?

Mr. FRANK. Yes.

Chairman BACHUS. Then we will have a markup.

Ms. SLAUGHTER. Excellent. We are happy to hear that.

Chairman BACHUS. I have no questions. I am going to yield to Mr.—do you have questions, Mr. Hensarling? No?

Mr. Frank?

Mr. FRANK. I just have a couple.

First, I want to say, Ms. Slaughter, I was one of those guilty of not looking sufficiently at the political intelligence. And that is a very important thing. Now—

Ms. SLAUGHTER. Frankly, to me, in writing this bill, that was of critical importance.

Mr. FRANK. —one of the questions, I notice this bill will be multiply referred. Because, for example, it changes the House Ethics rules, and we have no jurisdiction, and that is not legislative. The Senate has no jurisdiction over our rules and vice versa. And it goes to the Judiciary, which is important because there are obviously First Amendment considerations here.

Although I will say for people who are going to automatically say there is a First Amendment problem with the political intelligence, you don't get any stronger than the First Amendment protection for lobbying. It is called in the Constitution in the First Amendment the right to petition for the redress of grievances. And regulation of that has clearly been upheld—not prohibition, but regulation, information has been upheld. So I would think that Constitutional doctrine is already there to allow appropriate publicity regulation of these activities. Because, if anything, it is less than the lobbying, although it is an important thing for us to look at.

I also wanted to note and to comment to my colleague Mr. Jones, we obviously differ with some of what was done in the past, but I would point out that, as a result of this committee's actions, going forward, first of all, the power under which the Federal Reserve made some of those loans has been abolished. Section 13(3) of the Federal Reserve Act no longer exists. I will say that I believe that the Fed acted appropriately and that, in fact, the Federal Government will make money on those things and I think they were helpful. But, going forward, they will have to be done under more constraint and reported.

And, secondly, as a result of the legislation that was signed, no transaction, no transaction whatsoever, between the Federal Reserve and any private entity will go ultimately unreported. Now, there will be a time delay, in some cases, so you don't have a market impact. But that is—I think that what happened was, on the whole, constructive. But we have severely changed it.

As a matter of fact, you mentioned “too-big-to-fail.” Current expert opinion is that we went too far in the legislation, not total, but there are complaints that it has now become too hard in case of a crisis, and indicative of the fact that, from the standpoint of many analysts, we are never able to do anything right. We are either too much or too little. We have gone from being accused of tolerating

“too-big-to-fail” to now being “too-stingy-to-bail.” That is the current—The Economist ran a simulation and was very upset to find out that we can’t bail people out anymore. We believe that, in fact, yes, we knew that, and that is appropriate, and that will affect their behavior.

But let me just ask—the one, I guess—one last point I wanted to make, and I appreciate the chance just to make these. Because I heard reference as I was coming in, the gentleman from Texas talking about the Full Faith and Credit Clause. And I want to make a bipartisan criticism of the Congressional leaderships going back as far as I can remember. They are inclined to overuse the Full Faith and Credit Clause to shelter us, including, there have been arguments made by House counsel, supported by the leadership of both parties, that even taking bribes can, in fact, be sheltered from criminal prosecution if the act for which the bribe was taken could be put under the Full Faith and Credit Clause.

So I am telling the Members now—and I have had some arguments about this. I will be asking—and I would put our leadership on notice. From now on, I think we ought to have a full discussion of how much to use the Full Faith and Credit Clause.

Look, the Full Faith and Credit Clause had a very important purpose in the late 1500s and early 1600s, and it was to prevent Queen Elizabeth and King James from prosecuting members of the House of Commons who said things that they didn’t want them to say. That is also, by the way, why we can’t be arrested on the way to work, because the rule was that, once you were in parliament, they couldn’t get you. So they could stop you from getting there, and they could prosecute you afterwards.

Those two provisions of the U.S. Constitution were reactions to Tudor excesses. And I think it is time now to say, you know what, we are probably pretty safe from Queen Elizabeth. The second one may be a problem, but I don’t think so, but the first one is long gone.

And I believe there has been an overusage of the Full Faith and Credit Clause. And I say that because that is directly relevant here, and we will find people trying to hide behind Full Faith and Credit.

So, in addition to what we are doing, I believe it is important for the Members to be ready, and I think we probably ought to have some kind of session with our leadership. The narrower the Full Faith and Credit Clause is used, the better it will be. People should not be prosecuted for things they say on the Floor, for libel or for other reasons, but the Full Faith and Credit Clause should not be a shield here.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

Mrs. Biggert?

Mr. FRANK. I kept saying “Full Faith and Credit.” I meant “Speech and Debate.” But I also want to say—

Chairman BACHUS. We will give you full credit for saying “Speech and Debate.”

Mr. FRANK. I appreciate that. And I ask for immunity from having made that misstatement.

Ms. SLAUGHTER. But speaking of the Full Faith and Credit, Mr. Frank, I must tell you how much I appreciated your comments that we have troops all over the world and that we don't any longer have the necessity of protecting Germany from Stalin. And, again, like we are doing here, we really need to look at things pretty closely to see how much it makes sense.

Mr. FRANK. It is the Speech and Debate Clause, and I don't know what got into me. But that has been, unfortunately, by both leaderships, they have protected us, and that is part of this problem. And I have literally seen invocations of that from both parties' leaderships. People have argued that it immunized people who took bribes from prosecution, and we cannot allow that.

Ms. SLAUGHTER. No.

Chairman BACHUS. Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

I don't have too many questions, but just—I think this is an important hearing. I am concerned about the fact that—I hope that we don't overreact. We have a tendency to do that every time there is a crisis, and we overreact. I think we did that in Sarbanes-Oxley, and we did it in a lot of things.

My concerns are some of the things in the bill that I think will come up, and one of them is the reporting requirement of within 90 days of the numbers of—for people who would have to file, and even with a mutual fund. Within 90 days, people wouldn't even have—I don't think they would have the knowledge of that within that 90 days.

So I think there is a lot—we seem to have an awful lot of myths about Congress, and I don't want this to be one of them. For example, I go back to the district and people say, "Well, you don't have to pay Social Security," or "You get a pension after 1 day of service and a full salary." They don't understand the formulas and how many years it takes. Or with health care, we don't have to pay for health care. We do have—I have Blue Cross Blue Shield.

So I think that some of these things can be driven by the fact that there isn't an understanding of how Congress works, how our Ethics Committee works, so that I think we have to be careful that we don't overreact.

I think bringing this to our attention is really good, but we have to be very careful that we spell out specifically and not just make it that this is Congress and a usual thing, because it is not. I think most people come here with very high standards, and it just seems like all this takes us down, and it really worries me.

With that, if anybody would like to respond, I would—

Mr. WALZ. I would. Thank you, Ms. Biggert. And I couldn't agree more with you. As I say, I certainly take no joy in this.

My largest, biggest frustration with the "60 Minutes" story is that I think, if we had passed this thing, we wouldn't have had it. I think it would have been clearer. And my goal was to make sure we didn't have that, because I take no pleasure in seeing colleagues who I know have integrity being drawn into something that is very ambiguous, as you are saying.

And then I think when we overreact, we give the impression that everyone here is acting in an improper manner, and that is not

true. So I very much appreciate your words of, I would argue, wisdom.

I think Mr. Hensarling brought up some very good points in understanding wanting to fix this but do this in a measured manner that makes sense. Because there is going to be a cynicism amongst the public that, "Oh, look, now they are concerned, because it was on TV. Now they are going to do something. But is it ever really going to be enforced?" They have to believe that there is a strong desire to make this right, to put those things into place that make the transparency there.

We thought long and hard about these things. And, as I said, I certainly can't speak for my colleagues; I will let them say it. But I am more than willing, if this is the vehicle, to make the changes to improve it. That is how the best legislation is done, together in a bipartisan manner, to make it there, and we are certainly open to those suggestions.

But I agree with your sentiments wholeheartedly. And I want to be very clear about this: It is certainly not about bringing a hot light of shame to the Congress; it is bringing a hot light of transparency and openness. And I think if you do this right, the flip side of that is, look at the vast number of Members who are doing it correctly and doing it right, and that restores faith.

So thank you for those comments.

Mrs. BIGGERT. I thank you.

And I yield back.

Chairman BACHUS. Thank you.

Our three colleagues have graciously agreed to answer questions from the committee. In deference to the demands on their time and the fact we have two other panels to get to today, I am hoping we can exercise some restraint and not keep them all morning.

Ms. Slaughter?

Ms. SLAUGHTER. I want to thank you for that. I am supposed to testify before Transportation in 10 minutes.

Chairman BACHUS. Okay. So, in that spirit, is there anyone else who would like to ask questions of this panel?

Mr. Manzullo?

Mr. MANZULLO. Yes.

Chairman BACHUS. Sure. Go ahead.

Is there anybody on the—Ms. Waters first, and then we will go.

Ms. WATERS. Thank you very much.

First of all, let me thank Louise Slaughter for initiating this legislation a long time ago and absolutely understanding that there may be a serious problem here.

I just picked up a book called, "Throw Them All Out," and I am reading the so-called accounts of insider trading by Members of Congress.

Is there something to being able to separate out inadvertent actions from a pattern and practice that can be identified by a Member?

That is what concerns me a little bit. I think it is important that we know the difference between information that may have been picked up that one may not even know the meaning of and someone who appears to have access to information who consistently trades and earns money.

Is there a difference? And how does this legislation deal with that?

Ms. Slaughter?

Ms. SLAUGHTER. Actually, it just says we will not do insider trading, both for Members and staff.

As I pointed out a while ago, Ms. Waters, before you came, the most important part of this bill, to me, is what we have done to this whole industry called "political intelligence" that does not have to—they lobby and they give confidentiality to their clients because they don't have to report it at all. It is worth \$100 million a year, and the STOCK Act says simply we don't try to do away with them but just that they will be forced to sign these lobbyists, register with both the House and the Senate.

But we don't go into deep separation of who does what. I think for a lot of people, it may come as a great surprise that we are not supposed to do this. I would imagine that a staff person on one of the major committees would be a delightful dinner companion, if we allowed people to go to dinner anymore—thank goodness we don't do that—to tell everything that is going on in that committee. No matter how innocently they may do it, the fact that other people can make money off that information is something that should give us pause.

Ms. WATERS. Thank you very much.

Mr. WALZ. I think, Ms. Waters, if I could add, I think—and this is a question I asked the SEC folks and some of these witnesses following us that are experts in this, the 34 Securities and Exchange Acts, 10b-5. There is ambiguity in how the law is written in the first place. And some of it is to make sure that folks weren't, by—it could be pure chance, it could be that you are not putting someone under jeopardy of prosecution for something that was not insider trading even though it may have looked like it from the outside—and we are always very careful of that.

I think it goes back to Ms. Biggert's point on this. To overreact and create a criminal action where there isn't one is certainly not the intent of this law. And I think maybe asking those questions, it is the ones we have asked of them and they have been helpful with us to—and they have assured us the STOCK Act has that ability, to separate out those inadvertent acts.

Ms. WATERS. Thanks very much, Mr. Chairman. I yield back the balance of my time.

Chairman BACHUS. Mr. Manzullo?

Mr. MANZULLO. Thank you.

Certainly, no one is questioning the intent or motives of the legislation, because it is fine with me. The issue is the disclosure. What we are essentially doing is, the disclosure act that we fill out the compliance with every year lists all the stocks and transactions. But who is missing from this panel are people who handle things like mutual funds.

Mr. Chairman, I would hope we would have at least another hearing on this. My mutual funds are held at a house. I don't choose which funds they put the money into. And then, every 90 days, I get a report as to what the transactions were that took place.

Ms. SLAUGHTER. But this is not what—this is through personal trading, what the Congressperson does or what the staff does. All of us have some accounts, I suppose, and mutual funds. We are not expected to account for every trade that they make.

Mr. MANZULLO. No, I understand that.

Ms. SLAUGHTER. Unless you have told them that asbestos, for example, is not going to be punished; therefore, the price of asbestos should go up. And I am assuming you are not doing that to—

Mr. MANZULLO. I don't know if there is an asbestos mutual fund. I am just saying that—

Ms. SLAUGHTER. That was one of the cases that really prompted—

Mr. MANZULLO. But what most Members of Congress do is they put their money into a mutual fund—and I have a house back in Rockford—

Ms. SLAUGHTER. Some do, not all.

Mr. MANZULLO. I don't actively trade. I own one stock that is worth about \$2,000. The rest is all mutual funds.

And the issue here is on compliance, because, as you know, when we fill out the annual form, we get from our investment house the transactions that took place during the course of the year. So now, this moves it up to 90 days. I don't have a problem with it, but, functionally, you will get the 90-day statement after 90 days have run on the beginning of those transactions. Are you with me?

Ms. SLAUGHTER. I am with you.

Mr. MANZULLO. And so that is why, Mr. Chairman, I would—we don't have anybody here who runs an investment house. We ought to have the mutual fund people here and be able to take an ordinary portfolio and say, these are the functional problems that can happen with regard to the disclosure. And that is why, if you look at—

Chairman BACHUS. Reclaiming the time—

Mr. MANZULLO. Yes?

Chairman BACHUS. —I am going to—Ms. Slaughter has to testify before another committee.

So, at this point, you can be excused, Ms. Slaughter.

Ms. SLAUGHTER. Thank you so much.

Chairman BACHUS. And would the other two gentlemen be willing to stay?

Mr. Jones, you are on the committee.

Ms. SLAUGHTER. And I am always hanging around the hall, so anybody can reach me anytime. I thank you very much for allowing me—

Chairman BACHUS. You will be available to Members?

Ms. SLAUGHTER. Absolutely.

Thank all very, very much.

Chairman BACHUS. All right. Mr. Manzullo, go ahead.

Mr. MANZULLO. I guess my question is the people who actually handle the transactions, the ones who kick out the data have not been on the witness list. It is because you can't think of everything in looking at legislation.

My question to you is, would you be willing to have another hearing as to the people who would handle the portfolios just to make sure that they would be able to follow this legislation? I don't have

a problem with the intent or the nature of it. It is just the mechanics of it.

Chairman BACHUS. We can have as many hearings as we want to.

Mr. MANZULLO. Okay. Thank you.

Chairman BACHUS. We can explore all sorts of different things.

Mr. Scott?

Mr. SCOTT. Yes. I think it might be helpful if you could comment and get some clarity on the question of the narrowness of the application of this legislation. For example, it is limited to nonpublic information relating to any pending legislation. And there is an omission of tipping by Members of Congress or their staffs. If you could kind of give us some indication as to how this works, and why there is an omission of the concerns of tipping by Members of Congress or their staffs, and why it is limited only to nonpublic information material on pending legislation. Do we need to strengthen that any?

Mr. WALZ. Thank you, Mr. Scott. And again, and back to Mr. Manzullo, I think the questions you are bringing up are exactly right. That is why we look to the wisdom of this committee, who deals with these issues, to craft this and bring something to the Floor that works.

On the issue that Mr. Scott brought up, this narrowness issue is one we really struggled with. There are two schools of thought. And I think you will hear a very compelling argument, one we listened to greatly from Professor Nagy, who will be on the second panel. Some of this is the ambiguity of the law as it was written in the 1934 law that went into effect in 1942. Our take on this was to go back also where Ms. Biggert was, instead of having an overarching blanket on this, to be very narrow as to the types of behaviors that were deemed to be inappropriate. And the belief was, as the ranking member said, might be being protected by the Speech or Debate Clause wrongfully. So we narrowed in on the very key aspect of what does a Member of Congress benefit on here that could be translated into trade? And it was that knowledge that the public wouldn't get. That becomes a very difficult question. My standard for myself is I assume every piece of information I get here that I wouldn't have gotten in that classroom in Mankato, Minnesota, teaching geography to be knowledge I gained from the job.

Now, it goes back to where Mr. Manzullo is. That is easy for me to say, as someone pointed out, you are poor and don't trade stocks. But my point on this is not to jam someone up, not to make it so that they can't do what they need to do. The American public trades stocks. If we are a representation of that public, it would make sense that there would be people here. The question was, are they doing it in a fair, unbiased manner? So there is a great debate that as you narrow it, and I don't want to speak for Professor Nagy, that you may cause more problems by being overly narrow. And that is something that we addressed. I didn't come to that conclusion, but there is certainly a school of thought out there on that.

On the issue of tipping and tippees, this is where the political intelligence firms and the information going down, this issue of tipping and tippee as is addressed by the SEC in many instances, this is where the real problem might lie of inadvertently saying some-

thing at Thanksgiving dinner that your brother-in-law was able to use. And how would that come back to it when there was no intention by the Member of Congress to profit by it, but the information was passed forward and how the SEC views that.

Mr. SCOTT. So you are saying, going back to tipping, that the omission of the tipping in your view does not limit the effectiveness of this bill?

Mr. WALZ. No. And I think it is addressed, Mr. Scott, in the political intelligence firms. That is dealing directly with the idea of tipping. Now, those are under the impression that they are purposely coming to gather that information to go and use that information they were paid to gather for someone else. That is the tipping that is being gathered by that, and it is addressed under that portion of it. But what you are talking about is a broader issue, maybe this family member issue, of they are not a political intelligence firm, but information was passed on. The way we interpret it, and this is where it gets, again, whether the law is needed or not discussion, that issue of tipping amongst fiduciary responsibility, the idea if I have that responsibility, that is already in the law. And the SEC will go after you if you tip your brother-in-law off to something, whether inadvertently or on purpose. We think that this just clarifies and uses the enforcement of existing SEC to apply here. If that makes sense.

Mr. SCOTT. I think then the tipping, from my understanding, is that what you are saying is that cannot be effectively enforced with legislation. That is a behavioral—how do you police that?

Mr. WALZ. You may be right. The SEC again may be best on that. It is something I think they struggle with. And I was struck by this whole debate on the ambiguity of the original law and how it is still used. Some of the cases, we went back and looked at court cases, *O'Hagan v. U.S.*, a clear-cut case of a law firm using insider information on stock trade, to some of them are far more ambiguous. So it is a difficult one.

What we are trying to do, and what we think this does is set the bar higher for Members of Congress, let the public know that it is going to be very difficult to do this. And if it is done, there are repercussions for it. It doesn't get into the sticky point of how deep down that rabbit hole of insider trading can you go.

Mr. SCOTT. Thank you very much. I appreciate it.

Chairman BACHUS. Let me read the list on the Republican side, because I made a mistake and called on Mr. Manzullo, but it is supposed to be in the order that they arrived. And that would put Mr. Posey next, followed by Mr. Luetkemeyer, Mr. Huizenga, Mr. Duffy, Mr. Dold, Mr. Canseco, Mr. Schweikert, Mrs. Capito, Mr. Grimm, Dr. Hayworth, Mr. Neugebauer, Mr. Renacci, Mr. Fitzpatrick, Mr. Pearce, Mr. Stivers, and Mr. Hurt. So at this time, Mr. Posey is recognized.

Mr. POSEY. No questions.

Chairman BACHUS. Mr. Duffy?

Mr. DUFFY. Thank you, Mr. Chairman. And I appreciate the witnesses coming in. Mr. Walz, I appreciate your passion, and I appreciate your leadership on this bill as well. I want to kind of run through some of the thought processes of what is included and maybe what is not included in the legislation. I know we have a



\$1,000 trigger for the reporting. Is that \$1,000 per trade or is that a threshold amount? So if I do two \$950 trades, I obviously would be over \$1,000 and then have to report? Or could I trade Apple stock, \$950 trades, multiple in a day and I don't have to report?

Mr. WALZ. It is per trade.

Mr. DUFFY. Per trade. I could actually—

Mr. WALZ. Yes.

Mr. DUFFY. I could trade \$50,000 in a stock if I keep every trade under \$950. Is that right?

Mr. WALZ. Theoretically, that is correct.

Mr. DUFFY. Okay. And that is one of my concerns. Again, I commend you. I think the leadership here is fantastic.

Mr. WALZ. This kind of goes back to our reporting requirements of those zones, which are silly, but we do them I think for ease. Again, so your argument I think is well put.

Mr. DUFFY. And I think to the point I think the American people want sunshine. Sunlight disinfects. And I think we should let that light shine into every corner. I appreciate your willingness to say you know what, it may not be perfect. I am open to suggestions for improvement. Is there a reason why we picked \$1,000 and not if you trade anything, you have to report it?

Mr. WALZ. I think it was the same reason we do the zones on the reporting requirements, is the ease, some of the things Mr. Manzullo is talking about, the paperwork on this. We understand this, if we went to the pure 48 hours that CEOs on Wall Street have to abide by on their trades, the problem we have is we simply don't have the staff to handle that. So part of that was that was the threshold level. From a theoretical argument, I am certainly with you. One should be the number.

Mr. DUFFY. We might be excluding ourselves in the amount of trades that you and I make, but others in the House might be making larger.

Mr. WALZ. I think it makes sense.

Mr. DUFFY. And I notice you didn't include a blind trust aspect. In the bill that I drafted, I included a blind trust. Is there a reason—if you really want to take it out of the hands of Members, and Members want to protect themselves, they can take their assets and put it in a blind trust. Is there a reason why you didn't?

Mr. WALZ. One of the things I will stress again, is this is the bare minimum. It took us 6 years to get 7 people, and it was as easy as it possibly could be. If we had gone to that level, I think we would have probably gotten the same seven. But we tried to pass this before it became an issue. We tried to pass it and bring it to the committee where it was palatable, like most legislation is, leaving openings for improvement from the committee. I am certainly for it. I think you have to be careful that I don't want to incur a fee on a blind trust because I don't need one.

Mr. DUFFY. That is why I include an option you can use a blind trust or—

Mr. WALZ. Sure. Then I think that is what this committee should do.

Mr. DUFFY. And I think if we are going do it, I think we should do it the right way. I think there is a movement in the House. There are a lot of ideas that permeate throughout these buildings

that don't come up for years. But when there is a movement to move a bill, I think we should get the best bill possible. And my fear is that it sounds good and it feels good, but I think the American people, if it doesn't actually accomplish the goal, they look back a couple of years from now and go, man, people are still getting around the great STOCK Act.

Mr. WALZ. I think it would work, but I do think the STOCK Act, I think we have thought about this—it wasn't crafted overnight. And it was a lot of conversations, it has been around for 6 years. But I am certainly willing to improve it.

Mr. DUFFY. And I would throw out that I know we have a 90-day time period. Listen, things move quickly. In my bill, I threw in a 3-day time period. Why can't a Member, if you are going to trade stock, within 3 days report it to the House? In 3 days, say, this is the trade I have made. So if there is big news, and you are trading against the big news that is in the Wall Street Journal, and you are going in a different direction, it is like, were you meeting with someone who gave you insider information? I think that kind of transparency—

Mr. WALZ. You are preaching to the choir with me, but you might have to ask other Members what they think of that one.

Mr. DUFFY. And quickly, my concern too is we have the House and the Senate. The President, I know, oftentimes has a blind trust, but I don't think he is required. But also, his staff comes into insider information just like our staff. Why isn't the Executive Branch included in this bill? And then the Judiciary as well? We should include the Judiciary and their senior staff as well. If we are going to do this in government—

Chairman BACHUS. Mr. Duffy, they already have their rules.

Mr. WALZ. Yes.

Mr. DUFFY. And Judiciary as well?

Mr. WALZ. Yes.

Mr. DUFFY. Is it consistent with what you proposed, the 90-day disclosure rule, blind trust rule?

Mr. WALZ. Yes.

Mr. JONES. Mr. Duffy, if I could very quickly interrupt, and I will be very quick, Mr. Chairman, that is why this hearing today just shows exactly why we have an opportunity. I appreciate your bill going in and your resolution going in. And if nothing else comes from this but meaningful legislation that the Congresses of next year and the year after that, they know what is right and what is wrong, then the American people will win. So thank you for what you are doing and what you are doing as well. And let's come together and make this something that we can all join hands on and be proud of because the American people can see we care about integrity in the Congress. So thank you for what you are trying to do.

Mr. DUFFY. Mr. Walz, I appreciate your openness to try to find ideas that are going to work. But I would say, let's do the right thing. There is a movement right now to get it done. Let's do the best bill possible.

Mr. WALZ. We are certainly for being stronger, 170 stronger than we were last week. So we are ready.

Mr. DUFFY. I yield back the time I don't have.

Chairman BACHUS. Thank you. Any other questions by Members? If not, the panel is excused.

Mr. WALZ. Thank you, Mr. Chairman.

Mr. JONES. Thank you, Mr. Chairman.

Chairman BACHUS. Our second panel is made up of Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission. We welcome you and we look forward to your opening statement.

**STATEMENT OF ROBERT KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)**

Mr. KHUZAMI. Thank you. Chairman Bachus, members of the committee, thank you for the opportunity to provide testimony on behalf of the United States Securities and Exchange Commission on the subject of the application of insider trading prohibitions to Members of Congress.

Insider trading threatens the integrity of our markets, depriving investors of the fundamental fairness that comes with markets that are open, transparent, and fair, and all citizens of the benefits of economic growth and stability that comes with markets that operate on a level playing field. Because these goals are so important, prosecution of insider trading has been a top priority of the Division of Enforcement. Approximately 8 percent of the 650 average annual number of enforcement cases filed by the Commission in the past decade have been for insider trading. In Fiscal Year 2010, the SEC brought 53 insider trading cases against 138 individuals and entities, a 43 percent increase in the number of filed cases from the previous fiscal year. In this past fiscal year, we filed 57 actions against 124 individuals and entities, a nearly 8 percent increase over the number of filed cases in the previous year.

Now, there is no express statutory definition of insider trading. Rather, the SEC prosecutes insider trading under the general antifraud provisions of the Federal securities laws, most commonly Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, a broad antifraud rule promulgated by the SEC under that section. Section 10(b) declares in relevant part that it is unlawful "to use or employ, in connection with the purchase and sale of securities, any manipulative or deceptive device or contrivance" in contravention of SEC rules.

There is no reason why trading by Members of Congress or their staff would be considered exempt from the Federal securities laws, including the insider trading prohibitions. Having said that, the application of these principles to such trading, particularly with respect to Members of Congress, is without direct precedent and may present some unique issues. Just as in any other insider trading inquiry, there are several fact-intensive questions that would drive the analysis of whether securities trading or tipping by a Member of Congress or a staff member, based on information learned in an official capacity, violates Section 10(b).

The first question is whether the trading or communication of the information to someone else breached a duty owed by the Member or staff. Although there is no direct precedent for Congressional staff, there is case law from other contexts regarding misappropria-

tion of information gained through an employment relationship. This precedent is clear that a Congressional staff member as an employee owes a duty of trust and confidence to their employer, and that a Congressional staff member who trades on the basis of material nonpublic information obtained through his or her employment is potentially liable for insider trading, just like any non-governmental employee.

With respect to Members, courts have held in contexts other than insider trading that Members have fiduciary or fiduciary-like duties of public trust by virtue of their position. That such duties exist is reinforced by ethics rules applicable to Members, which provides that Members should not use information obtained in connection with their official duties for personal gain or private profit.

However, this is untested. There is no case law that addresses specifically the duty of a Member with respect to trading on the basis of information the Member learns in an official capacity. And commentators differ on the existence or reach of such duties.

The second question is whether the information on which a Member or staff trades or tips is material; that is, is there a substantial likelihood that a reasonable investor would consider it important in making an investment decision? Materiality is a mixed question of law and fact that depends on all of the relevant circumstances. In some scenarios, it may be relatively clear that upcoming Congressional action would be material to a particular issue or a company, while in other cases, it may be less clear.

The third critical question is whether the information on which the Member or staff traded or tipped is nonpublic. The Commission has stated that: "Information is nonpublic when it has not been disseminated in a manner making it available to the general public." Whether information is nonpublic would likely depend on the circumstances under which the Member or staff learned the information and the extent to which the information has been disseminated to the public. As with all issues of liability with regard to insider trading and other claims under Section 10(b), the conduct at issue must be intentional or reckless, or put another way, not in good faith. Since all of these issues are inherently fact-specific and difficult to generalize, it is hard to come to any general conclusions about the likely outcome of any particular scenario.

Now, while trading by Members of Congress or their staff is not exempt from the insider trading prohibitions, there are distinct legal and factual issues that may arise in any investigations or prosecutions of such case. For example, investigations into potential trading or tipping by Members of Congress or their staffs could pose some unique issues, including those that may arise under the Constitutional privilege provided to Congress under the Speech or Debate Clause. That said, in light of existing insider trading legal precedent, any statutory changes in this area should be carefully calibrated to ensure that they do not narrow current law, and thereby make it more difficult to bring future insider trading actions against individuals outside of Congress.

Thank you for the opportunity to testify today, and I would be happy to answer any questions.

[The prepared statement of Director Khuzami can be found on page 75 of the appendix.]

Chairman BACHUS. Thank you, Director. On the next panel, we are going to hear from Professor Nagy of the Indiana Law School. I read her testimony last night. And she states that Congress could use this current controversy to diagnose and treat the entire malady through the enactment of an express statutory definition and prohibition of insider trading for all individuals. Do you believe that the Congress should enact such an insider trading law?

Mr. KHUZAMI. Mr. Chairman, my view is that I think there is a simpler and clearer way to get to the same outcome without risking some of the dangers that would flow from a general statutory prohibition that attempted to cover the entire field of insider trading. The single biggest issue is, as I mentioned in my opening statement, whether or not there exists a duty, either a fiduciary duty or a duty of trust and confidence between Members of Congress and others, be it their fellow Members, be it the institution, be it the citizenry. And that duty is essential in one form or another for there to be the ability to bring an insider trading case.

From a pure enforcement perspective, I think the simplest and cleanest way would be simply to declare that such a duty exists, that Members have a duty not to use information gained in the course of their Congressional service for private gain or personal gain. With that duty, insider trading cases could then be brought, assuming they met the other requirements that I mentioned: scienter, which means intentional conduct, materiality, nonpublic, etc.

But those concepts I think are well developed in the law, and don't need to be included in a general statutory prohibition, the danger of which would be obvious. You might have two sets of standards, one in the statute that Congress drafted pertaining to itself, and one for everybody else. It could breed litigation or attempts to interpret what Congress did as changing existing law in the other areas.

So from my perspective, I think that is the simplest and cleanest way to go.

Chairman BACHUS. Are you available to work with the sponsors of this bill to review the legislation and make revisions consistent with what you have just testified?

Mr. KHUZAMI. Absolutely. Our staff at the SEC have been involved in extensive discussions on the details of the legislation. We would be happy to continue to do that.

Chairman BACHUS. All right. Thank you. Ms. Waters?

Ms. WATERS. Thank you very much. There appears to be some consensus that Members and employees of Congress are subject to the same rules on insider trading as others who use or disclose material nonpublic information of a company. But many questions remain as to application to Congress. If the STOCK Act becomes law, would the SEC's existing authority continue to apply to a Member or employee of Congress? If not, how would the SEC's new authorities differ?

Mr. KHUZAMI. The Act, in some cases, I think narrows existing law, and in other cases, it expands it. And so while we would still retain our authority potentially to bring our cases under existing law, the fact that Congress had passed a new piece of legislation to cover the field means that it would really be the source of our

authority to bring cases against Members of Congress. And if you compare it to the existing authority, there are a couple of instances in the STOCK Act where it narrows existing authority. For example, as was just previously discussed on the last panel, insider trading is limited to—excuse me, material nonpublic information is limited to that which deals with pending or prospective legislation, meaning that information that a Member of Congress might obtain, for example, from a briefing from the Executive Branch or a briefing from a regulatory agency, wouldn't be covered necessarily because it wouldn't deal with pending or prospective legislation. That conceivably is a narrowing of the current law.

The STOCK Act doesn't explicitly address tipping, which was discussed in the last panel as well, whereby existing authority says if you have a duty to keep information confidential, and it is material and nonpublic and you pass it to somebody else, you, the tipper, can be liable for doing that, as well as the tippee, the person receiving the information for trading. But the STOCK Act currently doesn't address that issue directly.

So I think again, for that reason, in order to have one uniform set of standards that apply to everyone, highlighting and establishing a duty on behalf of Members of Congress not to use the information they gain in their Congressional service for personal gain, and declaring that a duty would be the simplest way to go.

Ms. WATERS. Thank you. That is all. I yield back the balance of my time.

Mrs. BIGGERT [presiding]. Thank you. I recognize myself for 5 minutes. Do you know anything about the ethics procedures that we have? I served on the Ethics Committee for 3 terms. Fortunately, that is as long as you can stay on it. But I think it is a very important part of the Congress. I am just wondering if what is in that covers us at all that you would know of.

Mr. KHUZAMI. Obviously, as an enforcement authority, our job is to investigate and file cases based on a violation of the law. We can't file cases on the basis of ethics violations, obviously.

Mrs. BIGGERT. Right.

Mr. KHUZAMI. But anything that enhanced the ethical obligations of Members of Congress not to use information for personal and private gain, which is I believe currently—

Mrs. BIGGERT. Which is, yes.

Mr. KHUZAMI. —currently what the rules provide, helps us, because they help to establish this duty of trust and confidence. So if I were to go into court tomorrow with such a case, I would point to the ethics rules as a basis to say, yes, a duty already exists. But I think the benefit of the legislation that is being discussed is that I can't guarantee how a particular court might rule on that argument one way or another. But if there was a piece of legislation that had been passed that made it clear that there was such a duty, a lot of that ambiguity and uncertainty would be resolved.

Mrs. BIGGERT. Do you think that would be enough, rather than having the legislation, if the ethics was clearer?

Mr. KHUZAMI. I don't think it would be because, again, if there is a law that says such a duty exists, that is pretty clear and unambiguous. And I think it would reduce the uncertainty that a court might not find such a duty.

Mrs. BIGGERT. You certainly made it very clear that Members are not exempt from the insider trading laws. But there seems to be a swell from some people that reports to the contrary, that because Congress is not a corporation or a company or an entity as such like that, that they are not subject to the law. How do we get—put that all together?

Mr. KHUZAMI. I think hearings such as today's and last week's should make it pretty clear that there is no such exemption, and that you are subject to the same laws as everyone else, leaving aside things like the Speech or Debate Clause.

Mrs. BIGGERT. Thank you. I yield back and recognize the gentlelady from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Thank you for your testimony. And I just want to go over what you were saying that you think it should be expanded to cover tipping and other meetings with other agencies. Would you also include the SEC no-action letters and other actions like that? And do you think that would be broad enough if that was all included?

Mr. KHUZAMI. The no-action letters, along with some other means, are designed for a way to carve out certain safe harbors, or to give individual Members or individual persons comfort that what they are about to do won't violate the law. So if we pass such a law that proclaims such a duty, Members could take advantage of no-action letters, get advice from their own counsel, and take other steps to make sure that they didn't do something that inadvertently violated the law. So I think that would be an important part of any overall regulation in this area. And that option exists already, frankly.

Mrs. MALONEY. And if we do have a fiduciary duty with the citizens, and an ethics responsibility, how would the SEC investigate in those categories? How would they change what you are doing now, or would it change what you are doing now?

Mr. KHUZAMI. First, let me just be clear, I am not sure I would necessarily characterize it as a fiduciary duty, because the law also recognizes what would be a fiduciary-like duty, if you will, of a duty of trust and confidence that kind of has its origins in fiduciary duty, but is kind of a different creature. And my view would be it should be added as one of the examples of a duty of trust and confidence that would be owed. Because there are potential consequences that the academics and others on the following panel probably are better versed to discuss than I am. But there could be consequences to proclaiming a fiduciary duty that wouldn't necessarily be intended or couldn't be foreseen.

But that would be my personal view as to the best way to approach it. How would it affect our investigations? Frankly, it wouldn't. It would clear up the law, which means there would be less of a risk that a particular court would decide that such a duty didn't exist based on current circumstances.

The other thing that could be done, frankly, that I think is a critically important part of the STOCK Act, is the disclosure portion. Without disclosure of trading on a timely basis, it is difficult to get notification of circumstances that might justify investigation. We get tips and referrals on insider trading cases by all sorts of persons, from the exchanges, and from other sources. And we get

that often on a real time or near real time basis. And that is critically important to conduct an investigation, to get the information fresh. Memories are still sharp. Steps haven't been taken to cover up or conceal activity. So prompt disclosure, preferably electronic, and preferably searchable, would be probably the single most important thing that could be done for our investigations.

Mrs. MALONEY. Are there other legislative approaches out there that you are aware of in this area?

Mr. KHUZAMI. They tend to break down in between, the narrow approach, like simply establishing the duty and leaving it to existing law to address the other elements, or a statutory prohibition that attempts to define all the terms, such as scienter, and materiality, and nonpublic. And that I think is difficult to do. It was tried in the 1980s I think in general, and I think people gave up because it is very difficult to write a law that covers all the possible facts and circumstances to make sure that no one who should be captured is left to the side. But then you end up not providing the kind of specificity and guidance that you might like because it is so general and broad. And also, you don't want to kind of provide a roadmap for people to understand exactly what line they have to tack against in order to avoid liability. So that is kind of another reason why we prefer the narrower approach.

Mrs. MALONEY. Okay. Thank you. My time has expired. Thank you.

Mrs. BIGGERT. The gentlelady yields back. The gentleman from Missouri, Mr. Luetkemeyer, is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman. Director, I am just kind of curious, one of the things that concerns me is we can promulgate a lot of rules and regulations and new laws, but if we don't enforce them, we have just wasted all our time. And I guess my concern is, we have the MF Global situation here, and people, when I was home over the weekend, were talking about that, and what are you going to do about it? What are you going to do about it? I said, well, they broke the law, apparently. And if that is the case, they need to suffer some punishment, go to jail, whatever. And the rules are already in place.

So I guess my question to you is, the rules that are in place right now, is there an enforcement mechanism in place to enforce those rules?

Mr. KHUZAMI. Yes. There is an Enforcement Division.

Mr. LUETKEMEYER. If we pass this bill, is there an enforcement mechanism in place in this bill?

Mr. KHUZAMI. By enforcement mechanism, you mean just the ability to—

Mr. LUETKEMEYER. Right. You will be able to enforce this law. Is that correct?

Mr. KHUZAMI. Yes.

Mr. LUETKEMEYER. Okay. Is there going to be a difference between your ability to enforce the law and the penalties versus the rules that are in place right now?

Mr. KHUZAMI. Yes, in at least one sense. It reduces the risk that comes with the lack of clarity in the law as to whether or not such a duty exists between Members of Congress or the citizens or others. There is a risk currently that no court has decided that issue.



If we were to bring a case, a certain judge might look at it and say that no such duty exists. Whereas, if we had the legislation, that risk would be eliminated.

Mr. LUETKEMEYER. Okay. Have there been enforcements of the rules in the past, or the laws in the past? Have there been cases brought?

Mr. KHUZAMI. Insider trading cases in general?

Mr. LUETKEMEYER. Yes.

Mr. KHUZAMI. Yes.

Mr. LUETKEMEYER. Have they been referred to you by the Ethics Committee, or are they referred to you by other outside groups, or how do you become aware of them?

Mr. KHUZAMI. They come from all sources. They come from the exchanges, they come from letters, and emails, and cooperating witnesses, and things we read in the newspaper, and a dozen other sources.

Mr. LUETKEMEYER. You made the comment a couple times already with regards to some things that could either broaden or narrow your ability to do your job here. And I certainly hope that the authors of the bill will work with you to make sure that happens. My only comment I guess is from the standpoint that while the American people are outraged about things that happen here, and the things that they perceive may be inconceivable or incongruous of what we should be doing, the enforcement of existing rules and laws I think is critical from the standpoint that if somebody does something wrong, there has to be a punishment of some kind. Just a waving of the wand of forgiveness over everybody is not necessarily the way it should work. And I am just kind of curious as to your perception of how you see this all happening, your ability to enforce this and work with everybody.

I appreciate your views this morning. Thank you very much, and I yield back the balance of my time.

Mrs. BIGGERT. The gentleman yields back. The gentlelady from New York, Mrs. McCarthy, is recognized for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you, Madam Chairwoman. And thank you for giving your testimony. In your testimony you note that right now we have statutory changes needed to be carefully crafted to ensure that they do not narrow current law, and you talked about that a little bit in your opening statement, making it more difficult to pursue future violations of insider trading. The legislation requires your agency and the CFTC to adopt rules to help. How do you envision the agencies working together, as well as ensuring that the rules do not have an adverse effect on enforcement of inside trading? And I guess, how do you pick somebody up who has done inside trading? What are those signals? How do you look for those?

Mr. KHUZAMI. How do you detect the violations? They come from a number of different sources. First, the exchanges have analytics and software in which aberrational trading kind of pops out of the system. So if they see a spike in options trading 10 days or fewer before an announcement of a takeover, that will jump out of the system. And then an investigation will be done to trace back to see who is trading in those accounts. And then you look to see whether or not those persons, assuming you can identify them, have connec-

tions to the source of inside information that you would expect to see in such a circumstance, such as the bankers or the lawyers or the insiders at the company. Do they have a neighbor who happened to work for the investment bank that had the mandate on the deal? And so, it is a painstaking process of tracing and sort of layering together trading and events leading up to a corporate event or other event. And then, the telephone calls and the meetings and the emails, and you put it all together, and you hope—you put together a circumstantial case, because invariably it is circumstantial, where you can then reach a reasonable conclusion and hopefully convince a jury this person had access to the information. They had a conversation. And look what they did, they had never owned anything other than a mutual fund before, and all of a sudden, they bought \$20,000 worth of deep in the money options the day before the announcement. And that is the kind of circumstances that give rise to the inference that they acted wrongfully.

Now, on other occasions, as we did in the Galleon cases, with Raj Rajaratnam and others, we are up on wiretaps—we are not up on wiretaps, the criminal authorities are, but we are working closely with them, where you can actually detect conversations in real time where you actually capture the inside information being passed. We have cooperating witnesses who will—maybe they are in trouble somewhere else, and they come to us and they say, “you know what, I happen to know about some insider trading that occurred.” We have a whistleblower program now under the Dodd-Frank Act which may give us additional leads as well. So it comes from all sources, but inevitably it is a piece by piece building of a case.

Mrs. MCCARTHY OF NEW YORK. So basically, also just to follow up on that, if someone is calling their broker to make these trades, then you actually have two people who would be dealing with inside trading?

Mr. KHUZAMI. Potentially, if the client making the call to the broker has material nonpublic information that they are trading on in breach of a duty, they will have violated the insider trading laws. The broker, the tippee to be liable, has to know that the information is coming in breach of a duty. So if all the person said was buy 100 shares of IBM, it probably wouldn't do it. If they said buy me 10,000 deep in the money options and I need it done before noon because I just heard something from my friend who works on the board at IBM, that is a different story. He might be liable if he then traded himself.

Mrs. MCCARTHY OF NEW YORK. Just to follow up, because I don't know, how do you see your agency and the CFTC working together to do this? I think it is kind of confusing for many of us. I am sure almost every Member here puts in the same kind of hours I do, whether we are here or meeting with constituents or anything else like that. That is why you have a broker to do what they are supposed to be doing. My concern is that we do our compliance once a year. That is usually right after tax season. And if they want to do a thousand dollar trade, we would have to report that. Wouldn't it be easier to report it like every 3 months in groups, instead of having—I have no idea if he trades at a thousand dollars, or what

the bunches are, or anything like that. I guess we get statements once a month at the end of the month. So that means I would have to go through every trade to look?

Mr. KHUZAMI. It depends on where you set the threshold. Look, in the corporate world, corporate insiders have to file within two business days of the transaction. That is standard practice under those circumstances. In many situations, the disclosure is done electronically. So in some sense, there is no greater burden to file the \$100 trade than there is the \$5,000 trade. You can just file electronically with your brokerage statements just getting sent directly to whoever is maintaining the database.

Look, I recognize there are burdens associated with it. Speaking selfishly from an enforcement point of view, I want as much information as soon as I can.

Mrs. MCCARTHY OF NEW YORK. Would that add a cost onto the brokerages, a service charge, or yourself or—

Mr. KHUZAMI. No, if it came to whoever maintains—whether or not it is Ethics or the Clerk of the House or whoever it might be who maintains it, they would have to have the capacity to do that. It wouldn't cost any more money for the brokerage, because that would typically just mean hitting a button and sending account statements. And generally, we wouldn't get it directly, so it wouldn't increase our costs.

Mrs. MCCARTHY OF NEW YORK. I do hope that you will be able to work with the Members, because obviously, most likely we are going to do something, but hopefully we are going to do something that is correct. My personal belief is that this becomes a witch hunt, and the majority of Members here are not out to make a quick buck. But thank you for your testimony. I yield back.

Chairman BACHUS. Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman. And thank you, Mr. Khuzami, for coming here and answering questions on this very important issue. I personally am particularly concerned about Section 3 of the STOCK Act, which seems to contradict the Speech or Debate Clause. And as you mentioned in your testimony, in the case of *Gravel v. United States*, the Supreme Court stated that the Speech or Debate Clause was designed to assure a coequal branch of governmentwide freedom of speech, debate, and deliberation without intimidation or threat from the Executive Branch. So as Members of Congress go before CNN or MSNBC or CNBC and other networks, at all times Section 3 of the STOCK Act could essentially bar them from publicly saying anything that may or may not move markets or stocks, which really gags them from commenting on very important legislation for the American people.

Do you feel that Section 3 violates the Speech or Debate Clause?

Mr. KHUZAMI. The Speech or Debate Clause is for me a separate matter that is going to exist irrespective of what is done with respect to establishing a duty or passing legislation that prohibits insider trading. And it is something that we in the enforcement authorities have to navigate through and both respect—I am probably not the best person to opine on that. I am happy to consider that and get back to you with a response. There are some areas where the Speech or Debate Clause's application is clear, and there are other areas where it is less so. So I guess I would ask for the op-

portunity to get back to you on that and give it a little more thought.

Mr. CANSECO. Thank you.

Mr. KHUZAMI. The only thing I would say is that all the insider trading laws require scienter and intent. So that is the single biggest thing that protects the unwary from being trapped in a violation that inadvertently occurred. You have to be acting with corrupt intent, knowledge, or recklessness. If you act in good faith, you are not going to be guilty.

Mr. CANSECO. Which is the definition of scienter.

Mr. KHUZAMI. Yes.

Mr. CANSECO. Does the SEC have an opinion on how they could determine exactly which public companies could have their trading affected by Members' comments? And how would you determine this?

Mr. KHUZAMI. In a typical insider trading case that really speaks to the issue of materiality. Was the information as it is defined in the current law—

Mr. CANSECO. Let me interrupt you.

Mr. KHUZAMI. Sure.

Mr. CANSECO. This would be with regards to Section 3 of the STOCK Act, which is if I go out there in front of the microphone and TV and tell them what bill I am contemplating to push through the Floor of the House.

Mr. KHUZAMI. If that is all you did as part of your Congressional duties, and acted in good faith, I think that would be a difficult case to make from an insider trading point of view, particularly if you disseminated the information broadly to a wide audience.

Mr. CANSECO. Let me clarify this. Section 3 states that a Member or employee shall not disclose material, nonpublic information relating to any pending or prospective legislation, action, relating to any publicly traded company if that Member or employee has reason to believe that the information will be used to buy or sell. And that would include any kind of comments with regards to bills that are coming before the Congress of the United States or that you are contemplating using under Section 3 of the STOCK Act. So aside from the fact that if I know—assuming that I don't, but I do—if I know something that is happening with some bill, and I go back into my office and call my broker and say buy, or sell, or short, or go long, that would obviously be apart from Section 3. I am speaking specifically about speaking in public about a bill that could move a market.

Mr. KHUZAMI. That is one of the reasons why I think that if there was a clearly defined duty with respect to that information, that would clarify the law in this area and make it clear what kind of conduct stepped over the line and what kind of conduct did not.

Mr. CANSECO. With respect to Section 3 of the STOCK Act, which is the getting out in public and talking about a bill or legislation that is coming on there, do you think that it is the duty of the SEC to go out there and police 535 Members of Congress?

Mr. KHUZAMI. No. We are just looking for people who violate the law.

Mr. CANSECO. All right, sir. And is it workable within the SEC's enforcement operations to go out there and oversee 535 people of

Congress as to what they say publicly that may or may not move markets?

Mr. KHUZAMI. No. Our job would be to either identify or have brought to our attention trading that looks suspicious, and then to determine whether or not all the elements of the offense have been satisfied.

Mr. CANSECO. But I am speaking under the STOCK Act, assuming that the STOCK Act is passed and made into law.

Mr. KHUZAMI. I don't think we would be generally conducting a policing operation of what 535 Members of Congress were doing.

Mr. CANSECO. Thank you very much, Mr. Khuzami. I see that my time has expired.

Chairman BACHUS. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman. Dealing with the stock market, trading on the New York Stock Exchange is sort of like the cornerstone of our entire economic system. And it is basically based upon seeing pertinent information. When you are trading in stocks, it is sort of like just trying to be in the right area listening to the right gossip about what is going on at the right time. And so the question becomes, how do you enforce this? How will we really enforce this? Give me an example of what is nonpublic material. That is the core of this. Where would I go wrong? Give me an example, as a Member of Congress, give me some examples of what I would be doing which would be in violation of this Act.

Mr. KHUZAMI. In general, if as a Member of Congress you became aware of a company, say, that was going to be—you learn that it was going to be subject to a piece of legislation that would have a significant impact on their business, and as a result of that information which was not public in the sense that it was only known to a small group of people and not shared generally with the public—

Mr. SCOTT. Could you give me an example of what that information would be?

Mr. KHUZAMI. Let's say if you learned about a contract that was to be awarded to a certain company, if you were to learn about legislation that might greatly restrict the business opportunities of a certain company, if you were going to do something to the FDA drug approval process that might make it harder for companies to—specific companies to have drugs approved, those things can all have a significant impact on the price of a company's stock. If you took that, and then while it was nonpublic went and traded on that information, you could have violated the insider trading prohibitions.

Mr. SCOTT. And under this legislation, what would happen to me? What would be the penalty? What is the real axe in this legislation if I did that?

Mr. KHUZAMI. The penalties from the SEC's perspective are well established, which means you could be subject to, obviously, an enforcement action filed against you, and you could be required to disgorge all your ill-gotten gains or your profits. In addition, you could be assessed a penalty of up to 3 times of the amount of that disgorgement. So if you made \$100, you have to give the \$100 back, and you could be penalized \$300.

Mr. SCOTT. So in other words, there is no criminal sanction, there is no misdemeanor, there is no felony record. You don't go that far with the law.

Mr. KHUZAMI. We don't because we don't have criminal authority. However, the Department of Justice prosecutes insider trading cases on the exact same statutes. So they too could charge a person under those circumstances, in which case jail time, and restitution, and other remedies could be available. Now, the criminal authorities have a higher standard of proof of course. They have to prove guilt beyond a reasonable doubt. We at the SEC, as a civil authority, have a lower standard of simply proving by a preponderance of the evidence.

Mr. SCOTT. This bill opens up another area which we haven't touched upon or explained, and that is this concept of political intelligence. What is that?

Mr. KHUZAMI. My understanding is that these are firms sort of in the business of signing up clients who pay for their intelligence, which they in turn gather from mining various sources they have about what is going on with respect to pending legislation and other developments in Congress and in the Federal Government.

Mr. SCOTT. And at what point would a Member of Congress know that what he may be saying or responding to a constituent or anybody, which we do, he is engaging in political intelligence?

Mr. KHUZAMI. If you were having a conversation with such a firm and just talking about what is going on, you wouldn't have any insider trading exposure if you were acting in good faith and you didn't purchase or sell securities on your own. So I don't necessarily think it would have a chilling effect on bona fide, legitimate conversations that you might otherwise have.

Mr. SCOTT. One final point, Mr. Chairman? These political agencies may just want to call a Member of Congress. They could set him up, and then pass on and say to someone, I just got this bit here from—unbeknownst to the Member of Congress, he has been used. What protects that Member of Congress? He thinks he is doing a job of responding to a constituent.

Mr. KHUZAMI. Again, like I said, under those facts you generally wouldn't have liability for insider trading. You may have passed some nonpublic information, and that may have other repercussions not from an enforcement perspective, there may be ethical or other issues, I am not familiar with them, but from a pure insider trading perspective that would not render you exposed to insider trading liability.

Mr. SCOTT. Thank you, sir.

Chairman BACHUS. Thank you. Mr. Renacci?

Mr. RENACCI. Thank you, Mr. Chairman. And thank you, Mr. Khuzami, for being here. If I understand it correctly, and I try to be a good listener, today, currently, Congress and their staff are not exempt from the Federal securities laws, including insider trading prohibitions, and this is from your testimony, through the application of these principles to such trading. So today as it stands Congress is not exempt and their staff is not exempt from any insider trading rules?

Mr. KHUZAMI. Correct.

Mr. RENACCI. Okay. With that being said, this bill that we are talking about really, and I heard you say this earlier, just clarifies that.

Mr. KHUZAMI. No. I think what I was saying is the approach that I personally might prefer would be a narrower bill that simply declares that there is such a duty by Members of Congress to keep information that they obtain in the course of their Congressional service confidential, and not use it for private gain. That is the simpler approach that I think accomplishes the same end. The STOCK Act attempts a broader proscription to try and define all of the elements or many of the elements of insider trading. And I think in some cases, it may be at odds with existing law. In some cases, it may be underinclusive, and in some cases, it may be overinclusive. And I think there is just some danger in having that law exist as well as the law as currently developed. So that is what I was saying, that would clarify it.

Mr. RENACCI. So we could almost clarify this whole bill in another sentence that you just stated that would narrow it into a simple focus and—

Mr. KHUZAMI. Or maybe replace it.

Mr. RENACCI. Okay. Now, the other thing this bill does is it requires quarterly reporting of transactions of \$1,000 or more. But every Member of this Congress today is required to report every stock transaction of \$1,000 or more already on an annual report. So they are already reporting that. So the question I would have is where is that going? If every Member is reporting it and they have been reporting it for the last whatever, 20 years, 30 years, what are you doing with that information? Are you looking at it? Because it gets back to some of my colleagues. We can report everything we want to report, but if there is never any enforcement—So what are the enforcement mechanisms when a Member of Congress reports every transaction that he or she has had for the last year?

Mr. KHUZAMI. I think the disclosure would be greatly beneficial from a pure enforcement perspective if it was made on a timely basis, and was made electronically, and is searchable. It just creates ease with which we can identify trading and determine whether or not any investigation is warranted. If it is not reported, it is just—there is a long passage of time before you might have access to the information. Memories go stale.

Mr. RENACCI. Excuse me, though. I don't mean to interrupt, but it is reported every year.

Mr. KHUZAMI. Yes.

Mr. RENACCI. And every transaction you can pull up off the Internet. So those transactions of every Congressperson are already reportable, and on the Internet, and can be picked up and looked at.

Mr. KHUZAMI. But a year or however long after the events in question.

Mr. RENACCI. So what is normal with insider trading? You could still pick up insider trading if somebody filed a report in April and you did something with it, that report, you looked at all the Members and you saw some unusual transactions in April of last year

or June of last year, you could say, let's do an investigation on that. Is there anything being done in that regard?

Mr. KHUZAMI. You could. It's just, investigations that take place as close in time to the events in question are just, as a general matter, more effective. Memories are sharper, information is easier to obtain, and there are fewer opportunities for concealing what took place. So—

Mr. RENACCI. But if you are not looking at the 535 reports that are done today on an annual basis, are you going to look at the 535-times-4 reports that are done? That is what I am trying to get at. If you already have those reports and you are not doing anything with them, what would 4 more reports times 535 people do for you?

Mr. KHUZAMI. Some of the trading would still potentially be referred to us, if they took place on exchanges, still referred to us through the normal referral process that we get from the exchanges where the trades occur. But the problem is, if they are not—if they are not reported over that long a period of time, it is more difficult.

And frankly, in addition, if you are trying to, for example, sort of track the progress of a particular piece of legislation and understand when people knew certain things, it is just much harder to do with the passage of time. And, yes, it would be more burdensome to do it four times rather than once, and for us as well, but it is potentially more effective.

Mr. RENACCI. Again, more effective, but if you are not—it gets back to what a number of my colleagues have said. If there are no enforcement procedures in place today, maybe what we need to do is get the enforcement procedures in place and use the information we are getting already.

So that is all I am getting at. If we give you 4 times the information, and you still don't have any procedures to really do checks and balances, it is no better than giving it to you one time.

I am okay with the way this Act reads, if we clarify it more. I am just not sure if throwing more information at you that you are already not using is appropriate. That is the question I was trying to ask, but I know I have run out of time.

Thank you.

Chairman BACHUS. Thank you, Mr. Renacci.

Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witness for appearing today.

You seem to be indicating, sir, that a single sentence can replace the bill. Is this correct?

Mr. KHUZAMI. I wasn't necessarily suggesting a single sentence, but a briefer statute that defines and identifies the duty.

Mr. GREEN. The duty of, may I use the phrase, confidentiality?

Mr. KHUZAMI. Probably more technically a duty not to use information obtained in the course of Congressional service for personal gain or private profit, or words to that effect.

Mr. GREEN. And as you have been performing your duties, have you assumed that such a duty exists? Or have you been performing your investigations predicated upon a lack of such a duty?



Mr. KHUZAMI. I think, we assume that one exists, and in the appropriate—we wouldn't not file the appropriate case simply because there is some ambiguity in the current law as to whether or not such a duty exists. But we also have to recognize that because it is untested and a little uncertain, a court may not agree with us, and that is why there is some risk associated with such a theory.

Mr. GREEN. Let me restate my question. Have you, prior to this moment in time, performed your duties, assuming that such a duty exists? The question simply is, is there an investigation that you would not have pursued because you were not sure that a duty existed?

Mr. KHUZAMI. No.

Mr. GREEN. So, as you have performed your duties, you have assumed that the duty for Congressional Representatives exists not to disclose this type of information, true?

Mr. KHUZAMI. That is correct.

Mr. GREEN. If this is true, is it fair to assume that you would not perform investigations in the future to any greater extent than you do currently because you currently assume that the duty exists?

Mr. KHUZAMI. I think the answer to that would be yes, although, like I said, the disclosure aspects of this may, in fact, encourage more investigations, but—

Mr. GREEN. I understand.

Mr. KHUZAMI. —aside from that, yes.

Mr. GREEN. But the gravamen of your testimony appears to be the duty. There are other things; the tipping is important and other things. But the gravamen appears to be the duty. And if you have been proceeding assuming that the duty exists, I am just trying to ascertain whether or not there would be some difference in the behavior of your investigations in terms of how they are triggered, for example.

You have indicated that your investigations are triggered by a trade, generally speaking. Is that a fair statement?

Mr. KHUZAMI. Correct.

Mr. GREEN. And once you have a trade, then what you try to do is ascertain—a trade, by the way, not just any trade, but one that sort of stands out. Once you have this trade, then what you try to do is ascertain whether or not the person who made the trade had some sort of insider information or communicated with someone who communicated insider information. True?

Mr. KHUZAMI. Correct.

Mr. GREEN. Now, would any of this change if we codified the duty?

Mr. KHUZAMI. No, you would still take the same general investigative approach when you are talking about inquiring into the facts of what happened.

Mr. GREEN. Before my time expires, I need to say this for edification purposes. I believe that no one should be above the law by virtue of your station in life. I believe that no one should be beneath the law by virtue of your station in life. I think the law should apply to all equally.

What I am trying to find out, however, is whether or not there would be some change in the way you conduct your investigations

once this duty is established. And I think I am hearing you say, not likely. I will give you some wiggle room.

Mr. KHUZAMI. Thank you.

Mr. GREEN. A final comment or perhaps a question. When you perform these investigations—and this was triggered by something you said, my question—you indicated that you check with neighbors, you check phone records, you check emails.

Do you do this with the person that you have focused on having knowledge of what you are doing? Do you do this with a warrant? How do you perfect these searches such that you can acquire the intelligence necessary to prosecute properly?

Mr. KHUZAMI. Unfortunately, as a civil authority, we do not have the legal ability to engage in certain undercover or surreptitious activities. So we can't do search warrants, we can't do wiretaps and other things like that.

We partner with the Department of Justice frequently, as we did in the Rajaratnam case, where wiretaps were used, where often we will work jointly and they will engage in those kinds of activities, and we get the benefits of some of those investigative things.

But for us, our investigations, although we are trying to change this as much as we can, are often overt, which means we have to question witnesses with our target knowing that we are doing that.

Mr. GREEN. But you use civil litigation?

Mr. KHUZAMI. Yes.

Mr. GREEN. And subpoena duces tecum?

Mr. KHUZAMI. Yes.

Mr. GREEN. Thank you, Mr. Chairman. I yield back.

Chairman BACHUS. Thank you, Mr. Green.

Mr. Pearce?

Mr. PEARCE. One of the questions that I have about the legislation is, is there anything in the legislation that is not against the law right now? In other words, are we just restating things that are—it is not legal for Members of Congress to do insider trading, is it?

Mr. KHUZAMI. No, not in our view.

Mr. PEARCE. So is there anything in the bill that is new, that does not already exist in law as a prohibition?

Mr. KHUZAMI. It changes some of the—it narrows in some cases and expands in some other cases terms that are currently in use as the insider trading laws are applied.

Mr. PEARCE. Could you tell me exactly what you are saying there?

Mr. KHUZAMI. Yes, sure. So, for example, it is limited to material nonpublic information dealing with pending or prospective legislation. There isn't really such a restriction in the law in general. And so, in the case of Members of Congress, if you got information from the Executive Branch or a regulatory agency, it wouldn't be covered by this legislation.

It is limited to securities or the swaps of certain issuers, which means it doesn't cover options, it doesn't cover exchange-traded funds, or it doesn't cover mutual funds. Those things would generally be covered in insider trading law as it currently exists. The tipping, there is no explicit provision—

Mr. PEARCE. Is there a reason for this piece of legislation?

Mr. KHUZAMI. Again—

Mr. PEARCE. Would you take this legislation and go to work on Members of Congress who have been getting by with things? Would this open the door to you to undergo things that right now you won't take on because you don't have enough powers?

Mr. KHUZAMI. No. I don't think that is the case.

Mr. PEARCE. Okay.

One of my suggestions is that the White House and the Administration are completely not mentioned in here, and, as I look at the numbers of regulations, they have far more impact—in other words, the BART rule, Best Available Replacement Technology on coal-fired turbines, Mac boilers—those things have far more effect on the price of stocks than much of what we do.

Is there something in law like this that prevents members of the Administration or members of the Cabinet from doing the same thing? Because the regulations have greater immediate impact on stock prices than 90 percent of the stuff that passes through this body.

Mr. KHUZAMI. I don't know if there is anything on the ethical rules or other aspects that cover the Executive Branch or others, but we have brought cases. We just brought a case against an FDA chemist, for example, who was trading ahead of FDA drug approval announcements. And that was based primarily on his agreeing to ethical rules, where he agreed not to use—

Mr. PEARCE. But do you think that we should have something that specifically prohibits this? In other words, if we are going to highlight possible actions by people in the Congress and their employees, we should take in all of Washington. Because, frankly, the people at home don't identify the Congress and Senate as being the problem; they say Washington is the problem. They see us all rolled up.

And so, yes? No? You think so? Maybe?

Mr. KHUZAMI. Certainly, our current approach is we don't draw any distinctions.

Mr. PEARCE. All right.

Now, when I consider abuses, I look back at Global Crossing. Did you all ever do anything? There were a lot of people on the—a lot of people made a lot of money. About \$700 million appeared to evaporate out of the price of that stock. And that wasn't necessarily just Members of Congress, but there were people who were associated with Members of Congress, people in the party structure.

Have you all ever taken a formal look at that?

Mr. KHUZAMI. Congressman, I have only been with the Commission since March of 2009—

Mr. PEARCE. Could you get me an answer on that?

Mr. KHUZAMI. I could certainly get back to you, sure.

Mr. PEARCE. And this was probably now 5 to 7 years ago.

Mr. KHUZAMI. Sure.

Mr. PEARCE. And, also, I had asked when you all were here previously—I appreciate what we are trying to do to get transparency here. I am still wondering about the big fish. Are we still doing anything on Madoff? Are we investigating him? Have we put him in jail? Is he gone?

Mr. KHUZAMI. The criminal authorities put Mr. Madoff in jail, and he is serving a very lengthy prison term. In addition, we, as well as the criminal authorities, have continued to charge civilly and criminally a number of individuals associated with him.

Mr. PEARCE. Yes. My question, though, was, inside the agency, a lot of people were looking the other way. And so I know that we got Mr. Madoff. Have we done anything inside the agency? And that is what I have never been able to—I see my time has elapsed, but if you could get with my office, we have asked this question before. What has happened internally?

Mr. KHUZAMI. Sure.

Mr. PEARCE. Because he was existing for a long time. And I know we got him. What about us, part of the agency?

Thank you very much. I yield back.

Mrs. BIGGERT [presiding]. The gentleman's time has expired.

The gentleman from Missouri, Mr. Cleaver, is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Madam Chairwoman.

Mr. Khuzami, thank you for being here.

This body and Washington always overreacts to everything. And the way this system is designed is, when someone introduces a bill like this, even if it is bad, people vote for it because they don't want to be accused the next morning of being unethical and "slimebaggish." That is my word. And so what happens is we do things that create this never-moving cloud that hangs over Washington.

Not long ago, a member of this committee held a fundraiser and a bank appeared before our committee, which also attended the fundraiser, so then somebody filed an ethics charge against him. Now, he actually ended up voting against the measure. You mentioned earlier, you said it is a difficult case—you were responding to a Member—you said it is a difficult case to make.

That is irrelevant in this situation, because all that is needed is for somebody to make an allegation. We are in Congress. If somebody makes an allegation, it is in the newspapers. It is irrelevant about whether or not it is a difficult case to make; it is the allegation that does the damage, and it ends up in the newspapers. And so, political enemies use it to talk about how horrible Washington is. Now, it doesn't matter that they will spend several million dollars trying to join Washington.

And we have another Member who got into trouble because his staff did something and the committee said that he should have known.

So I sit in this committee, I get some information, I am talking to Congressman John Doe, just sitting around talking, and I tell him what just happened in the committee, and he tells somebody, and they end up taking advantage of some information. So then, somebody is in trouble, right? Somebody goes and takes advantage of the information, and now they are in trouble. Am I right?

Mr. KHUZAMI. You mean you, as the source of the information, would you be in trouble under those circumstances? Is that what you are saying?

Mr. CLEAVER. Yes.

Mr. KHUZAMI. Legally, no. Again, because you have to have acted with sort of, corrupt intent and knowledge.

Mr. CLEAVER. Not if you are in Congress.

Mr. KHUZAMI. Well—

Mr. CLEAVER. Not if you are in Congress. All you have to do is be in Congress.

Mr. KHUZAMI. I can't speak to the court of public opinion. I can only speak to the legal court. But I understand your concern. That is one of the reasons why, look, we are careful. Our investigations are confidential. We don't make accusations before we have done a full investigation. We are very—

Mr. CLEAVER. But you would—I am sorry. That is impolite. Go ahead, I am sorry.

Mr. KHUZAMI. We recognize the impact that allegations can have, and that is why we are very careful about the confidentiality of our investigations.

Mr. CLEAVER. Is there another way for Congress to deal with this issue without passing a law that, in my opinion, is flawed and is going to create problems? Look, when it comes to the Floor, everybody is going to vote for it, because that is what we do. We vote for things that probably the majority realizes are bad. And the media is going to say it is good, anytime you can do anything that holds people more accountable.

I am just afraid that this is one additional deal we are piling on ourselves that is flawed. And everybody knows it, and few are willing to say it. It is flawed.

And I hope there is another way of doing this. If we are going to do this and—I don't know if a blind trust is the deal that we have to do, I don't know, an SEC no-action letter, something. I think it would be helpful if you could suggest something other than something that I think and others believe to be terribly, terribly flawed. It will create problems for the image of Congress because there is no way that we can end up not talking about this issue among ourselves.

Thank you, Madam Chairwoman.

Mrs. BIGGERT. The gentleman's time has expired.

The gentleman from Ohio, Mr. Stivers, is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Khuzami. I appreciate your testimony. And I think we all take this issue very seriously, and I think it is important that we address it in the proper manner.

I want to follow up on some statements and questions that Mr. Luetkemeyer, Mr. Canseco, and Mr. Renacci had, as well as, I guess, Mr. Pearce. Can you just state one more time for the record whether Members of Congress are exempt from insider trading laws?

Mr. KHUZAMI. They are not.

Mr. STIVERS. Thank you.

I think we need to keep any fix here as simple as we can. I do have a concern for the Constitutionality of Section 3 of the STOCK Act with regard to the Speech and Debate Clause. And I think enforcement is really important.

So my first question revolves around, you have given us a solution earlier in your testimony and in your questions by just cre-

ating a duty that says that Members of Congress—and I hope the Administration would be included in that, as well—cannot use information gained for either personal gain or private profit. Do you think a duty like that would conflict with the Speech and Debate Clause? Because I don't think it sounds like it does.

Mr. KHUZAMI. Again, I am not an expert, but I wouldn't believe so.

Mr. STIVERS. And then with regard to tipping, because I think that is the other piece that might be worth addressing here, wouldn't it be pretty easy to add to that duty some responsibility not to tip others who have the purpose of personal gain or private profit?

Mr. KHUZAMI. You could easily draft language like that, but that kind of—the tipper/tippee liability is already well established in the law. And so, again, in order to avoid a potential conflict between what already exists and what might be in the bill, I think my view would be, you have the legislation and you basically include in it what would be called a savings clause or language that would say, this is not intended to affect other law.

Mr. STIVERS. Okay. So a simple legislative change that would create that duty, and then make sure that we enforce the laws that are on the books—and I want to get to enforcement in a second—would not change or conflict with the insider trading laws that are on the books today, correct?

Mr. KHUZAMI. I think that is right.

Mr. STIVERS. And isn't there some risk of creating dual standards that then nobody knows how to enforce or what applies to whom?

Mr. KHUZAMI. I think there is some risk of that.

Mr. STIVERS. So, let's get to enforcement for a second. Do you think that you have enough—you talked in the beginning of your testimony about some of the statistics of your enforcement and how it is going up and you are—obviously, the SEC is doing a little more of it.

Do you have the resources you need to do the enforcement that is necessary to clean up insider trading, whether it is by a Member of Congress or somebody else?

Mr. KHUZAMI. We don't have the resources to do the job across-the-board of enforcing the securities laws that we need.

We have made great strides in the last few years, both in terms of the number of cases, quality of cases, particularly the credit crisis cases, that we brought cases against over 80 individuals and entities, 40 CEOs, CFOs, and senior executives across-the-board. We are doing a lot of great things, but it is a significant challenge, given the additional Dodd-Frank burdens and just the numbers.

We have 1,300 people across the Nation in the Enforcement Division, and we are responsible for 35,000 regulated entities—broker-dealers, investment advisors, transfer agents, and others, as well as any citizen who might choose to violate the law.

So, resources are a real challenge for us. And if we put more into insider trading, we are doing less somewhere else. It is a zero-sum game.

Mr. STIVERS. Let me ask you about—can you tell the members of this committee what happens to the ill-gotten gains that you are able to get back through the process of insider trading? And is

there a way to help use those, the way we do drug profits, to go back into enforcement?

Mr. KHUZAMI. It does not—as a general matter in securities cases, we often take disgorgement or the ill-gotten gains and penalties and return it to the harmed investors. We have returned, I think, \$3.6 billion in the last 2 years to harmed investors.

In insider trading cases, it is a little harder, because identifying the victim or if it was just somebody on the other side of a trade who didn't have the information—and because the amounts are so small, those numbers often end up going to Treasury, rather than being distributed to people on the other side of the trade.

Mr. STIVERS. I only have 15 seconds left here, but what do you think about the idea of insider trading, maybe using some of those gains to help you with your enforcement costs?

Mr. KHUZAMI. I would love to be able to have—we attempted to get self-funding; it didn't happen. We have some additional means now. But, our budget doesn't come at the expense of other government agencies because it is funded by fees, transaction fees and other fees by Wall Street, and I think that is appropriate. I wouldn't want to see us funded directly from penalties or sanctions. I think that probably sets up a bad incentive.

Mr. STIVERS. Okay.

Mrs. BIGGERT. The gentleman's time has expired.

The gentleman from Minnesota, Mr. Ellison, is recognized for 5 minutes.

Mr. ELLISON. Thank you, Mr. Khuzami, for being here.

There was the big story on "60 Minutes," a lot of people were, I think, probably given more attention than they wanted and a type of attention they didn't want, and we come up with a bill, and here we are. Of course, the bill existed long before, and I don't want to imply it didn't.

But I was intrigued by the idea that you think it is—this is an already—Members of Congress already cannot use inside, non-public information in order to enrich themselves. Could you expand on that?

Mr. KHUZAMI. Yes. I think the point is that law currently prohibits insider trading, and there is no special exemption or special carveout for Members of Congress.

Mr. ELLISON. Right.

Mr. KHUZAMI. And I think the point that I was trying to make is that, while that is true, there is some legal uncertainty about how those principles that currently exist would be applied to the special situation of Members of Congress. And that is why establishing this explicit duty I think would be very helpful.

Mr. ELLISON. And, in that same vein, as Members of Congress, we have a—as you and others make the point, we have a public duty, and our responsibility is to pursue the public interest. Now, if we are doing something to pursue our private, narrow interests at the very same time, that puts both of those interests at odds, you know.

And this "60 Minutes" piece—of course, I don't want to attribute that to being absolutely accurate. It is media, it is actually entertainment too. Part of what they were saying is that one Member was supposed to be trying to stabilize the economy at the same

time they were purchasing equities or options that could enrich them if the economy went down.

That seems to me, if—and, again, if—and this is a two-letter word that means a whole lot—if that is to be believed or proved, I think there is already ample stuff to say that you cannot do that. Specifying it may be a great advantage. That is why I am a co-author on the STOCK Act. But I just wanted to make it clear that I already think that the things that this news broadcast brought out you can't do already.

Let me ask this: How do the varying designations of the term “confidential information” among Member offices and committees affect the determination of when material, nonpublic information has been disclosed? Do you understand my question?

Mr. KHUZAMI. How do the various definitions—

Mr. ELLISON. Yes. How do the varying designations of “confidential,” the term “confidential information” among Member offices and committees affect the determination when material, nonpublic information has been disclosed?

Mr. KHUZAMI. If there is an explicit agreement that the information is confidential, then that generally establishes a kind of duty of trust and confidence between the two parties who made that agreement. And if one of the parties who had that information then turns around and uses that information for private gain, they have violated that duty of trust and confidence.

Mr. ELLISON. And, do you think there is any problem with the perhaps multiple understandings of how this term might be applied in various circumstances? Do you think the rule—or do you think one of the things we need to focus on is how we can come up with perhaps a standard understanding?

Mr. KHUZAMI. The more standardization, the better. It may not always be possible, but certainly that is correct.

Mr. ELLISON. Yes.

What kind of information would be regarded as relating to commodity and futures contracts within the context of Members of Congress? What kind of information would be considered as related? Do you understand my question?

Mr. KHUZAMI. What kind of insider trading might—

Mr. ELLISON. Yes.

Mr. KHUZAMI. If you are talking about certain commodities, any legislation that might impact companies involved in the commodities business would certainly fit that definition.

Mr. ELLISON. Okay.

And under what circumstances would a Member or an employee of Congress be considered to have reason to know that a person requesting information would use the information obtained to trade securities or futures contracts?

Mr. KHUZAMI. If that were the law, you could look at the circumstances. If you had a friend who was a day trader and you secretly whispered to them some information that you learned about some nonpublic legislation, you would have a pretty good basis to say you either knew or should have known that this person was going to take that information and trade on it. Other cases would be less clear.

Mr. ELLISON. Yes.



At what point do prognostications as to the prospects of legislation become political intelligence?

Mr. KHUZAMI. I am not sure I—that would be a difficult question to answer without knowing the facts and circumstances of a particular situation.

Mr. ELLISON. It is a very fact-based question.

Mrs. BIGGERT. The gentleman's time—

Mr. ELLISON. I am out of time. Thank you for your cooperation, sir.

Mrs. BIGGERT. Thank you.

The gentleman from Michigan, Mr. Huizenga, is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Madam Chairwoman. I appreciate it.

And, actually, we are running out of time from my colleague across the way here, but I would like you to—maybe we can pursue that a little bit. As I was hearing that interchange, something struck me, and it is called the farm bill. All right? We are going to be reauthorizing this thing soon, and whether it has to do with ethanol or direct or indirect subsidies or payments or any of those things, it seems to me that this may cause some huge headaches for not just Members but a number of others who are involved and engaged in the legislative process dealing with a major portion of our economy. This isn't just Wall Street; this is Main Street and grain elevators out in Michigan and Nebraska and wherever else.

And so I am just curious, maybe we can keep, kind of, unpacking that a little bit, along with the whole notion of this political intelligence information. And, is it really just a judgment call what is or isn't on your part? Or explain that a little bit, if you would.

Mr. KHUZAMI. When something, whether it is farm bill legislation or a corporate takeover, at what point it crosses the line from being just very preliminary or tentative and at what point it crosses the line to being material, which means it is kind of an important matter to a reasonable investor in an investment decision, is at the end of the day a determination based on all the facts and circumstances of what happened.

And that is why in the course of our investigations, we spend a great deal of time trying to tease out every fact and every event to make sure we understand what had occurred and make our professional judgment as to whether or not that factor has been satisfied, and thus everything else was as well, whether or not it was a case that we would file.

The same is true for scienter or intent. You can't look into somebody's mind, so you have to look at the circumstances under which they may have passed the information. Did they put down a taped telephone line, instead pick up their cell phone and ask someone to call them back on an untaped line and speak cryptically or take some steps to conceal what they had done? You look at all these things to figure out whether or not people have acted with bad intent, whether or not it is material, in order to decide whether or not you have the sufficient basis to file a case.

Mr. HUIZENGA. Do you see any problems with what we are trying to do here? Because I do think that this is a good idea, but I, like myself and a number of my other colleagues, have had previous lives that follow us here. My family happens to be involved in con-

struction back in Michigan, in real estate. I own a gravel company; I have three employees. But if I vote on a highway bill which means we are going to be using more concrete, and suddenly sand and stone is more expensive, and I somehow benefit from that, is there a pitfall here that would be—I am assuming that would be an unintended consequence to something like that.

But I see that with the farm bill and a number of these other things that are, sort of, regular order and regular business here that may cause some problems. And I know there had been one proposal out, that when you got elected to Congress, you had 90 days to liquidate everything, and the only thing that you were allowed to hold would be a government treasury bill. And I can tell you, that is not something I would be interested in doing, especially in this real estate market.

How do we strike this balance? Because I think there is a real need here to make sure that we have transparency and that we aren't unduly using information that is coming to us.

Mr. KHUZAMI. Right. There are a number of protections. Proposed legislation is discussed openly, it becomes public. And, therefore, if you were to discuss it, it is not nonpublic and therefore wouldn't give rise to any sort of liability.

Again, you have to act with knowledge and bad intent. You have to purchase or sell securities. The information has to be material. You have to meet all those elements. If you were to simply discuss proposed legislation with a group of people and they went off and traded, and you were doing it consistent with your duties and obligations as a Member of Congress, it would be hard to see how that would give rise to a case.

Mr. HUIZENGA. So me talking at the local rotary isn't going to get somebody in trouble when suddenly that is viewed as insider—okay. I appreciate it.

Thank you, Madam Chairwoman.

Mrs. BIGGERT. Thank you.

The gentleman from Colorado, Mr. Perlmutter, is recognized for 5 minutes.

Mr. PERLMUTTER. Thanks, Madam Chairwoman.

And, Mr. Khuzami, thanks for sitting through this for so long.

I am generally supportive of the legislation as it has been proposed. I guess I bring the same concerns to the table that you do, that in trying to define this, you end up exaggerating one piece and forgetting another.

And, you focused primarily on legislative activities of the Congress. So, in the legislative arena, we have two parts. We make policy, and we either fund it or we don't. Okay? We have oversight of your organization and every other organization of the Federal Government, in which case either in a public forum, as today, you provide us with information and in certain instances we have maybe private briefings, a Secretary comes to somebody's office or whatever.

So we have legislative, we have oversight, and then we have constituent relations, which is what Mr. Huizinga was talking about. Speaking to the rotary or somebody comes to my office and says, you know what, they are thinking about, well, like last week, fracking, okay? Fracking in my neighborhood. Shouldn't there be

some legislation about disclosing what is in those fluids? And I know the SEC is having to deal with subjects like that. And we have every subject under the sun, from farming to foreign policy, etc.

So I do fear that, in trying to define all this, we forget the breadth of the activities that we face here in Congress. So can you comment on that?

Mr. KHUZAMI. I think I would probably give somewhat of the same answer I gave previously, which is I think that there are a lot of protections that are inherent in the insider trading law that prevents it from becoming a trap for the unwary because of the various legal requirements that have to be satisfied.

And it may be that that is not sufficient, that you need some sort of carveout through a no-action letter that would give you some comfort going forward that a certain type of activity, if you met the requirements, would protect you from any sort of liability.

I realize it can be a challenge. It is, frankly, a challenge on the corporate side, as well, where you have corporate officers who are responsible for all sorts of communications and outreach to their shareholders and others. And so I don't mean to underestimate the challenge, but I am hopeful that conscientious people can come together and figure out a solution.

Mr. PERLMUTTER. I think of the day when we had TARP on the Floor of the House of Representatives. And there was—that was one where, are you going to pass it or not? Now, under this bill, that would be public, because it was as public as possible, that everybody who was transacting business on the markets, could see as we—were we going to pass it, were we not going to pass it.

What would the agency do—let's say a Member is counting up votes, and he realizes that it isn't going to pass. Now, I don't know that any of this would happen, but he counts up votes, and he realizes this is not going to pass, and he goes and sells whatever. What happens then?

Mr. KHUZAMI. I wouldn't want to speculate about particular circumstances.

Mr. PERLMUTTER. I know you wouldn't, but that is—we are in the legislative arena, so you have to. That is what we have to—we have to look forward like this.

Mr. KHUZAMI. Right.

Mr. PERLMUTTER. And that is why this is the legislature as opposed to the Judiciary. We have to look at the broad expanse.

Mr. KHUZAMI. Right. No, that is right, that is right. That set of circumstances could conceivably give rise to a case, because it certainly was material to investors, and if the vote was that close or there was uncertainty about it, it certainly would be nonpublic, and to trade on that, if a court were to find that a duty existed, that could, in fact, be a violation.

Mr. PERLMUTTER. Okay. No, I could see that one as being, wow, what do we now? It is right here in front of everybody all at the same time, but this guy counted the vote an hour ago.

Mr. KHUZAMI. Right. Now, it could also raise Speech or Debate Clause issues, as well.

Mr. PERLMUTTER. Okay.

Mr. KHUZAMI. It occurred on the Floor, and there would be, in all likelihood, a challenge on those grounds.

Mr. PERLMUTTER. All right. And just to close, you are going to work with the sponsors of this bill to try to tighten it up as best we can?

Mr. KHUZAMI. Yes.

Mr. PERLMUTTER. Okay. Thank you. That would make me more comfortable.

Thanks.

Mrs. BIGGERT. The gentleman yields back.

The gentleman from Delaware, Mr. Carney, is recognized for 5 minutes.

Mr. CARNEY. Thank you, Madam Chairwoman.

And thank you, Mr. Khuzami. There aren't many questions that haven't been asked, but I have a few. And I appreciate your forbearance through this long hearing.

I am just trying to understand your testimony. You said earlier that you would prefer—I am a supporter of the bill and a cosponsor. I was surprised to learn that Members of Congress may not be covered by the rules for insider trading. You say that you assume that they are, that we have some duty. I accept that and make the same assumption.

I also believe that Members of Congress ought to be held to a higher standard. And my hope, frankly, in this legislation or what ultimately passes will set up a system that does hold us to a little bit of a higher standard, just because we have a special trust with the public in the duties that we do.

So do you think a narrower bill with a simpler approach is a better approach?

Mr. KHUZAMI. I do, because I think it accomplishes everything that needs to be accomplished to make it clear and to eliminate uncertainty as to whether or not such a duty exists, but at the same time avoids—

Mr. CARNEY. So, for you, the big question is to eliminate that uncertainty.

Mr. KHUZAMI. Correct.

Mr. CARNEY. And you had a back-and-forth with Mr. Green about whether it would change anything you do, or you would do the same. Have you prosecuted any of these cases? Have you actually taken them to a court and had prosecutions to find out what might happen currently?

Mr. KHUZAMI. No. In my time at the SEC, there has not been a filed case against a Member of Congress for insider trading. There have been cases against members of the Executive Branch, FBI agents, and others, but not Members of Congress.

Mr. CARNEY. So, given the attention that this issue has gotten right now—which, for me, is a bad thing because it besmirches the reputation further of this institution which really should be the people's House and they should have trust in it—it is an opportunity to do something to improve that. How would you do that? How would you improve it? And I appreciate the fact that you are going to work with the sponsors to do that.

Mr. KHUZAMI. In a couple of ways. One is this process, obviously, to work on the legislation to clear up these issues. And the second

is, when any sort of suspicious trading or other activity is brought to our attention in insider trading or in any aspect of the Federal securities laws, we take a look at that and we conduct our inquiries and determine whether or not there is a basis for a violation of law.

Mr. CARNEY. So I think some of that, as I understood your testimony, comes through disclosure practices, right? And this would require a 90-day disclosure compared to the 1-year, the annual disclosure that we do now. And you mentioned, I think, in reference to corporate directors or something, an obligation of 2 or 3 days or something.

What is an appropriate—and what kind of trade would you be talking about for that kind of disclosure?

Mr. KHUZAMI. I am sorry, what kind of what? Trade?

Mr. CARNEY. Trade or activity.

Mr. KHUZAMI. I think, in general, our preference from an enforcement view would be, we would like to see the shortest period of time between the trade and the disclosure so that we have a better chance of getting the information, and to have it done in a searchable and electronic format.

As it is now, we do look at trading by Members and anybody else if we have reason to conduct an investigation, but what you can't do is you can't search a database in general without kind of a tip or a complaint, just search it in order to determine whether or not there is something suspicious. And you can't bring into the analysis other information you may have, because if it is in a paper format, it is just too unworkable. So electronic filing would really have the ability to manipulate the data and analyze it and combine it with other information just to make your inquiries much more thorough.

Mr. CARNEY. Right. So you mentioned earlier, too, some things that were not included under this legislation. Could you elaborate on that again? I don't see them in my notes here.

Mr. KHUZAMI. What is not included is I think it is a—because it speaks of material, nonpublic information in terms of pending or prospective legislation, it wouldn't cover other information that Members receive that might be material and nonpublic, including—

Mr. CARNEY. But it includes all kinds of transactions. I thought you mentioned certain transactions that wouldn't—

Mr. KHUZAMI. Oh, I am sorry, types of securities.

Mr. CARNEY. Yes, I am sorry, types.

Mr. KHUZAMI. Yes, yes. It is limited to securities and swaps of issuers. So it wouldn't include options, which are not a security of an issuer; an option is bought and sold by an exchange. It wouldn't include an ETF, which is put together and traded by and sold by a dealer on an exchange. It wouldn't include mutual funds because mutual funds in general are diversified. There are lots of different issuers in a fund, so it is not really—and it is issued by investment advisors or investment companies. So those would all be exempt.

Now, there are not many insider trading cases in mutual funds. Because they are diversified, it is harder to move the market. But options are typically the insider trader's first choice because they offer a great leveraged opportunity.

Mr. CARNEY. So I see my time has run out, but you will work with the sponsors on those, as well?

Mr. KHUZAMI. We will.

Mr. CARNEY. Thank you, and thanks for your testimony today.

Mrs. BIGGERT. The gentleman's time has expired.

The Chair notes that some Members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to this witness and to place his responses in the record.

Thank you so much, Mr. Khuzami, and thank you for giving us the time and the expertise that you have.

Mr. KHUZAMI. Thank you.

Mrs. BIGGERT. With that, I will call up the next panel.

Without objection, your written statements will be made a part of the record, and you will each be recognized for a 5-minute summary of your testimony.

We will hear from: Mr. Jack Maskell, legislative attorney, Congressional Research Service; Professor Donna Nagy, Indiana University Maurer School of Law; and Mr. Robert Walker, of counsel with Wiley Rein LLP.

Thank you all, and thank you for your patience. You will each be recognized for 5 minutes.

Mr. Maskell, we will begin with you.

**STATEMENT OF JACK MASKELL, LEGISLATIVE ATTORNEY,  
AMERICAN LAW DIVISION, CONGRESSIONAL RESEARCH  
SERVICE (CRS)**

Mr. MASKELL. Thank you very much, Madam Chairwoman.

Good morning, and thank you to the chairman and the members of the committee for inviting me here today. The committee has a copy of a legal memorandum that I previously prepared addressing in a little more detail what I will be discussing today.

One of the areas of law that I have covered for CRS since 1973 is governmental ethics and conflicts-of-interest law. And when questions have come in to CRS from time to time over the years about Members of Congress using nonpublic information for their own personal benefit, we approach the issue generally as a matter of Congressional ethics. Our advice over the years has consistently been that such conduct may be a violation of specific House and Senate ethics rules as well as contrary to recognized and accepted ethical guidelines and norms in Congress. A recent advisory opinion from the House Ethics Committee released last week has generally confirmed this kind of approach.

Because of the allegations that we have all been talking about, the issue of insider trading has now come to the fore. And as I mentioned and as was mentioned earlier, I think it is fairly clear now to everyone following the issue that Congress did not exempt itself from the insider trading laws. So, to cut through some of what I wanted to say and which would be fairly redundant, let me speak to really two points I would like to make today.

The first point is that CRS considers that the characterization made by some critics of Congress that the position of a Member of Congress is one which does not involve the public trust or a general duty of entrustment is wrong as a matter of both law and ethics.

I am certainly not the first to say that the office of the Member of Congress involves a public trust. Even before the adoption of the

Constitution, James Madison noted in the Federalist Papers the importance of measures to keep Members “virtuous whilst they continue to hold their public trust.” The phrase “public office as a public trust” is recognized explicitly in both the House and the Senate, and that phrase is more than merely an aphorism, because it denotes that Members of Congress wield public power, and have a fiduciary-like responsibility to use that power in the interests of the general public, who are supposed to be the beneficiaries of that trust.

The Senate, in its standing orders, has stated it this way: “Public office as a public trust signifies that the officer has been entrusted with public power by the people, that the officer holds this power and trust to be used only for their benefit and never for the benefit of himself or a few.” And that is in the standing orders for the Senate, and the House has similarly recognized that standard.

This fiduciary duty of Members toward the public is one which has been also expressly recognized by Federal courts. In 1978, the United States Court of Appeals for the Second Circuit—and it is interesting that it is from the Second Circuit, which covers New York and Wall Street—applied the fiduciary theory of public trust owed by a Member in a case in which the government moved to have the proceeds from an illegal transaction between a Member of the House and a private party recovered by the government under a theory of a constructive trust. The court agreed with the lower court decision to “impose a constructive trust on moneys the Member received in breach of his fiduciary duty as a United States Congressman.”

There are also specific House and Senate ethics rules that have been interpreted to mean that Members may not use their official positions for personal gain. Significantly, the House of Representatives has expressly recognized the continued application to the House of the ethical guidelines and standards adopted in the Code of Ethics for Government Service, which provides expressly that any Federal official, including a Member of Congress “may never use information coming to him confidentially in the performance of governmental duties as a means for making private profit.”

We think these factors create this public trust and this duty of trust of Members to the general public, including the investing public.

And I would point out that the ethics rules in the Executive Branch of government on using information for private gain are similar to these Legislative Branch ethics rules. And, of course, you are probably familiar with and the last witness spoke about the guilty plea to insider trading charges this summer by a Federal employee who worked as a chemist for the FDA. They are under similar ethical guidelines, that they can’t use inside information for their own use.

The second point I want to make today is about potential issues with enforcement of any measure that you propose. The express authorization and duty for Congress to discipline its own Members under Article I, Section 5, is there in part because there is the Speech or Debate privilege in Article I, Section 6, that says Members can’t be questioned in any other place for their legislative conduct.

And so I also want to point out that Section 3, which some Members questioned and brought up, would be a House rule and would be interpreted internally by the House and by the House Ethics Committee. So there may not be a problem at all with Speech or Debate with the House interpreting the rule because they are being questioned in this place and not some other place.

But if you expect that the Securities and Exchange Commission or any outside entity is going to come in and regulate legislative conduct and look at information that Congress may receive because of a hearing or a deposition that a Member takes or something, you may run into evidentiary issues concerning the Speech or Debate privilege that are certainly going to be practical considerations that anyone prosecuting that kind of provision would run into. I am not saying don't enact the law, but just be aware that privilege is there and that could interfere with some of the enforcement opportunities.

Thanks for the opportunity to be here. I will be available to answer any questions you may have relative to my testimony.

[The prepared statement of Mr. Maskell can be found on page 83 of the appendix.]

Chairman BACHUS. Thank you.  
Professor?

**STATEMENT OF DONNA M. NAGY, C. BEN DUTTON PROFESSOR  
OF LAW, INDIANA UNIVERSITY MAURER SCHOOL OF LAW**

Ms. NAGY. Thank you, Chairman Bachus, and members of the committee. I am honored by the invitation to testify.

I have researched and taught in areas including securities litigation and insider trading for over 17 years. Last spring, I published an article on Congressional insider trading. The article sought to debunk what at the time was bordering on urban myth: that Congress had exempted itself or was somehow immune from the existing law that prohibits insider trading. My article concluded that Congressional insider trading is already illegal under existing law because it violates the broad antifraud provisions in Rule 10b-5 and the Federal mail and wire fraud statutes.

I acknowledge that many distinguished securities law scholars see gray areas in existing law, and some believe a court would likely rule the other way in a prosecution.

The controversy surrounding the application of existing law to Congress stems from the fact that Congress has never enacted a Federal securities statute that explicitly prohibits anyone from insider trading. The STOCK Act addresses one manifestation of this much larger problem, but an explicit statutory definition and prohibition of insider trading that would apply equally to everyone, Congress included, would be the most equitable and appropriate solution.

In the absence of a statutory prohibition, insider trading is generally illegal only insofar as it is fraudulent. To be sure, the vast majority of insider trading prosecutions involve quintessential fiduciary-like relationships where the trader is an employee or agent alleged to have defrauded his employer or principal. But the Supreme Court has never implied, let alone stated, that a relationship has to be strictly a fiduciary one for a duty of disclosure to attach



under Rule 10b-5's misappropriation theory. Rather, the Supreme Court uses the term "fiduciary duty" interchangeably with a "duty of trust and confidence."

The SEC and the Justice Department have cast a tremendously wide net in Rule 10b-5 investigations premised on the misappropriation theory. Dozens of those caught have been family members, friends, or business associates who misappropriated material, non-public information that was entrusted to them. In all of these cases, the Securities and Exchange Commission and the Justice Department have proven themselves quite adept at convincing courts to find the type of feigning fidelity that is essential to liability under the misappropriation theory.

In view of these precedents, I very much doubt that a Federal Court would have the temerity to conclude that a Member of Congress lacks a duty of trust and confidence for purposes of the existing misappropriation theory. The Constitution refers repeatedly to public offices being of trust. Members also take an oath of office to faithfully discharge their duties. So there should be little doubt that a Member's undisclosed, self-serving use of Congressional knowledge constitutes a misappropriation that would defraud the United States and the general public, among others.

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

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

I would be honored to work with the committee and its staff to remedy this concern and to clarify some of the other drafting issues relating in large part to the Act's underinclusiveness, and in some respects overinclusiveness.

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

[The prepared statement of Professor Nagy can be found on page 86 of the appendix.]

Chairman BACHUS. Thank you. Mr. Walker, I welcome you.

**STATEMENT OF ROBERT L. WALKER, OF COUNSEL, WILEY  
REIN LLP**

Mr. WALKER. Thank you. And good afternoon, Mr. Chairman, and thank you, members of the committee, for this opportunity to discuss the Stop Insider Trading on Congressional Knowledge Act with you. As a former Chief Counsel of the House and Senate Ethics Committees, and as a former Federal prosecutor, I will add my

voice to the chorus: Current Federal insider trading prohibitions do apply fully to Members and employees of Congress under the misappropriation theory of insider trading.

I understand the view of many that notwithstanding the fact that insider trading prohibitions are enforceable against Congressional Members and staff, passage of the STOCK Act would give more specific and explicit authority, maybe even direction to the SEC and the Department of Justice to prosecute such cases if they arise. However, at least with regard to the provisions of the Act addressing so-called tippee liability for information coming from within Congress, and I do read the Act as addressing such instances, I believe that caution is advisable to make sure that the provisions do not chill the legitimate and necessary exchange of information between Congressional Members and staff, and individuals and entities outside of Congress.

Proof of insider trading cases under the misappropriation theory is not easy in any context, whether inside or outside of Congress. There is, of course, a unique complicating factor for enforcement by the DOJ or the SEC of insider trading prohibitions against Members of Congress. The Speech or Debate Clause, as you know, provides that certain, but not all, actions and activities of Members of the House and Senate may not be cited or used in proof in prosecutions or legal actions against Congressional Members. But this provision may limit available and admissible evidence in outside proceedings involving allegations of any sort, not just proceedings involving insider trading.

The important point to keep in mind here, however, with respect to Speech or Debate privilege is that no matter how carefully the STOCK Act is drafted, it cannot trump this Constitutional privilege where it applies. The privilege does not, of course, apply in investigations or proceedings of the Congressional Ethics Committees or offices. In such proceedings, for example, paragraph 8 of the Code of Ethics for Government Service could apply to capture and sanction insider trading by a Member or employee of the House or the Senate. This provision states that a person in Federal Government service should never use any information coming to him confidentially in the performance of governmental duties as a means for making private profit. Securities trading by a Member or employee based on confidential Congressional information would be a clear violation of this provision.

Having said this, however, proof of whether the Congressional information at issue in any given instance was in fact confidential under applicable House, Senate, or committee rules could be problematic. Allegations of insider trading in Congress may also be addressed under the overarching Congressional standard of conduct which enjoins Members and staff never to engage in conduct which may reflect discredit on the House or the Senate. In the House, this standard is set forth in paragraph one of House Rule 23, the Code of Official Conduct. If a specific credible allegation of securities trading by a Member or employee based on material, nonpublic information were to come before the Ethics Committees of the House or Senate, or before the House Office of Congressional Ethics, such an allegation would be investigated fully by those offices as constituting potentially conduct reflecting discredit on the institution.

Turning to the provisions of the STOCK Act that would require public disclosure of securities transactions within 90 days, rather than as currently on an annual basis, these provisions are consistent with, and would extend, the general approach to policing conflicts of interest in the Legislative Branch. That is an approach in which public disclosure is emphasized and recusal or divestment are disfavored.

Finally, three brief points on the section of the STOCK Act that would amend the Lobbying Disclosure Act, the LDA, to apply the Act's registration, reporting, and other requirements to a newly defined class of individuals and entities; that is, to so-called political intelligence consultants and firms. First, as has been acknowledged, these provisions would raise First Amendment concerns, and so there must be a compelling interest to impose this regulatory scheme. Second, the Act imposes a hair trigger threshold for registration and reporting. One, just one political intelligence contact, and registration and reporting requirements would kick in. And third, the definition of political intelligence contact in the Act is very broad, and would seem to capture communications that would have nothing to do with securities trades.

Thank you very much for the opportunity to speak with you today, and I look forward to answering your questions.

[The prepared statement of Mr. Walker can be found on page 99 of the appendix.]

Chairman BACHUS. Thank you. Normally, the committee has both Republican and Democratic witnesses. And this is an extreme compliment to each of you panelists. In this case, the committee agreed that you were probably the most knowledgeable expert witnesses, and we invited the three of you unanimously. So I want to thank you, and I want to thank you for your testimony, which I read last night. I thought it was very thorough.

As a backdrop, many Members of Congress have been accused of really some indefensible acts had they taken place. And so, I think it has created a public perception. As a result of that, the number one misconception is that insider trading laws do not apply to Members of Congress. However, I do believe that we can clarify that and make it clearer to restore public trust. Because when an accusation is made, it has an effect, even if it is a false allegation. Even if it is totally false.

Let me ask Mr. Walker, in your view would requiring all Members of Congress to place our assets in a blind trust eliminate the concerns that they are somehow violating the public trust by trading stocks or options or futures? Would that be a good idea?

Mr. WALKER. The short answer to whether it would eliminate allegations that the Members themselves were trading stocks on inside information, the short answer to that is yes, it would. There are other concerns that would enter into whether it was a good approach to take, at least from a practical point of view. In listening to your fellow committee members discuss some of their proposals today, I understand that proposals in this area would either require Members to place their assets in a blind trust or to disclose within a very brief window of time securities transactions. With that latter part added on, some of the practical concerns that I initially had with respect to a requirement that everyone put their as-

sets in a blind trust would be eliminated. Because in fact, a blind trust is an option for people who have a considerable number of assets and level of assets to begin with. There are administrative costs that go on in connection with it. And it is just not practical for a Member who may be here for a 2-year term to upend their financial lives, put it in a blind trust, and then they are "one and done," so to speak, in terms of their election to Congress. And it would not—and if you had that requirement, simply, Members who had relatively few assets would be in a position of not being able to trade at all unless you had that additional provision where they could opt for disclosure of trades within a very brief window of time.

Chairman BACHUS. Thank you. Professor Nagy, you stated in your testimony that Congress should use this current controversy to diagnose and treat the entire malady through the enactment of an express statutory definition and prohibition of insider trading for all individuals. Given that the SEC testified this morning that any statutory changes in this area should be carefully calibrated to ensure they do not narrow the current law, and thereby make it more difficult to bring future insider trader actions against any such persons, how would you suggest that we go about drafting an insider trading law?

Ms. NAGY. Mr. Chairman, I think there are a number of approaches that Congress could take. As I mentioned at the start of my testimony, Congress has never enacted a Federal securities statute that explicitly prohibits anyone from insider trading. Congress would not be starting on a blank slate if it chose to undertake that mission today. In 1987, there was a proposal that came relatively close to enactment: the Insider Trading Proscriptions Act of 1987. That proposed Act would have prohibited the wrongful use of material nonpublic information and the use of information that has been wrongfully obtained. The legislation sought to bring existing law under an express statutory prohibition. The advantage was that a statutory definition would not limit insider trading to fraud. It would include fraud, so it wouldn't have displaced the anti-fraud view of insider trading. But it would build on top of that fraud-based prohibition.

So for instance, someone who misappropriates material nonpublic information and uses that information to trade securities, but doesn't breach any fiduciary-like duty of trust and confidence, poses a prosecutorial challenge for the Securities and Exchange Commission or the Justice Department. Government prosecutors are incredibly creative, and I think they should be applauded for advancing new legal theories. There is a case involving a computer hacker where computer hacking is deemed to be deceptive. But we can all imagine, and I realize I risk sounding like a law professor here, but we can all imagine situations where misappropriated information is not obtained in any deceptive manner. So a broad statutory prohibition like the Insider Trading Proscriptions Act would be a place to start. However, we don't need to end right there. An alternative short of that would be bringing Congress and Congressional officials and Federal employees explicitly within existing law and making it explicitly clear that there is a duty of trust and confidence.

I could talk some more about that in answer to other questions. Chairman BACHUS. Thank you. Mr. Maskell, I appreciate the work that you do, and the Congressional Research Service.

Mr. MASKELL. Thank you.

Chairman BACHUS. They are a highly professional group, and of great assistance to us. Please explain the fiduciary duty that you say Members of Congress owe to the American public. And do you believe that the breach of that duty can give rise to action under Section 10b-5 in certain circumstances?

Mr. MASKELL. Yes, I do believe that in certain circumstances, that duty can give rise to a violation of insider trading law. This is a concept that has been around as long as the Nation has been around, that Members of Congress, public officials particularly, but especially Members of Congress who pass legislation and make laws, wield this public power for the benefit of the general public. And the general public are the beneficiaries of the trust that Members have. I explained in this one case, *United States v. Podell*, which arose out of the Second Circuit, that the court actually went back in, there was a transaction in which a Member had received money to help an airline industry get a route to Florida, a very lucrative route from New York to Florida, and the Justice Department came in and said since you have a fiduciary relationship to the public and a public trust, we consider that the money you took was not yours, but really belonged to the people, to the government. And the court agreed with them and allowed them to come in and recover that \$50,000 on behalf of the United States Government because of this fiduciary relationship that the court, the fiduciary duty that the court recognized in that case.

So I think it could be strong enough. I agree almost unanimously with everyone that it could be clarified. And certainly, this legislation would make it more explicit. And any legislation that does make that duty more explicit could be useful.

Chairman BACHUS. Thank you. I would just conclude by asking, on behalf of the committee, that the three of you make yourselves available—and you have made yourself available—to the sponsors of this bill and to the committee staff as we work to do just that, to clarify and make certain that the public is certain that these laws apply to us, and that our trading is measured by that standard.

Thank you. Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank our panelists for their patience, and for staying here to share with us their expert knowledge about this very, very complicated subject. I have listened very carefully to all of our presenters here today. I think one thing that there is a consensus on is that legislators, Members of Congress, are not exempted from insider trading. I think that is very, very clear based on everybody's testimony. And I think it is important for that word to go out among the Members of Congress, because I do believe that there was a belief by Members of Congress that there was an exemption, that somehow based on the work that we do, we do have access to information that may or may not be privileged or public, but somehow you would not be held accountable for discussing that or sharing it in some way. And I understand that. And that is accepted.

What is not clear to me is how the details of this legislation will be worked out, and who will have oversight responsibility, what role will the SEC play, what role will the Ethics Committee play, and even the Justice Department as we look at all of this. So that really does have to be ferreted out. That has to be thought through. Now, having said all of that, I have been trying to think about all of the circumstances that Members of Congress could be involved in that could be either/or. And I am focusing on the discussions that go on between staffs. For example, if members of Democratic staff and members of Republican staff get together, they are trying to work out problems with legislation, and perhaps even in what they are doing there are lobbyists involved as they are trying to work through how to resolve differences. In doing this, some facts began to emerge, or thoughts that may not be facts, that as these members look at what they are dealing with they could see how certain actions could either advantage or disadvantage a company or companies. And based on the information that they are concluding, or one person may be concluding, even though there are no facts to support it, that they could go out and they could say to a neighbor or a friend or a group at a party, "We are working on this legislation and these companies are involved. And I just kind of believe that if we go this way, this company is going to lose a lot of money. And if we go this way, these companies are going to gain a lot of money. I have just been working on this, I have been thinking it through, and that is really what I believe.

Now, the staff member does not act upon that information and go out and start trading, but do they become a tipster because somebody they are talking to, say, that person is very smart, and I have always listened to what this person had to say on so many levels and I think if they think that perhaps this is going to lead to this company making a lot of money, I am going to invest. I am going to trade. I am going to invest in that.

What is that? Is that tipping? Is that undermining the fiduciary responsibility? How would one calculate that? Professor?

Ms. NAGY. Right now under Rule 10b-5, whether it is the Securities and Exchange Commission or the Justice Department bringing an action, the government would have to show that the person who communicated the information breached a duty of trust and confidence in doing so. The Supreme Court has interpreted the requisite breach to mean essentially that the tipper, the communicator needs to have made that communication for a personal benefit. Without the personal benefit, there is no improper motivation. And if there is no improper motivation, under current law there is no liability for either the tipper or the tippee. So the type of well-intentioned communication of information from a knowledgeable source to another would not be illegal insider trading under Rule 10b-5. And I would encourage Congress not to reach beyond that established precedent. I think that works reasonably well. So under Rule 10b-5 it is the motivation of the person communicating the information that is going to be the linchpin for liability.

Ms. WATERS. Let me complicate this a little bit more. The tipper, who is not a conscious tipper who would receive benefit in any way from the tipping, has communicated this general information and thoughts to someone who could be a relative in that crowd where

you are talking. And that relative could be someone who in some way shares profits with, or would lend money to, or would designate that person in some way to be a part of their business. Does that mean that the would-be tipper then has violated some law? Because in a protracted way, they could be the beneficiary of the gain of the person who actually made the investment without even knowing at that time that they would be a beneficiary. How is that viewed? How is that dealt with?

Ms. NAGY. Congresswoman, in the example you give, without the intention to assist the friend or relative, the communicator of the information would not have liability because the communicator would not be breaching a duty of trust and confidence. And in the tippee-tipper type scenarios we are talking about, the tippee's liability is derivative of the tipper's. But current law would reach the type of scenario you are talking about not so much as a tipper-tippee situation, but as a misappropriation situation. I mentioned before that the government casts a very wide net vis-a-vis its application of the misappropriation theory.

Your hypothetical involves a situation where a knowledgeable source was sitting at the dinner table, sharing information with family members. The Supreme Court would not view the knowledgeable source—or a current court, I should say, would not view the knowledgeable source as a tipper. Rather, current case law would view the knowledgeable source as a person defrauded. That is, the recipients of that information sitting around the dinner table would be viewed as owing a duty of trust and confidence to the person sharing that information. So if Aunt Tilly, for instance, used that information in her own personal securities trading, the government could bring an action against Aunt Tilly for defrauding the person who told her that information, assuming the government could show a relationship of trust and confidence.

Now, there is a rule that the Securities and Exchange Commission promulgated that establishes three nonexclusive circumstances for finding a duty of trust and confidence. And the third category in that rule is one that pertains to family members. But it defines family members as parent, child, spouse, and sibling. So Aunt Tilly wouldn't be covered under that section of the rule. But she would potentially be covered under a second section which specifies that anyone who has a history, pattern, or practice of exchanging confidential information can be deemed to have a duty of trust and confidence. And so, if this family's history, pattern, and practice was to respect each other's confidentiality, then current law under the misappropriation theory could cover that as a fraud on the communicator.

Ms. WATERS. Thank you very much, Mr. Chairman.

Chairman BACHUS. Any of the panelists, if the tippee or tipper were Tipper Gore or Tip O'Neill, would it change your answer to the question? Never mind. Mrs. Biggert?

Mrs. BIGGERT. A quick question. It seems like with all of the financial disclosure that we have now, and if this is in the forefront, there is going to be a lot more scrutiny of our financial disclosures for good or bad. What I was wondering is, when we file the financial disclosures, we include spouses and dependent children, I guess is what their stocks are. Would this be something that could

be, with all of the whatever our spouses trade or anything, would this be included under a STOCK Act for Members? Maybe Mr. Walker, you could—

Mr. WALKER. I had been assuming that the answer to that is yes, to the same extent that the financial disclosure requirements currently apply to interests of spouses or dependent children. I think it would, although I don't believe the legislation addresses that specifically.

Mrs. BIGGERT. Okay. Does anybody else have any comments on that?

Mr. MASKELL. I agree with Rob. The legislation amends, though, Section 103 of the Ethics in Government Act of 1978. As Rob said, spouses and dependent children are covered. And you have to disclose transactions by spouses and dependent children because it tries to close an obvious loophole that you could just put money in your spouse's name or child's name.

Mrs. BIGGERT. It is just that with that further scrutiny, I always go back to maybe, Mr. Walker, you were in Ethics at that time, but I remember filing one of the first financial disclosures, and I had put in there "covered hopper." So I got a call, what is a covered hopper? I said, I don't know. You don't have time to always look at these things. A covered hopper is a railroad car. But I had to go and ask what it was. And I think that sometimes we don't really pay as much attention because we have somebody to do this. So it is going to make it hard for us sometimes on this. I think we have to be very careful.

My other question is really on the Speech or Debate Clause. I am not really sure what you meant, Mr. Maskell, when you were talking about the Speech or Debate, we might have a problem with solving how this is going to work. If you could explain that a little bit more.

Mr. MASKELL. When you have something going on like an inside trade, you substantially have two parts. You have a Member or other individual who is covered by the statute making a transaction, telling this broker, whomever, to buy or sell stock. And then on the other hand, there is this—it is based on certain information that the person received within their government employment, their Congressional employment. The first part of that is there is not going to be a problem with Speech or Debate. To be able to go in and prove that a Member of Congress made an order, bought stock, sold stock, all of that is outside of the legislative sphere and outside of the legislative process.

However, it is that second part, where the Member got that information, where you may have a practical issue with outside enforcement. Someone to come in and say, a Member sits on this committee, and they took a deposition of a witness, and that Member traded on that. That may run into problems with Speech or Debate privilege if a Member can say, wait, you cannot—I claim my privilege. You cannot introduce that into evidence because that speaks to a legislative activity that is covered under the Speech or Debate Clause. It is not a complete bar to a prosecution. You just look back in the very recent history, and Members of Congress can be prosecuted for things that are based on official acts, for bribery and all, because they have gotten evidence in other ways and they have



been able to bring that in. But if it is strictly on where someone got information, there could be an issue.

Let me tell you about one case, *United States v. Swindall*, which concerned at that time a Member of Congress who was at that time from Georgia. He was indicted on 10 counts of perjury related to money laundering. He was convicted on nine counts. The U.S. Court of Appeals and the Eleventh Circuit threw out three of the convictions because the Justice Department argued that the Member of Congress had “unique and specific knowledge” of these kinds of transactions because he sat on the committee that dealt with these. And the court said, you can’t introduce the fact that he sits on this committee and that he has dealt with that information. That is protected by Speech or Debate privilege. So this case went up, and cert was denied by the Supreme Court.

So I am just saying when you enact something and you expect an outside group to enforce it, there could be evidentiary issues that they run into, which would not be a problem if the Ethics Committee says, you violated the statutory provision that we enacted. And even though the SEC might have problems, we don’t have any problems with this because we are this place, we are the House Ethics Committee or the Senate Ethics Committee for Senators, and we can certainly enforce this under the standard that Rob mentioned, which is that you have caused the reputation of the institution to be denigrated, and therefore because you violated the statutory provision, we have authority over it.

Mrs. BIGGERT. Okay. Thank you. I yield back.

Chairman BACHUS. Mr. Sherman?

Mr. SHERMAN. Somebody who engages in transactions might do 100 transactions, just on a hunch, and 99 times, they lose money. Once they make a fortune, society looks at that and says, aha, he must have had insider knowledge. If Members of Congress should be subject to these rules, and we should, and I believe we are, and I believe we should clarify that, the question is what steps should Members of Congress take so that we don’t bring this institution into further disrepute?

Now, in the private sector, you are an officer of one corporation, you know you have to get legal advice to trade in the stock of that one corporation. I have colleagues who invest in hundreds of different companies. They are buying and selling every day. So the corporate executive is trading in his own company stock once every few months, or according to a preexisting plan, getting careful advice, and I have colleagues trading from their iPads on the Floor—or maybe. Does it make sense for Members of Congress to own shares of individual stock knowing that every one of those companies is affected by Congressional action or inaction? You could go to a caucus meeting and find out that everybody is talking about X, Y, and Z, so they are not talking about A, B, and C, so companies in that industry are safe.

Have any of you advised those with insider knowledge how to avoid violating these rules? And have you ever had to advise somebody where their insider knowledge didn’t relate to just one company, but they had insider knowledge of facts affecting everything on the board and in the pink sheets? Can anybody reflect their personal experience on this?

Ms. NAGY. The SEC has promulgated a rule, Rule 10b5-1, that provides a safe harbor, so to speak, for preexisting trading plans.

Mr. SHERMAN. And you can have a preexisting trading plan with one company. You may own 20 percent of it, you are going to retire, and you are going to sell 2 percent of your shares every month or whatever. But I don't know anybody who has a preexisting trading plan with regard to a portfolio of 50 stocks that they are in and out of every day.

Ms. NAGY. Potentially, one could have a preexisting trading plan for mutual fund investments where purchases are pre-arranged. Now, as long as the person who sets up the plan is not communicating with the portfolio manager of the mutual fund and sharing information, the portfolio manager can purchase and sell individual securities in that mutual fund portfolio, and there would be nothing wrong with that.

Mr. SHERMAN. You are almost arguing for what I am arguing for, and that is to let Members invest in mutual funds, but not in individual stocks. I would like, for the record, for you to provide—each witness who wants to, to provide us with the answers to two questions. First, what steps do we have to take with regard to the bill we are considering to make sure that it makes things tougher and clearer rather than serves to allow Members of Congress to do that which is pretty clearly illegal? And then second, what prophylactic policies should be imposed on Members, or recommended—I would say imposed, to make sure not only that they are not trading on inside information, because if one of my colleagues makes \$10,000 that they shouldn't, that worries me. But what worries me more is we are down to 9 percent. And if every one of my colleagues just plays their hunches, then out of every hundred trades, there is going to be one that you folks out there can say is another reason to hate Congress, or to distrust Congress. So should we have a policy that says don't—put all your money only into mutual funds and U.S. and State bonds. If you are in mutual funds, don't buy or sell more than 5 percent of that fund in any month? What would be the rules that you would suggest not to give us the maximum investment flexibility, but to give us the minimum likelihood of further opening up Congress to attack? Many of those attacks are unfair. But Congress' position, and the trust of the American people in Congress is a scarce and valuable commodity that can be degraded by both true and false charges.

Mr. Walker, you were trying to say something?

Mr. WALKER. Yes. Certainly, the measures that you have suggested, and the potential of requiring blind trusts or more prompt disclosure would be prophylactic measures, including ones you have talked about about having a policy of investing in mutual funds. I think it may be an unattainable goal to avoid ever raising public concern about potential conflicts of interest. I am not sure you are going to protect against that completely if someone is of a mind to raise an issue.

With respect to other provisions of the Act that would tighten up the approach to these things, I do think that the approach of disclosure that is currently in the Act, as I have said, is consistent with the current framework for addressing conflicts, and would have beneficial effects.

Mr. SHERMAN. Yes, Professor?

Ms. NAGY. Congressman, I would be very happy to provide a list of steps that could be taken to eliminate the underinclusiveness, and to some extent the overinclusiveness as well. The one point that I would like to make now is that the STOCK Act should make unmistakably clear that it builds on existing law, and that nothing in the STOCK Act should be read to displace existing law. This way, Rule 10b-5 and the Federal mail and wire fraud statutes will be there as a baseline, and the STOCK Act can be read as legislation that makes unmistakably clear how current law applies in the context of Congress.

Mr. SHERMAN. Thank you.

Chairman BACHUS. Thank you. Mr. Huizenga?

Mr. HUIZENGA. Thanks, Mr. Chairman. I don't want to put words in your mouth, but I want to make sure I am understanding as I was hearing you. Description of the fiduciary with people, with the public, is this legislation really necessary? And I am kind of hearing that it may not be necessary, that the legislation may not be necessary. I think, Professor Nagy, you talked about it being a little too explicit at some points. But is it just sort of belt and suspenders legislation? And is that your point, and why you want to make sure that it is not supplanting or that it rather is building on current case law?

Ms. NAGY. Yes, Congressman. When I wrote my article last spring, I wrote it in response to questions that had been raised as to whether Members of Congress owed a duty of trust and confidence for purposes of the misappropriation theory of insider trading. To be candid, I was surprised to hear that there was some difference of opinion on this issue. It would strike me that since the Constitution refers to a public office being "of trust", that should settle the matter. And when I think of the many cases the Securities and Exchange Commission and the Justice Department bring that involve relationships that are by no means ordinary fiduciary ones, or fiduciary-like ones, this is an issue that shouldn't generate much debate. But that doesn't appear to be the case. Securities professors whom I tremendously respect see this as a gray issue. And some go even further. So I am now at a point where I see that much use and much clarity can come from a declaration that Members of Congress owe a duty of trust and confidence for purposes of existing misappropriation theory law.

So yes, I would see this as a belt and suspenders legislation. My concern would be that the STOCK Act's suspenders are not viewed as somehow loosening or eliminating Rule 10b-5 and Federal mail and wire fraud statutes as the belt. Because then, I think we would have taken a step backwards. But as long as it is clear that this is belt and suspenders, we can make a good attempt at getting the suspenders as tight as they can be.

Mr. HUIZENGA. So let me ask this. My colleague right in front of me here, Mr. Canseco, has a resolution. It is not legislative, but it is a resolution that goes in, and in the brief description that I have heard, might be that belt and suspenders. It doesn't change or move anything else; it keeps it internal. He was talking about that dealing with ethics. Is a resolution actually a better direction to go?

Maybe Mr. Maskell, you would have an opinion on that. Is a resolution a better direction to go than a legislative proscriptive?

Mr. MASKELL. I wouldn't say it is a better way to go. It is an alternative way to go that could make the same kind of points about the duty of trust and confidentiality of information, not to use it for your own personal benefit. You could have more specificity in the House rules. That would be one way to go. I have never said that the STOCK Act is unnecessary. I personally wouldn't say that. I know CRS would never say that, because I don't want to usurp your position.

Mr. HUIZENGA. I wasn't implying that you were saying that. But I was hearing that in the context that it may not, because of Rule 10b-5 and the Constitutional notion of trust, that we already have established in law the fact that we have a fiduciary responsibility to the public.

Mr. MASKELL. And that is a fair statement. Absolutely we do, yes.

Mr. HUIZENGA. The other quick thing I wanted to address, and Mr. Walker, you were starting to talk a little bit about this, is political intel and the political intelligence. In your experience here on the Hill, is this a problem? And is this a major problem or a small problem? Is it something that we need to tackle and address as well?

Mr. WALKER. It is interesting. The question is what is the problem? You mean a problem in political intelligence—

Mr. HUIZENGA. Or maybe is there a problem, the fact that we have people—

Mr. WALKER. I am certainly not going to say that instances of abuse of the gleaning of information—I am not going to say that has never occurred. I would say, however, that to the extent that a Member or staffer was involved, and knowingly involved, and it was brought to the attention of the Ethics Committees appropriately, either through a complaint, or a letter, or a news article, it would have been addressed in that fashion. And without meaning to be unduly critical of any portion of the legislation, I do think that the last portion of the legislation relating to amending the Lobbying Disclosure Act, it in a way stands separate from the other provisions of the STOCK Act. And I do have the concerns I have raised as to the breadth of some of the terms and the potential First Amendment issues that would be raised.

Mr. HUIZENGA. Earlier today, we heard the authors of the bill, at least one of them, argue vigorously for that provision, that this is a major problem on the Hill, and that amendment needs to happen. So in your opinion, it is not necessary, or do you think if it is a direction we need to go we need to be very cautious about how that would be dealt with?

Mr. WALKER. I don't want to offer a conclusion as to whether or not, again, it is necessary. To the extent that you are asking my opinion, it seems to me that it could be addressed separately. And again, without saying whether or not it merits being addressed, I think it does stand apart from the other provisions of the STOCK Act, and may be more prudent to address that in a kind of separate approach.

Mr. HUIZENGA. I appreciate it. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. This concludes the third panel. We appreciate your testimony, and we do ask that you work with us over the next few days as we approach a markup. And so, you are dismissed.

The Chair notes that some Members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]



# **A P P E N D I X**

December 6, 2011

**The Stop Trading on Congressional Knowledge (STOCK) Act, H.R. 1148**  
**Submission for the Record**  
December 6, 2011

As a member of the Financial Services Committee, I am pleased the Committee is having this hearing to discuss an important piece of legislation that would ensure Members of Congress and their staffs are held to the same standards as the American public.

Americans need confidence in their institutions. Members and their staffs are privy to sensitive information on a regular basis. It is vital that decisions by Members of Congress be free from any consideration of what those actions would have on one's personal gains. I think many of us conduct ourselves with a great amount of integrity, and I see H.R. 1148, *The Stop Trading on Congressional Knowledge (STOCK) Act*, as an opportunity to make clear to the American people they can trust that we are completely focused on their bottom line and not ours.

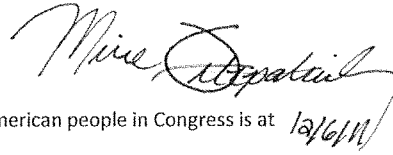
I welcome this hearing today as an opportunity to raise awareness of a practice that is already illegal on Wall Street and should similarly be for those who walk the halls of Congress each and every day. Insider trading is not just unethical – it is a betrayal of the American public's trust of those they voted to represent them here in Washington. This is why I am proud to be a cosponsor of The STOCK Act. Members of Congress and their staffs should be prohibited from using any nonpublic information received in the course of their work for financial gain. This legislation is a prime example of the type of straightforward, bipartisan initiatives the House of Representatives should be debating, abandoning partisan politics and joining together to work for a better America.

I look forward to working with my colleagues to see that The STOCK Act is passed through the House of Representatives and ultimately signed into law.

Joe Donnelly

Member of Congress



A handwritten signature in cursive script, appearing to read "Miss Depatie", with a date "12/6/11" written below it.

Thank you Mr. Chairman. The confidence of the American people in Congress is at an all-time low. Any suggestion that members of Congress are somehow above the law deserves scrutiny. We simply cannot afford for even the appearance of in propriety to act as a distraction when we have so many problems facing our country.

I think this hearing is going to be very instructive and I look forward to the expert testimony. The STOCK Act is a serious proposal worth examination and I know there are several other bills that have been introduced as well. I think the American people deserve to know that this issue is receiving our attention and hopefully the testimony here will inform not only us but the public as well.

Whatever legislation or any other fix may be necessary; we must act to restore the faith of the American people in our body.

**Statement of the Honorable Louise M. Slaughter  
Before the House Committee on Financial Services  
December 6, 2011**

Chairman Bachus, Ranking Member Frank and Members of the Committee, thank you for holding this important hearing today and for giving me the opportunity to testify. Ranking Member Frank, thank you for acknowledging the need for this legislation and for requesting a hearing. Your leadership will be missed when you retire at the end of this Congress. I look forward with working with you and Chairman Bachus to enact yet another historic financial reform to add to your legacy.

I want to thank the Committee for taking up such an important issue that has now gained national notoriety. The issue of insider trading in the halls of Congress has given the American people the very worst impression of the men and women that serve this institution. I believe, as I have for some time now, that we must end the possibility of personal enrichment within the Halls of Congress.

The STOCK Act has been around for five years now and never gained more than fourteen cosponsors. Representative Brian Baird and I introduced the STOCK Act in 2006 after increasing reports of Members of Congress and staff abusing their official status for private gain, and the rise of political intelligence firms using congressional nonpublic information to gain an advantage on the stock market. In addition, an academic field had developed to study whether Members of Congress performed better than average on the stock market in the 1980's and 1990's.

The bill was reintroduced in the 110<sup>th</sup> and again in the 111<sup>th</sup>. On July 13, 2009, I testified before this committee's Oversight and Investigations Subcommittee at a hearing on this very topic, but the bill never went any further. The STOCK Act has been reintroduced for the fourth time. The bill is supported by a broad base of groups focused on government reform, including Public Citizen, Citizens for Responsibility and Ethics in Washington (CREW), Common Cause, Democracy 21, League of Women Voters, Project on Government Oversight, the Sunlight Foundation, and U.S. PIRG.

Leading up to the *60 Minutes* report on congressional insider trading, the STOCK Act had received 9 cosponsors, a typically low amount, though we did have Representative Walter Jones sign on, making him the first Republican to join since the 109<sup>th</sup> Congress. I want to thank him for the support he has lent the legislation.

We now have 171 cosponsors and counting. There are not one, but two Senate counterparts to the STOCK Act after years of attempting to get the upper chamber's attention on the issue. I have never seen such an explosion of interest in a bill. My colleagues are really starting to understand that light needs to be shed on insider trading and the political intelligence industry, which has been creeping into the halls of Congress for years now. There are 535 of us privileged enough to serve in this Congress and the fact that any one of us would think to personally profit off the information that's shared with us upsets me greatly.

To make up for lost time, the Senate has held a hearing on the STOCK Act and committed to markup the bill before the year's end. I encourage the Members of this Committee to work in concert with the other five House committees of jurisdiction, including the Rules Committee of which I serve as the Ranking Member, in bringing this bill to markup and to the House floor for a vote in short-order.

Congressional approval is at six-percent. Thousands of people across the country have been peacefully protesting to break the intimate relationship between Wall Street and Washington, D.C. Enacting the STOCK Act will prove that Congress is capable of reforming its internal operations and will help ensure Members are held to at least the same standards as everyone else when it comes to insider trading. Failing to pass the STOCK Act will send a clear signal to the American public that we have no interest in gaining their approval or reforming a broken system.

Members of Congress, congressional staff, and federal employees have the unique opportunity and means to make profound changes in our economy, the country and the world. But with this historical opportunity comes the serious potential for abuse of power and the public trust.

Now, I sincerely believe that the vast majority of members of Congress and congressional staff are here to serve the best interests of their constituents and the public, not to line their own pockets. This bill is not about individuals, it is about reforming this institution as a whole. By explicitly prohibiting the improper use of sensitive information for personal gain, we will be taking an enormous step in providing transparency while preserving and strengthening public faith in our government and the democratic process.

I understand there are some who do not think the STOCK Act is necessary. They might argue that, in theory, the current ethics rules and SEC rules could be applied to cases of trading using congressional material nonpublic information. However, in practice, we have never seen these rules applied to Congress. This has made the public rightly question the adequacy of the rules we have today. That is why the STOCK Act has a multi-pronged effort to address congressional insider trading and remove any current ambiguity around the issue. The STOCK Act requires the Securities and Exchange Commission (SEC), the Commodities Future Trading Commission (CFTC) and House Ethics rules to explicitly ban such trading, and provides two new enforcement tools. The bill requires timely financial disclosures similar to what is required of Wall Street insiders, and I cannot emphasize this enough, it requires the registration of Political Intelligence firms similar to what is required of lobbyists.

Throughout our current economic crisis, and indeed since their creation in the 1970's, so called "political intelligence" firms have operated quietly in the background without any regulation or oversight. Recently, the size of this industry has grown considerably, bringing in an estimated \$100 million a year. These firms focus *not* on influencing Congress, but rather on using Congressional information to influence their clients' stock portfolios. For example, one political intelligence firm brazenly makes this concerning claim on their website, and I quote:

"Providing this service for clients who do not want their interest in an issue publicly known is an activity that does not need to be reported under the Lobbying Disclosure Act (LDA), thus providing an additional layer of confidentiality for our clients."

The STOCK Act does not ban political intelligence firms, but simply requires that the industry is as transparent as the lobbying industry.

Chairman Bachus and Ranking Member Frank, once again, let me thank you for holding this hearing today to shed light on this important issue. I look forward to working with you and all the Members of this Committee, as well as any other interested parties, to enact this critical legislation in a timely fashion.

**Statement by Congressman Tim Walz**  
**U.S. House of Representatives Committee on Financial Services**  
**Hearing entitled “H.R. 1148, the Stop Trading on Congressional Knowledge Act”**  
**December 6<sup>th</sup>, 2011**

Thank you Chairman Bachus and Ranking Member Frank for inviting me to offer testimony today, and thank you for holding this important hearing.

Before serving in Congress, I was a social studies teacher at Mankato West High School and served for twenty-four years in the National Guard.

For over ten years, I taught the students of southern Minnesota about the honor of public service. When I came to Congress, I was astounded and outraged to learn there were no clear laws prohibiting Members of Congress from using non-public information to profit on Wall Street.

Members of Congress and their staff should not be able to profit from the honor of serving the United States. As members of Congress, we have access to information the average American does not. It is not right that Congress can benefit from information that is not available to other Americans.

We need to make it explicitly clear this behavior is illegal.

In the last few weeks, there has been considerable attention focused on the issue of insider trading on Capitol Hill. Particular attention has been given to the STOCK Act, a bill I have been a co-sponsor of since 2008 and the reason why we are here today.

Last March, Congresswoman Slaughter and I re-introduced the Stop Trading on Congressional Knowledge Act (STOCK Act). The STOCK Act explicitly prohibits Members of Congress, their staff and other federal employees from buying or selling securities, swaps, or commodity futures based on congressional and executive branch nonpublic information. It increases transparency by requiring financial disclosures in a more timely fashion and requires political intelligence firms to register with the House and Senate – much like lobbying firms do now.

Some critics say the STOCK Act is not needed. I disagree. This is an area where we need the law to be absolutely clear and leave no room for doubt. Some folks have said they don't believe the STOCK Act goes far enough. Let me be clear: the STOCK Act is real reform. But I stand prepared to work with anyone and everyone who has ideas about how to reform the way Washington works. We should pass this bill. Like my hometown newspaper, the Mankato Free Press said - passing this bill “should be a no-brainer for lawmakers.”

I would also like to recognize the outstanding leadership of now retired Congressman Baird, and Congresswoman Slaughter for supporting this bill since 2006. Their work to close this loophole has been outstanding, and we would not be here today without their efforts. I also want to

recognize Congressman Jones, who has been leading the Republican efforts on this bill. In addition, I would like to thank Senator Gillibrand, Senator Brown and Senator Tester for their work on similar bills in the Senate. I am proud that this bill enjoys bipartisan support. I wish we worked in a bipartisan fashion more often around here.

Americans are understandably frustrated and they have lost faith in our ability to govern. We can and we should do something about it. The STOCK Act is a big step in the right direction to help restore the American people's faith in Congress and the work of democracy. As the Star Tribune in Minnesota noted, "The bill is smart politics and policy, and is a dose of what's needed to start reversing voters' rampant cynicism." We need to ensure the people of this country know that lawmakers are working in their best interests, and not the interests of their own bank account. Americans need to know that their elected leaders play by the same rules as everyone else. It is simply not right - we should not be above the rules. It is time for us to do the right thing and pass the STOCK Act.

**Testimony on “H.R. 1148, the Stop Trading on Congressional Knowledge Act”**

**By**

**Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission**

**Before the Committee on Financial Services of the U.S. House of Representatives**

**December 6, 2011**

Chairman Bachus, Ranking Member Frank, and Members of the Committee:

Thank you for the opportunity to provide testimony on behalf of the U.S. Securities and Exchange Commission on the subject of insider trading.

Insider trading threatens the integrity of our markets, depriving investors of the fundamental fairness of a level playing field. To deter this conduct and to hold accountable those who fail to play by the rules, the detection and prosecution of those who engage in insider trading remains one of the Division of Enforcement’s highest priorities.

My testimony provides a summary of the Division of Enforcement’s recent work in the area of insider trading, an overview of the law of insider trading as developed through our enforcement program and judicial precedent, and a description of how the current law of insider trading applies to securities trading by Members of Congress and their staffs.

**Enforcement’s Insider Trading Program**

Insider trading has long been a high priority for the Commission. Approximately eight percent of the 650 average annual number of enforcement cases filed by the Commission in the past decade have been for insider trading violations. In the past two years, the Commission has been particularly active in this area. In fiscal year 2010, the SEC brought 53 insider trading cases against 138 individuals and entities, a 43 percent increase in the number of filed cases from the prior fiscal year. This past fiscal year, the Commission filed 57 actions against 124 individuals and entities, a nearly 8 percent increase over the number of filed cases in fiscal year 2010.

The increased number of insider trading cases has been matched by an increase in the quality and significance of our recent cases. In fiscal year 2011 and the early part of fiscal year 2012, the SEC obtained judgments in 18 actions arising out of its investigation of Galleon hedge fund founder Raj Rajaratnam, including a record \$92.8 million civil penalty against Rajaratnam personally. The SEC also discovered and developed information that ultimately led to criminal convictions of Rajaratnam and others, including corporate executives and hedge fund managers, for rampant insider trading. In addition, we recently filed an insider trading action against Rajat Gupta, a former director of both Goldman Sachs and Procter & Gamble, whom we allege provided confidential Board information about both companies’ quarterly earnings and about an

impending \$5 billion Berkshire Hathaway investment in Goldman Sachs to Rajaratnam, who traded on that information.

Among others charged in SEC insider trading cases in the past fiscal year were various hedge fund managers and traders involved in a \$30 million expert networking trading scheme, a former Nasdaq Managing Director, a former Major League Baseball player, a Food and Drug Administration chemist, and a former corporate attorney and a Wall Street trader who traded in advance of mergers involving clients of the attorney's law firm. The SEC also brought insider trading cases charging a Goldman Sachs employee and his father with trading on confidential information learned by the employee on the firm's ETF desk, and charging a corporate board member of a major energy company and his son for trading on confidential information about the impending takeover of the company.<sup>1</sup>

The Division also has targeted non-traditional cases involving the misuse or mishandling of material, non-public information. This past fiscal year, the Commission charged Merrill Lynch, Pierce, Fenner & Smith with fraud for improperly accessing and misusing customer order information for the firm's own benefit. The Commission also censured broker-dealer Janney Montgomery Scott LLC for failing to enforce its own policies and procedures designed to prevent the misuse of material, nonpublic information. Charles Schwab Investment Management was charged for failing to have appropriate information barriers for nonpublic and potentially material information concerning an ultra-short bond fund that suffered significant declines during the financial crises. This deficiency gave other Schwab-related funds an unfair advantage over other investors by allowing the funds to redeem their own investments in the ultra short-bond fund during its decline. The Commission also charged Office Depot, Inc. and two of its executives for violating Regulation FD by selectively disclosing to certain analysts and institutional investors that the company would not meet its earnings.

To respond to emerging risks, the Enforcement Division has developed several new initiatives targeted at ferreting out insider trading, which have enhanced our effectiveness in this area. During our recent reorganization, the Division established a Market Abuse Unit, with an emphasis on various abusive market strategies and practices, including complex insider trading schemes.

The Market Abuse Unit has spearheaded the Division's Automated Bluesheet Analysis Project, an innovative investigative tool that utilizes the "bluesheet" database of more than one billion electronic equities and options trading records obtained by the Commission in the course of insider trading investigations over the past 20 years. Using newly developed templates, Enforcement staff are able to search across this database to recognize suspicious trading patterns and identify relationships and connections among multiple traders and across multiple securities, generating significant enforcement leads and investigative entry points. While still in its early stages of development, this new data analytic approach already has led to significant insider

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<sup>1</sup> A broader discussion of select insider trading cases from fiscal years 2011, 2010, and 2009 is available on the SEC's website at our Insider Trading Spotlight page, <http://www.sec.gov/spotlight/insidertrading/cases.shtml>.



trading enforcement actions that were not the subject of an SRO referral, informant tip, investor complaint, media report, or other external source.<sup>2</sup>

As part of the reorganization, the Division also established a cooperation program to encourage key fact witnesses to provide valuable information. Insider trading investigations are extremely fact-intensive. Enforcement staff undertake the often painstaking work of collecting and analyzing trading data across equity and options markets, analyzing communications (email, telephone calls and instant messages, among others) and analyzing market-moving events (e.g., announcements of corporate earnings, product development, and acquisitions and mergers) to identify persons who may have engaged in insider trading or who may have information about such activity. Our new cooperation program is a valuable tool that can help us break open an insider trading investigation earlier in the process, thereby preserving resources. We are already seeing the effectiveness of the cooperation program in our insider trading cases and expect this trend to continue as more cooperators come forward in our investigations.

With an aggressive investigative approach that includes early coordination with the FBI, Department of Justice, and other law enforcement agencies, we have been able to identify potential cooperators who may assist criminal authorities with their covert investigative techniques, helping amass critical evidence in numerous insider trading investigations. Our work with certain SROs has provided valuable early tips, helping us mitigate the harm from insider trading schemes by freezing the illicit proceeds before funds are moved to offshore jurisdictions.

#### **Law of Insider Trading**

There is no express statutory definition of the offense of insider trading in securities.<sup>3</sup> The SEC prosecutes insider trading under the general antifraud provisions of the Federal securities laws, most commonly Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5, a broad anti-fraud rule promulgated by the SEC under Section 10(b). Section 10(b) declares it unlawful “[t]o use or employ, in connection with the purchase or

<sup>2</sup> See, e.g., *SEC v. Nicos Achilleas Stephanou, Ramesh Chakrapani, Achilleas Stephanou, George Paparrizos a/k/a Georgios Paparrizos, Konstantinos Paparrizos, Michael G. Koulouroudis and Joseph Contorinis*, Civil Action No. 09 CV 1043 (S.D.N.Y. Feb. 5, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr20884.htm>; *SEC v. James W. Self Jr. and Stephen R. Goldfield*, Civil Action No. 10-CV-4430-ER (E.D. Pa. Sept. 1, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21638.htm>; *SEC v. Jeffery J. Temple and Benedict M. Pastro*, Case No. 10-CV-1058 (D. Del. December 7, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21765.htm>; *SEC v. Matthew H. Kluger and Garrett D. Bauer*, Case No. 11-cv-1936 (D.N.J. April 6, 2011), <http://www.sec.gov/litigation/litreleases/2011/lr21917.htm>; *SEC v. Jonathan Hollander*, Civil Action No. 11-CV-2885 (S.D.N.Y. April 28, 2011), <http://www.sec.gov/litigation/litreleases/2011/lr21950.htm>.

<sup>3</sup> On several occasions, Congress has considered but ultimately declined to enact an explicit statutory prohibition of insider trading. See, e.g., H.R. Rep. No. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048 (legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988 notes that although Congress had considered a legislative definition of insider trading, the Committee declined to include a statutory definition in the bill because in its view “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.”). Congress has specifically provided the SEC with authority to seek civil money penalties for insider trading, 15 U.S.C. § 78u-1, and provided an express private right of action for certain contemporaneous traders in insider trading cases. 15 U.S.C. § 78t-1.

sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”<sup>4</sup> Rule 10b-5 broadly prohibits fraud and deception in connection with the purchase and sale of securities. As the Supreme Court has stated, “Section 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception,” because “[n]ovel or atypical methods should not provide immunity from the securities laws.”<sup>5</sup>

There are two principal theories under which the SEC prosecutes insider trading cases under Section 10(b) and Rule 10b-5. The “classical theory” applies to corporate insiders – officers, directors, and employees of a corporation, as well as “temporary” insiders, such as attorneys, accountants, and consultants to the corporation.<sup>6</sup> Under the “classical theory” of insider trading liability, a corporate insider violates Section 10(b) and Rule 10b-5 when he or she trades in the securities of the corporation on the basis of material, nonpublic information. Trading on such information qualifies as a “deceptive device” under Section 10(b), because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”<sup>7</sup> That relationship “gives rise to a duty to disclose [or to abstain from trading] because of the ‘necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.’”<sup>8</sup>

The Supreme Court has recognized that corporate “outsiders” can also be liable for insider trading under the “misappropriation theory.”<sup>9</sup> Under this theory, a person commits fraud “in connection with” a securities transaction, and thereby violates Section 10(b) and Rule 10b-5, when he or she misappropriates confidential and material information for securities trading purposes, in breach of a duty owed to the source of the information. This is because “a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”<sup>10</sup> The misappropriation theory thus “premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”<sup>11</sup> Under either the classical or misappropriation theory, a person can also be held

<sup>4</sup> 15 U.S.C. § 78j(b).

<sup>5</sup> *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

<sup>6</sup> *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

<sup>7</sup> *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

<sup>8</sup> *Id.* at 228–29 (citation omitted).

<sup>9</sup> *United States v. O’Hagan*, 521 U.S. 642, 653 (1997).

<sup>10</sup> *Id.* at 652.

<sup>11</sup> *Id.*

liable for “tipping” material, nonpublic information to others who trade, and a “tippee” can be held liable for trading on such information.<sup>12</sup>

A common law principle is that employees owe a fiduciary duty of loyalty and confidence to their employers. In addition, employees often take on contractual duties of trust or confidence as a condition of their employment or by agreeing to comply with a corporate policy. Accordingly, employees have frequently been held liable under the misappropriation theory for trading or tipping on the basis of material non-public information obtained during the course of their employment.<sup>13</sup> This includes prosecution of federal employees who, in breach of a duty to their employer, the federal government, trade or tip on the basis of information they obtained in the course of their employment. For example, the SEC recently brought insider trading charges against a Food and Drug Administration employee alleging that he violated a duty of trust and confidence owed to the federal government under certain governmental rules of conduct when he traded in advance of confidential FDA drug approval announcements.<sup>14</sup>

In light of existing precedent regarding the liability of employees – including federal employees – for insider trading, any statutory changes in this area should be carefully calibrated to ensure that they do not narrow current law and thereby make it more difficult to bring future insider trading actions against any such persons.

#### **Application of Insider Trading Law to Trading by Members of Congress and Their Staff**

The general legal principles described above apply to all trading within the scope of Section 10(b) and Rule 10b-5. There is no reason why trading by Members of Congress or their staff members would be considered “exempt” from the federal securities laws, including the insider trading prohibitions, though the application of these principles to such trading, particularly in the case of Members of Congress, is without direct precedent and may present some unique issues.

Just as in any other insider trading inquiry, there are several fact-intensive questions – including the existence and nature of the duty being breached and both the materiality and nonpublic nature of the information – that would drive the analysis of whether securities trading (or tipping) by a Member of Congress or staff member based on information learned in an official capacity violates Section 10(b) and Rule 10b-5.

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<sup>12</sup> *Dirks v. SEC*, 463 U.S. at 660-62.

<sup>13</sup> *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *Carpenter v. United States*, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

<sup>14</sup> *See, e.g., SEC v. Cheng Yi Liang, et al.*, Exchange Act Rel. No. 21097 (March 29, 2011), <http://www.sec.gov/litigation/litreleases/2011/lr21907.htm>; *see also United States v. Royer*, 549 F.3d 886 (2d Cir. 2008) (affirming a conviction of an FBI agent for tipping information about ongoing investigations and information on law enforcement databases); *SEC v. John Acree*, Litigation Rel. No. 14231, 57 SEC Docket 1579 (Sept. 13, 1994) (announcing a settled action with a former employee of the Office of the Comptroller of the Currency for trading on the basis of material non-public information concerning banks).

The first question is whether the trading, or communicating the information to someone else, breached a duty owed by the Member or staff. Although there is no direct precedent for Congressional staff, there is case law from other employment contexts regarding misappropriation of information gained through an employment relationship. This precedent is consistent with a claim that Congressional staff, as employees, owe a duty of trust and confidence to their employer and that a Congressional staff member who trades on the basis of material non-public information obtained through his or her employment is potentially liable for insider trading under the misappropriation theory, like any other non-governmental employee.

The question of duty is more novel for Members of Congress. There does not appear to be any case law that addresses the duty of a Member with respect to trading on the basis of information the Member learns in an official capacity. However, in a variety of other contexts, courts have held that “[a] public official stands in a fiduciary relationship with the United States, through those by whom he is appointed or elected.”<sup>15</sup> Commenters have differed on whether securities trading by a Member based on information learned in his or her capacity as a Member of Congress violates the fiduciary duty he or she owes to the United States and its citizens, or to the Federal Government as his or her employer.<sup>16</sup>

Existing Congressional ethics rules also may be relevant to the analysis of duty for both Members and their staff. For example, Paragraph 8 of the Code of Ethics for Government Service provides that “Any person in Government service should . . . [n]ever use any information coming to him confidentially in the performance of governmental duties as a means for making private profit.”<sup>17</sup>

The second question is whether the information on which the Member or staff trades (or tips) is “material” – that is, is there “a substantial likelihood” that a reasonable investor “would consider it important” in making an investment decision?<sup>18</sup> Materiality is a mixed question of fact and law that depends on all the relevant circumstances. In some scenarios, it may be relatively clear that an upcoming Congressional action would be material to a particular issuer or group of issuers, while in others it may be more challenging to establish that.

The third critical question is whether the information on which the Member or staff traded (or tipped) is “nonpublic.” The Commission has stated that “[i]nformation is nonpublic when it has not been disseminated in a manner making it available to investors generally.”<sup>19</sup>

<sup>15</sup> *United States v. Podell*, 436 F. Supp. 1039, 1042 (S.D.N.Y. 1977) (citing *Trist v. Child*, 88 U.S. (21 Wall.) 441, 450 (1874)). See also *United States v. Carter*, 217 U.S. 286, 306 (1910) (“The larger interests of public justice will not tolerate, under any circumstances, that a public official shall retain any profit or advantage which he may realize through the acquirement of an interest in conflict with his fidelity as an agent.”).

<sup>16</sup> Cf. Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U.L.R. 1105, 1111, 1148 (2011); Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011).

<sup>17</sup> H.Con.Res. 175, 85<sup>th</sup> Cong., 2d Sess., 72 Stat., pt. 2, B12 (1958).

<sup>18</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

<sup>19</sup> *In re Investors Management Co.*, 44 SEC 633, 643 (1971), (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969)).

Whether information is “nonpublic” would likely depend on the circumstances under which the Member or staff learned the information and the extent to which the information had been disseminated to the public.

As with all issues of liability with regard to insider trading and other claims under Section 10(b), the conduct at issue must be intentional or reckless.<sup>20</sup> Since all of these issues are inherently fact-specific, it is difficult to generalize about the likely outcome of any particular scenario. However, trading by Congressional Members or their staffs is not exempt from the federal securities laws, including the insider trading prohibitions.

**Application of Tipper and Tippee Liability Theories to Members of Congress and Their Staff**

Communication of nonpublic information to others who either trade on the information themselves or share it with others for securities trading purposes, could be analyzed under the case law relating to tipper and tippee liability and also would turn on the specific facts of the case.

A person can be liable as a tipper where he or she discloses information in breach of a fiduciary duty or other similar duty of trust or confidence and the tippee trades on the basis of that information. The same duty requirement described above is applicable in the tipper context, as are the requirements that the tipped information be nonpublic and material. In addition, a court may require a showing that the Member of Congress or staff member personally benefited from providing the tip.<sup>21</sup>

A person who trades on the basis of material, nonpublic information conveyed by a Member or staff member in breach of a duty also could be liable for illegal insider trading as a tippee. An additional element of liability is that the tippee knew or should have known of the tipper’s breach of duty in disclosing the information.<sup>22</sup>

Investigations into potential trading or tipping by Members of Congress or their staff could pose some unique issues, including those that may arise from the Constitutional privilege

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<sup>20</sup> See, e.g., *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198-201 (1st Cir. 1999); *SEC v. Environmental, Inc.*, 155 F.3d 107, 111 (2d Cir. 1998).

<sup>21</sup> See *Dirks v. SEC*, 463 U.S. 646, 662 (1983).

<sup>22</sup> *Id.* at 660.

provided to Congress under the Speech or Debate Clause, U.S. Const. art. I, § 6, cl.1.<sup>23</sup> The Supreme Court has stated that “[t]he Speech or Debate Clause was designed to assure a co-equal branch of the government wide freedom of speech, debate, and deliberation without intimidation or threats from the Executive Branch.”<sup>24</sup> The Clause “protects Members against prosecutions that directly impinge or threaten the legislative process.”<sup>25</sup> While the “heart” of the privilege is speech or debate in Congress, courts have extended the privilege to matters beyond pure speech and debate in certain circumstances.<sup>26</sup> There may be circumstances in which communication of nonpublic information regarding legislative activity to a third party falls “within the ‘sphere of legitimate legislative activity,’”<sup>27</sup> and thus may be protected by the privilege.

### **Conclusion**

The SEC’s continued focus on insider trading and innovative investigative techniques demonstrates our commitment to pursuing potentially suspicious trading in a variety of contexts. While recent innovations in the Division of Enforcement are enhancing our ability to obtain that evidence, to establish liability we must satisfy each of the elements of an insider trading violation, including the materiality of the information, the nonpublic nature of the information, the presence of scienter, and a fiduciary or other duty of trust and confidence that was violated by the trading or tipping. While trading by Members of Congress or their staff is not exempt from the federal securities laws, including the insider trading prohibitions, there are distinct legal and factual issues that may arise in any investigations or prosecutions of such cases. Any statutory changes in this area should be carefully calibrated to ensure that they do not narrow current law and thereby make it more difficult to bring future insider trading actions against individuals outside of Congress.

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<sup>23</sup> See, e.g., *In re Grand Jury Subpoenas*, 571 F.3d 1200, 1203 (D.C. Cir. 2009) (holding that testimony and documents relating to a Congressman’s testimony to the House Ethics Committee were protected under the Speech or Debate clause); *United States v. Rayburn House Office Building*, 497 F.3d 654, 663 (D.C. Cir. 2007) (finding that the Speech or Debate clause prohibited law enforcement officials from searching a Member’s office and reviewing documents concerning legislative activities without the Member’s consent).

<sup>24</sup> *Gravel v. United States*, 408 U.S. 606, 616 (1972).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 625 (citing *United States v. Doe*, 455 F.2d 753, 760 (1st Cir. 1972)).

<sup>27</sup> *Id.* at 624 (citing *Tenney v. Brandhove*, 341 U.S. 367, 376 (1951)).

Good morning, and thank you Mr. Chairman and Members of the Committee.

My name is Jack Maskell. I am a legislative attorney in the American Law Division of CRS. I have been at CRS since 1973, and one of the areas of law that I cover is governmental ethics and conflicts of interest law.

When questions have come into CRS from time-to-time over the years regarding Members of Congress and the use of confidential or nonpublic information for their own personal financial benefit, we have approached that issue, generally, as a matter of congressional ethics. Our advice over the years has consistently been that such conduct may be a violation of specific House or Senate ethics rules, as well as contrary to recognized and accepted ethical guidelines and norms in Congress. A recent advisory opinion from the House Ethics Committee, released last week, has confirmed this approach.

Because of allegations over the last number of years with regard to trading in securities of publicly traded companies by Members of Congress, there have been questions raised also about possible violations of the insider trading rules.

I think it is now fairly clear to everyone following this issue that Congress did not “exempt itself” from the insider trading laws:

- the statutory provisions prohibiting fraud and market manipulation provide no exception for Members,
- the regulations of the SEC do not express any exemption for Members of Congress,
- and the case law has not recognized any specific congressional exemption.

When an individual is in a position or has a particular relationship to issuers, to those who are stockholders, or even to a provider of information, as described in the SEC regulations, and that person trades on material, nonpublic information, such person would likely violate the insider trading provisions whether or not he or she is a Member of Congress.

Because of the lack of case law specifically applying the insider trading laws to Members of Congress, -- there are certainly some areas for dispute concerning any particular hypotheticals, and how the law would or not apply, especially in relation to information that is not from a private company, insider, or trader, but rather is merely about a potential or proposed congressional action. However, one of the two main points I want to make this morning is that CRS considers that the characterization made by some critics of Congress that the position of a Member of Congress is one which does not involve a public trust, a duty of entrustment, is wrong as a matter of both law and ethics.

I am certainly not the first to say that the office of a Member of Congress involves a public trust. Even before the enactment of the Constitution, James Madison noted in the Federalist Papers the importance of measures to keep Members “virtuous whilst they

continue to hold their public trust.” The phrase “public office is a public trust” is recognized explicitly in both the House and the Senate. That phrase is more than merely an aphorism, because it denotes that Members of Congress who wield public power have a fiduciary responsibility to use that power in the interests of the general public who are supposed to be the beneficiaries of that trust.

The Senate, in its Standing Orders, has stated it very nicely:

“It is declared to be the policy of the Senate that ... The ideal concept of public office, expressed by the words, ‘A public office is a public trust’, signifies that the officer has been entrusted with public power by the people; that the officer holds this power in trust to be used only for their benefit and never for the benefit of himself or a few ....”

(Standing Orders of the Senate, *Senate Manual*, § 87, S. Doc. 107-1, at 118-119 (2002)).

This fiduciary duty of Members towards the public is one which has been expressly recognized by federal courts. In 1978, the United States Court of Appeals for the Second Circuit applied a fiduciary theory of public trust owed by a Member in a case in which the government moved to have the proceeds from an illegal transaction between a Member of the House and a private party recovered by the government under a theory of a “constructive trust.” The court agreed with the lower court decision to “impose a constructive trust on monies [the Member of Congress] received in breach of his *fiduciary duty as a United States Congressman*.” (*United States v. Podell*, 572 F.2d 31, 32 (2d Cir. 1978)).

There are also specific House and Senate ethics rules relative to the use of one’s office for one’s own personal benefit. The Ethics Committee has noted that the language of the House Rules means that Members “may not use their official positions for personal gain.” (*House Ethics Manual*, at 186 (2008)). Additionally, the House of Representatives has expressly recognized the continued application to the House of the ethical guidelines and standards adopted in the Code of Ethics for Government Service, which provides expressly that any federal official, including a Member of Congress, may

“[n]ever use any information coming to him confidentially in the performance of governmental duties as a means for making private profit.”

The ethics rules in the executive branch of government on using information for private gain are similar to these provisions, and, of course, you are probably familiar with the guilty plea this summer by a federal employee who worked for the FDA to insider trading charges. (*United States v. Cheng Yi Liang*, Crim. No. DKC-11-0530, plea agreement of August 18, 2011 (D.Md. 2011))

The second point I want to make today is about potential problems with enforcing certain measures proposed to address this issue. The express authorization and duty of each House to discipline its own Members for misconduct in Article I, Section 5 of the Constitution is there, in part, because of existence of the provisions of Article I, Section 6



of the Constitution, which help enforce separation of powers by providing that Members of Congress may not be “questioned” in other place regarding their speech or debate in either House. The courts have found that Members of Congress are immune from criminal or civil proceedings for their official legislative activities which are considered “an integral part of the deliberative and communicative process by which Members participate in committee and House proceedings.”<sup>1</sup> So, if Congress passes a law in which it delegates to an *outside* body, such as an independent regulatory agency in the executive branch of government, the responsibility to police congressional activity inside of Congress arising from, for example, hearings, depositions, or even legislative strategy sessions, any outside enforcement authority may encounter some significant evidentiary issues regarding the “Speech or Debate” privilege. Its not a bar to prosecution or to civil action, but it certainly would impact outside enforcement decisions.

I am available to answer questions you may have relative to my testimony.

Thank you.

**Hearing on H.R. 1148**  
**The Stop Trading on Congressional Knowledge Act**  
**Before the United States House of Representatives Committee on Financial Services**

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

December 6, 2011

Chairman Bachus, Ranking Member Frank, and Members of the Committee: Thank you for inviting me to submit written testimony as part of your hearing on H.R. 1148, the Stop Trading on Congressional Knowledge (STOCK) Act. My name is Donna M. Nagy and I am the C. Ben Dutton Professor of Law at Indiana University Maurer School of Law in Bloomington, Indiana. I began my academic career 17 years ago at the University of Cincinnati College of Law. Before that, I practiced securities litigation as an associate at Debevoise & Plimpton in Washington, D.C. I am the co-author of two books: a treatise on the law of insider trading (with Ralph C. Ferrara and Herbert Thomas) and a casebook on Securities Litigation and Enforcement (with Professors Richard W. Painter and Margaret V. Sachs). I have also published several law review articles on insider trading, including a 58 page article on the precise topic of today's hearing.<sup>1</sup>

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

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

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

<sup>2</sup> See, e.g., DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION § 3.09 (2011) (observing that the issue "raises difficult constitutional and political questions"); Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 107 (2009) (maintaining that although a plausible theory exists that

such scholar has concluded that “the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted.”<sup>3</sup>

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

#### **A Brief Snapshot of Existing Insider Trading Law**

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

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would render insider trading by members of Congress illegal, a narrower view of the current law might be more likely to prevail).

<sup>3</sup> Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011).

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

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

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

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

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

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

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

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

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

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

<sup>8</sup> SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2. The SEC promulgated this rule in partial response to *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), a decision that adopted what the SEC regarded as an unduly narrow interpretation of the “trust and confidence duty” in the context of a spousal relationship. See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,863 (Dec. 20, 1999) (“[T]he *Chestman* majority’s

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

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

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

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

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

In all of these instances, and in dozens of other prosecutions falling outside of ordinary fiduciary categories, the linchpin has been a securities trader (or tipper) who breached a

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approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.”).

<sup>9</sup> *Id.*, § 240.10b5-2(b)(1)-(3).

<sup>10</sup> Specific cites to these examples can be found in Nagy, *supra* note 1, at 1120-21.

duty of entrustment by secretly profiting from the use of material nonpublic information that rightfully belongs to somebody else. And while that linchpin might not be readily apparent from the facts of all of these cases (as I have observed in my scholarship),<sup>11</sup> the SEC and Justice Department have proven themselves quite adept at convincing courts to find the type of “feigning fidelity” that, under *O’Hagan*, is “essential” to liability under the misappropriation theory.<sup>12</sup>

#### **Application of Existing Law to Members of Congress**

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

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

In view of the substantial number of cases holding the insider trading prohibition applicable to relationships that are by no means ordinary fiduciary ones, I very much doubt that a federal court would have the temerity to conclude as a matter of law that a Member of Congress lacks a duty of “trust and confidence” for purposes of the

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

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

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

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

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

As with all insider trading cases, when the person prosecuted is a Member of Congress, one can envision both reasonably straightforward cases as well as cases that are more factually complex. In my view, a relatively straightforward case falling well within the misappropriation theory of Rule 10b-5 and the federal mail and wire fraud statutes involves a Representative who learns from a Committee Chair that an aircraft manufacturer will be receiving a multi-million dollar defense contract in an

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



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

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

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

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

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

Court, “tak[ing] advantage of information intended to be available only for an [institutional] purpose and not for the personal benefit of anyone.” *Dirks*, 463 U.S. at 654.

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

Given that congressional funds and tangible property are deemed to “belong” to the United States and the public, and given the Supreme Court’s clear dictate that that the “intangible nature” of material nonpublic information does not render it “any less property,” it is difficult to see how a court could reject the SEC or Justice Department’s claim that Rule 10b-5 is violated by a Member’s undisclosed self-serving use of material nonpublic congressional knowledge.<sup>17</sup> To be sure, this analysis assumes that the government would be able to prove that the information was material, nonpublic, and, in fact, was used with scienter by the Member in deciding to trade securities -- and many practical and constitutional obstacles could stand in the way of prosecutors as they attempt to gather evidence to make this showing. But such practical and constitutional obstacles would be present in any criminal or civil prosecution involving a Member of Congress, even prosecutions brought pursuant to an express statutory insider trading prohibition such as the one proposed in H.R. 1148’s STOCK Act, to which I shall now turn.

#### **The Legislative Response**

H.R. 1148’s proposed STOCK ACT seeks to explicitly proscribe insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and

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

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

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

First and foremost, the language in the bills should clarify that the Act does not constitute the exclusive insider trading prohibition applying to Members of Congress and legislative staffers. Without such clarification, there is a very real risk that the STOCK Act could be read to displace the application of Rule 10b-5 and the mail and wire fraud statutes regarding instances of congressional insider trading. This risk is particularly troubling because, as I read H.R. 1148, the bill fails to reach a host of hypothetical situations involving congressional insider trading that would almost certainly fall within this existing law.

Much of the under-inclusiveness stems from H.R. 1148's language authorizing the SEC to proscribe congressional insider trading only when the material nonpublic information pertains to "pending or prospective legislative action" relating to "such issuer" – that is, the issuer of the particular securities which were traded. But Members of Congress and legislative staffers routinely possess all sorts of material nonpublic information that do not relate to any "pending or prospective legislative action," such as information conveyed in confidential briefings by federal officials outside of Congress, including those conducted by Cabinet and sub-cabinet officials and those conducted by independent regulatory agencies. Thus, while SEC rules promulgated under the STOCK Act would reach a Representative who buys stock in an aircraft manufacturer based on information pertaining to a not-yet publicly announced multi-million defense contract in an Appropriations bill, those rules would likely fail to reach that same Representative if he learned of a multi-million dollar defense contract through a confidential informational briefing by the Secretary of Defense.

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

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

confidential information to a trading relative or a friend.” *Dirks v. SEC*, 463 U.S. 646, 659 (1983). The STOCK Act, however, only authorizes the SEC to prohibit tippee trading. Thus, any liability on the part of a Member of Congress or legislative staffer for self-interested tipping would have to be inferred from the statutory ban on tippee trading (a ban that, as it is currently drafted, extends far beyond the tippee-trading prohibition under existing law).

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

But a mere fix to those drafting problems, although crucial to do, would not go far enough. H.R. 1148 strives to send the public an important message: that Senators, Representatives, and legislative staffers should not operate under a different set of rules, but should instead be treated the same as all other investors who trade securities in the capital markets. Unfortunately, the statutory prohibition in H.R. 1148 risks sending an alternative message that is antithetical to the principle of uniform application: Such an explicit statutory prohibition could imply that Rule 10b-5’s fiduciary-focused anti-fraud prohibition is hopelessly vague and uncertain as it applies to Congress and federal employees, and hence must be corrected, but that such vagaries and uncertainties are acceptable for all others who trade in the capital markets.

There is, however, an alternative approach that would accomplish H.R. 1148’s worthy goal – and more – without creating the anomalous and potentially harmful situation of an explicit statutory definition of insider trading for Congress and federal employees, but none for anyone else. On several past occasions, Congress has sought to bring greater coherence, legitimacy, and predictability to the law of insider trading through the enactment of an express statutory definition and prohibition that would apply to all securities traders. The most promising attempts at legislation were undertaken in the period preceding the enactment of the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Congress, however, ultimately decided against any explicit statutory prohibition because, in its view, “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.”<sup>18</sup>

Yet, these “court-drawn parameters of insider trading” have not proven to be particularly effective when applied to some *nontraditional* insider trading cases. Such

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

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

Thus, rather than addressing one manifestation of the problem through a legislative effort such as H.R. 1148, Congress could use this current controversy to diagnose and treat the entire malady through the enactment of an express statutory definition and prohibition of insider trading. For example, the proposed Insider Trading Proscription Act of 1987 would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a "person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."<sup>20</sup> Much could be gained from dusting off that proposal and reconsidering it in light of the insider trading jurisprudence that has developed over the last 25 years. Then, as part of this general statutory overhaul, Congress should consider addressing the particular issue of congressional insider trading by including a separate provision in the new statute that would expressly prohibit securities trading based on material nonpublic information learned in the course of congressional service.

Even if Congress is not prepared to take on the task of a general statutory overhaul, there are several legislative responses that would be vastly superior to the lengthy and complicated provisions in H.R. 1148. For example, just last week in hearing testimony on two STOCK Act proposals before the Senate Committee on Homeland

<sup>19</sup> Hazen, *supra* note 5, at 889.

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

Security and Governmental Affairs, Professor John Coffee suggested a single sentence statutory prohibition declaring in essence “that a Member of Congress is a fiduciary for purposes of insider trading liability, and that no personal benefit or deceptive act is required to establish liability.” Professor Donald Langevoort proposed an alternative route to an effective congressional insider trading prohibition that would conform with the anti-fraud prohibition applied to the rest of the investing public. I then suggested a variation on that route: Congress could instruct the SEC to add a new fourth subsection to the three nonexclusive situations already set out in existing Rule 10b5-2(b) – a new fourth subsection specifying that for purposes of the misappropriation theory, a duty of trust and confidence exists whenever a person is a Member of Congress, federal official, or federal employee and that person has learned material nonpublic information in the course of his or her governmental service. All three of these alternatives would allow Congress to rely substantially on existing case law, but would make unmistakably clear that congressional insider trading constitutes a violation of federal law.

#### **Conclusion**

H.R. 1148 would explicitly ban some instances of insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and other federal employees. But the proposed STOCK Act would not do anything to clarify the uncertainty for the millions of other investors who must continue to look to the vicissitudes of a fiduciary-focused anti-fraud prohibition to determine the legality – or illegality – of securities trading based on material nonpublic information.

The record must be made clear that Rule 10b-5 and the federal mail and wire fraud statutes do indeed apply to insider trading by Members of Congress and legislative staffers. The current controversy can then serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. Although H.R. 1148 should receive thoughtful consideration in the weeks and months ahead, congressional attention to insider trading in securities should not end there. Instead, these hearings should initiate a serious conversation that could result in a statutory overhaul of the federal law of insider trading. A generally applicable statutory prohibition of insider trading would clarify and simplify the law for all those who trade securities in our capital markets -- from Members of Congress right on down to electricians, business associates, and friends.

**Statement to the Committee on Financial Services, United States House of Representatives, on “H.R. 1148, the Stop Trading on Congressional Knowledge Act”**

**Robert L. Walker  
Of Counsel, Wiley Rein LLP**

**December 6, 2011**

Good morning Chairman Bachus, Ranking Member Frank, and Members of the Committee, and thank you for the opportunity to appear before you to discuss the important issues surrounding H.R. 1148, the Stop Trading on Congressional Knowledge (“STOCK”) Act.

In my testimony and prepared remarks I will address primarily the extent to which the congressional ethics rules and standards already in place address, or may be applied to address, potential instances of insider trading in securities by Members and staff of Congress. As an initial matter, however, I do want to state my view that the current prohibitions on insider trading under federal securities laws and rules, as worked out and applied by the courts through the “misappropriation theory” of insider trading, do apply fully to members and staff of Congress. In other words, in my view, Members and staff of the House and Senate do not enjoy any blanket immunity from enforcement actions, whether civil or criminal, for violations of the prohibitions on insider trading; an enforcement action may be brought where a Member or employee of Congress uses – in connection with a securities trade – material, nonpublic information, to the source of which the Member or employee owes a duty of trust or confidence.

Having said that Members and staff of Congress *could* be prosecuted for insider trading under the “misappropriation theory” as a matter of law, I do not say that any such prosecution or civil enforcement action against a congressional individual would be easy. Difficult matters of proof – difficult factual issues – could, and almost certainly would, arise. For example, there could well be proof problems as to the “materiality” of the information in question. Would a reasonable shareholder of the security traded by the congressional individual consider the information important in making an investment decision or – because congressional action on a matter often comes after extensive disclosures about a given company through other avenues – would such information more likely be seen as moot or cumulative? Given the flow of information in, around, and through the Capitol, was the information truly “nonpublic”? Or, to cite a point discussed by Professor Donna Nagy in her important article on the subject, was the information actually used in the securities trade in question or was the trade made on a separate and independent basis?

So there are practical difficulties to bringing an insider trading case against a congressional individual based on the “misappropriation theory.” To my understanding, however, there are inherent practical, proof difficulties to bringing a “misappropriation” insider case – or, to use another term, an “outsider” insider trading case -- regardless of

the arena or institution in which the questioned conduct occurs. On the other hand, not to minimize the potential practical difficulties of proving an insider case in Congress, proof in many such cases could be impeded by Speech or Debate Clause concerns; but such issues could arise as well in connection with enforcement actions brought under the STOCK Act, since no statute could trump a constitutional privilege.

I have not yet discussed the potential practical and factual problems that could arise in the congressional context in proving the final element of an insider trading allegation under the “misappropriation theory.” To sum up these potential problems in a question: Did the congressional individual under investigation for allegedly trading on the basis of material, nonpublic congressional information have the requisite duty of confidentiality with respect to that information? It is by way of addressing the question of what duty of confidentiality (or similar duty of trust) obtains on the part of Members and staff of Congress in connection with information before the Congress that I discuss those congressional ethics rules and standards already in place in the House and Senate that may – or may not – be used internally within each house of Congress to address alleged insider trading activity.

#### **The Code of Ethics for Government Service and Congressional Obligations of Confidentiality**

The “Code of Ethics for Government Service” provides, at paragraph 8, that a person in government service should “Never use any information coming to him confidentially in the performance of governmental duties as a means for making private profit.”

The “Code” was passed by the House and Senate by Concurrent Resolution in July 1958. The Code is specifically listed in the Rules of the Senate Select Committee on Ethics as one source for the Committee’s investigative and disciplinary jurisdiction. The Committee on Ethics of the House states in its *Manual* that the Code not only states “aspirational goals for public officials, but violations of provisions contained therein may also provide the basis for disciplinary action . . .” Provisions of the Code have formed the basis for disciplinary and/or admonitory action against Members by each of the congressional ethics committees.

Quite clearly, paragraph 8 of the Code of Ethics for Government Service – with its prohibition on the use of confidential information as a means for making private profit – may be used by the House and the Senate, and their respective ethics committees, to capture and sanction the kind of conduct covered by the “misappropriation theory” of insider trading. What is less clear is the extent to which information before Congress, or before a committee or office of Congress, may be considered “confidential.”

There are no House or Senate rules, or policies, that impose a blanket duty of confidentiality on Members and employees in connection with information coming before them in the course of their official duties. The rules of some committees – for example, the rules of the ethics committees of both the House and the Senate and of the intelligence committees – explicitly impose obligations of confidentiality on committee



members and staff with respect to committee information. The rules of some other committees impose an obligation of confidentiality with respect to specific classes of information. The rules of many other committees of the House and Senate, however, do not impose any specific duties of confidentiality with respect to committee information.

Where does this uneven approach, among congressional committees and offices, to defining “confidentiality” leave use of paragraph 8 of the Code of Ethics for Government Service as a vehicle for addressing, within the congressional disciplinary process, allegations of insider trading, allegations that “confidential information” coming to a Member or employee “in the performance of governmental duties” was used “as a means for making private profit”? It ties congressional enforcement of paragraph 8 of the Code to a case-by-case, committee-by-committee, office-by-office analysis of whether a duty of confidentiality existed with respect to the information in question. If this is viewed as insufficiently systematic or insufficiently rigorous by some, doesn’t such a case-by-case approach largely characterize enforcement of insider trading prohibitions under the “misappropriation theory” in the world outside of Congress? Should Congress, by blanket rule or law, impose on itself stricter prohibitions against insider trading than apply to the general public? In my view, the STOCK Act would impose such stricter standards on congressional Members and employees.

One possible alternative to the blanket approach taken by the STOCK Act, would be for the House and Senate to require committees and offices to adopt more specific policies, procedures and rules regarding what information must be treated as confidential and what sanctions will apply if and when the duty of confidentiality is violated.

#### **House and Senate Conflict of Interest Rules**

Apart from paragraph 8 of the Code of Ethics for Government Service, do any other House or Senate ethics rules or standards capture insider trading? It is arguable that the general conflict of interest provisions of House and Senate rules would cover instances of insider trading by Members and staff based on information coming to them in the course of their official duties. Consider, for example, paragraph 3 of House Rule XXIII states:

A Member, Delegate, Resident Commissioner, officer, or employee of the House may not receive compensation and may not permit compensation to accrue to the beneficial interest of such individual from any source, the receipt of which would occur by virtue of influence improperly exerted from the position of such individual in Congress.

Senate Rule XXXVII, paragraph 1, contains a similarly worded provision.

It is arguable that the operative phrase “by virtue of influence improperly exerted from his position” in Congress should and does include instances where a Member or employee, in effect, “improperly” influences the securities markets by trading on material, nonpublic information that has come to the Member or employee through his or her official position. This reading is implied by the House Ethics Committee in its

citation of the rule in its recent, and very timely, advisory memorandum on “Rules Regarding Personal Financial Transactions” (November 29, 2011).

However, in the Senate, at least, application of its parallel provision has been reserved for instances where an individual’s official power or position has been used to obtain some personal benefit “under color of official right” or office. For instance, the following examples from the legislative history to the Senate rule are provided in the *Senate Ethics Manual*, at page 66, to illustrate the meaning of this provision:

For example, if a Senator or Senate employee intervened with an executive agency for the purpose of influencing a decision which would result in measurable personal financial gain to him, the provisions of this paragraph would be violated. Similarly, if a Senator or Senate employee intervened with an agency on behalf of a constituent, and accepted compensation for it, the rule of this paragraph would also be violated.<sup>1</sup>

Similarly, the discussion in the *House Ethics Manual*, at page 186, of the House provision emphasizes that “[a]s noted in the debate preceding adoption of this rule, an individual violates this provision if he uses ‘his political influence, the influence of his position . . . to make pecuniary gain.’” (Citation omitted.)

A broader reading and application of this provision in the Senate – whereby the rule might be applied to allegations of insider trading – could be supported by other language from the legislative history of the rule, which, as stated in the *Senate Ethics Manual* at page 66, indicates that the provision was intended “as a broad prohibition against members, officers, or employees deriving financial benefit, directly or indirectly from the use of their official position.”<sup>2</sup> And as, the House Ethics Committee points out in its discussion of this provision in its *Manual*,

Members and staff, when considering the applicability of this provision to any activity that they are considering undertaking must also bear in mind that under a separate provision of the Code of Official Conduct . . . they are required to adhere to the spirit as well as the letter of the Rules of the House.

Notwithstanding such suggestions by the House and Senate ethics committee’s regarding the potential scope of Senate Rule XXXVII, paragraph 1, and House Rule XXIII, paragraph 3, it is my view that application of either of these provisions to instances of alleged insider trading by Members and staff of Congress would be an innovation going beyond the intent of these rules.<sup>3</sup>

<sup>1</sup> S. Rep. No. 95-49, The “Nelson Report.”

<sup>2</sup> *Id.*

<sup>3</sup> I take this view notwithstanding the following language from The Senate Ethics Committee’s discussion of the “Basic Principles” of conflicts of interest at page 66 of the *Manual*: “The Senate’s commitment to avoiding conflicts of interest is embodied in Senate Rule 37. Paragraphs 1 through 4, 7, and 10 target the possibility or appearance that Members or staff are “cashing in” on their official positions . . .”

### **Conduct Reflecting Discredit**

I want to discuss one further current congressional ethics standard pursuant to which allegations of insider trading by Members and staff may be addressed. Paragraph 1 of House Rule XXIII provides that a “Member, Delegate, Resident, Commissioner, officer, or employee of the House shall behave at all times in a manner that shall reflect creditably on the House.” Although the Senate Code of Conduct does not explicitly contain a similar provision, the Senate Ethics Committee is obligated by its authorizing resolution “to investigate allegations of improper conduct which may reflect upon the Senate.” The Senate Ethics Committee and the Senate have admonished and disciplined Members for violations of this deliberately open-ended and flexible “catchall” provision.

In my view and experience, if credible allegations of insider trading by a Member or employee were to come before the House Ethics Committee, the Senate Ethics Committee, or the House Office of Congressional Ethics, and these allegations were supported by sufficient specific evidence -- that is, if the allegations were more than merely conclusory or based on more than mere coincidence -- even if it were determined that the specific provisions discussed above were applicable, these allegations would be diligently pursued and investigated as, potentially, constituting conduct reflecting discreditably on the institution.

### **The STOCK Act Disclosure Provisions**

The STOCK Act would amend the financial disclosure requirements applicable to Members and senior staff of Congress to require that the “purchase, sale, or exchange” of any “stocks, bonds, commodities futures, or other forms of securities” be reported publicly within 90 days. Current financial disclosure requirements mandate only annual public disclosure of securities transactions.

In the House and Senate, as a historical matter, public financial disclosure – rather than recusal or divestment – has been viewed as the principal means for policing potential conflicts of interest. The Senate Ethics Committee, in its *Manual*, has “made the case” for this reliance on disclosure:

Senators enter public service owning assets and having private investment interests like other citizens. Members should not “be expected to fully strip themselves of worldly goods” — even a selective divestiture of potentially conflicting assets is not required. Unlike many officials in the executive branch, who are concerned with administration and regulation in a narrow area, a Senator exercises judgment concerning legislation across the entire spectrum of business and economic endeavors. The wisdom of complete (unlike selective) divestiture may also be questioned as likely to insulate a legislator from the personal and economic interests that his or her constituency, or society in general, has in governmental decisions and policy.

Thus, public disclosure of assets, financial interests, and investments has been required and is generally regarded as the preferred method of monitoring possible conflicts of interest of Members of the Senate and certain Senate staff. Public disclosure is intended to provide the information necessary to allow Members' constituencies to judge official conduct in light of possible financial conflicts with private holdings.

*Senate Ethics Manual*, at pages 124-125, citations omitted.

Enactment of the STOCK Act provision requiring public reporting of securities transactions by Members and employees of Congress within 90 days of the transaction would undoubtedly be viewed as intrusive and burdensome by some Members and employees. I don't think anyone who is subject to the current annual disclosure requirements enjoys filling out the form; an annual disclosure filer once told me he found completing his income tax form to be more enjoyable. However, increasing the frequency of reporting on securities transactions would be more consistent with the current framework for addressing potential congressional conflicts of interest than an approach that would directly restrict trading itself or an approach that would create and impose new obligations of confidentiality, the unintended repercussions from which on the necessary and beneficial flow of information in and through Congress may be impossible to predict.

#### **The "Political Intelligence" Provisions of the STOCK Act**

Finally, I have a few observations in connection with the provisions of the STOCK Act that would amend the Lobbying Disclosure Act (the "LDA") to impose registration and disclosure requirements on so-called "political intelligence consultants" and "political intelligence firms."

First, the Act defines "political intelligence contacts" to include "any oral or written communication . . . to or from a covered executive branch official or a covered legislative branch official, the information derived from which is intended for use in analyzing securities or commodities markets, or in informing investment decisions and which is made on behalf of a client . . ." This seems very broadly worded. Is the language on "informing investment decisions" intended to cover potential capital investment decisions by, for example, a company in the oil services industry in connection with which a representative of the company has a purely informational, non-lobbying contact with an executive branch agency official about the administration or execution of a federal energy program in the Gulf?

Further, with respect to who would qualify as a "political intelligence consultant," the act takes a strict "one and done" approach; in other words, a "political intelligence consultant" means anyone "who is employed or retained by a client for financial or other compensation that include *one or more* political intelligence contacts." (Emphasis added.) This definition is not consistent with the manner in which "lobbyist" is defined under the LDA; the definition of "lobbyist" excludes any "individual whose lobbying activities constitute less than 20 percent of the time engaged in the services provided by

such individual to [a] client over a 3-month period.” Other than potentially deterring many individuals outright from becoming “political intelligence consultants,” what purpose is served by imposing the burdensome registration and disclosure requirements of the LDA on a person who simply makes one contact requesting information from a government official?

My final point concerns overburdening the LDA as a vehicle for regulating protected conduct. It is important for you to remember that the LDA creates an anomaly, that is, it creates a regulatory scheme that lives within the legislative branch. As such it is not subject to the legal tests and requirements to which other, executive branch regulatory schemes are subject pursuant to the Administrative Procedure Act. Violations of the LDA are potentially subject to civil and criminal enforcement, and yet no agency or office provides legally dispositive or authoritative guidance regarding the meaning of the terms or requirements of the LDA or regarding the application of the LDA in specific circumstances. The LDA requires the Secretary of the Senate and the Clerk of the House of Representatives to provide guidance and assistance on the registration and reporting requirements of the LDA and to develop common standards, rules and procedures for compliance with the LDA. But the LDA does not provide the Secretary or the Clerk with the authority to write substantive regulations about or issue definitive opinions on the interpretation of the LDA. It is problematic enough that a regulatory scheme for which no government office or agency is truly accountable – that is, the LDA – currently regulates the First Amendment protected activities of one class of persons, lobbyists. Extending the requirements and potential sanctions of the LDA to yet an entire new class of persons, “political intelligence consultants,” would compound this arguably constitutional concern.

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Thank you for considering my views on the STOCK Act and on other approaches to addressing allegations of insider trading within Congress. I would certainly welcome any questions you may have.

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### Rob Khuzami Inserts/Replies in Response to Member Questions

Rep. Canseco, Page 84

*So as Members of Congress go before CNN or MSNBC or CNBC or other networks, at all times Section 3 of the STOCK Act could essentially bar them from saying anything publicly that may or may not move markets or stocks, which really gags them from commenting on very important legislation for the American public.*

*Do you feel that Section 3 [of the STOCK Act] violates the Speech or Debate Clause?*

Among other things, Section 3 of H.R. 1148 (“the STOCK Act”) would amend the Rules of the House of Representatives to clarify that a Member shall not “disclose material nonpublic information related to any pending or prospective legislative action related to any publicly traded company if that Member has reason to believe that the information will be used to buy or sell the securities of such publicly traded company based on such information.”

Although Members of Congress and their staffs are not exempt from existing insider trading prohibitions, Section 3 of the Act clarifies that Members of Congress and their staffs do in fact owe a duty of trust and confidence to the Congress, the U.S. government and the American people not to trade on material nonpublic information or to disclose such material nonpublic information to another person whom that Member has reason to believe will trade on the material nonpublic information. As I have testified, no court has yet addressed the question of a Member’s duty not to trade on material nonpublic information learned in their official capacity. I therefore support Congress’s efforts to make explicit that such a duty does in fact exist.

Importantly, existing insider trading prohibitions require the SEC to have sufficient evidence of all elements of a violation in order to charge an individual with insider trading and thus serve to limit the likelihood that Section 3 will operate as a “gag” on Members. Among these elements is scienter, which in the insider trading context means that the trading on, or the tipping of others with, material nonpublic information in violation of a duty not to do so must be intentional or reckless in order to be illegal.

Although it is difficult to generalize about the likely outcome of any particular scenario, the scienter requirement means that a Member speaking to mainstream television media outlets about legislation in order to describe his or her views on that legislation for the benefit of the American public’s general information would not ordinarily be acting with the scienter necessary to violate insider trading prohibitions. Accordingly, Section 3’s language seems sufficiently narrowly tailored to avoid the concern of operating as a broad “gag” on Members.

In addition, the other elements required to establish an insider trading violation limit the likelihood that Section 3 will operate as a “gag” on Members. In addition to scienter, in order to prove a violation the SEC must have evidence sufficient to establish that the information on which the Member trades or tips another is “material” — that there is “a substantial likelihood”

that a reasonable investor “would consider it important” in making an investment decision. Materiality is a mixed question of fact and law that depends on all the relevant circumstances. In some scenarios, it may be relatively clear that an upcoming Congressional action would be material to a particular issuer or group of issuers, while in others it may be more challenging to establish that fact. In addition, the SEC must have evidence that the information on which the Member traded or tipped is “nonpublic.” The Commission has stated that “[i]nformation is nonpublic when it has not been disseminated in a manner making it available to investors generally.” Whether information is “nonpublic” would likely depend on the circumstances under which the Member learned the information and the extent to which the information had been disseminated to the public.

Finally, as you anticipated, the Speech or Debate Clause is an additional consideration that doesn’t exist in corporate insider trading cases. It raises Constitutional issues that certainly could impact investigations or prosecutions of some potential insider trading scenarios. Though many insider trading scenarios may well not implicate Speech or Debate Clause issues, to the extent some do, we would need to analyze its impact on the particular facts at issue in those matters. In any case, we will not hesitate to investigate potential violations of the securities laws, as appropriate.

Rep. Pearce, Pages 103-4

***Now, when I consider abuses, I look back at Global Crossing. Did you ever do anything -- there were a lot of people on the -- a lot of people made a lot of money. That's \$700 million dollars appeared to evacuate of the price of that stock. And that wasn't necessarily just members of Congress, but there were people who were associated with members of Congress, people in the party structure. Have you all ever taken a formal look at that?***

Although it was prior to my tenure as Director of Enforcement, I understand that in April 2005, the Commission filed enforcement actions against Global Crossing Limited (“GX”) and Global Crossing’s CEO, CFO, and Executive President of Finance arising from the failure of GX and its senior management to completely and accurately certain transactions it entered into in the first half of 2001. *See In the Matter of Global Crossing, Thomas J. Casey, Dan J. Cohrs, Exchange Act Rel. No. 51517 (April 11, 2005).*<sup>1</sup> In that case, the Commission found that because of GX’s inadequate disclosure, investors were not given the opportunity to fairly judge the quality of GX’s financial results and the likelihood that its past performance would be indicative of its future performance.

These significant transactions involved GX’s sales of telecommunications capacity to other carriers that were linked to, and in some cases dependent on, its purchase of capacity from the same carrier. GX referred to these transactions as “reciprocal transactions.” In early 2001, GX was increasingly reliant on the reciprocal transactions as a substantial source of GX’s announced “pro forma” results, i.e., results of operations that were prepared on a basis defined

<sup>1</sup> Available at <http://www.sec.gov/litigation/admin/34-51517.pdf>

by GX, and that were not in accordance with generally accepted accounting principles (“GAAP”). For example, GX had a pro forma measurement called “Cash Revenue” that GX defined as revenue calculated in accordance with GAAP, plus the cash portion of the change in deferred revenue. Without these reciprocal transactions, GX would not have met securities analysts’ estimates for its first and second quarter 2001 pro forma results.

