Hearing on Insider Trading and Congressional Accountability before the United States Senate Committee on Homeland Security and Governmental Affairs

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My name is Donald C. Langevoort, and I am the Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center in Washington, D.C. I have spent much of my professional career writing and teaching about the law of insider trading, including a treatise on the subject entitled *Insider Trading: Regulation, Enforcement and Prevention* (West), and have testified before committees of Congress numerous times on matters relating to insider trading and securities enforcement. Before becoming an academic, I served on the staff of the Office of the General Counsel at the United States Securities & Exchange Commission, where I worked on insider trading matters in the aftermath of the Supreme Court's seminal 1980 decision in *Chiarella v. United States*.

My testimony today strongly supports legislative efforts to explicitly proscribe insider trading by Members of Congress and their staffs, as is intended by the various STOCK Act bills recently introduced in the House and Senate. To be sure, there is no current exemption from the main thrust of U.S. insider trading law for either Members or staff, and many forms of trading or tipping by such persons are adequately proscribed under existing legal authority. Indeed, it is possible that courts would rule that current insider trading law adequately proscribes *all* abusive trading in securities on Capitol Hill. But there is sufficient doubt, especially in light of how courts recently have been reading Section 10(b) and SEC Rule 10b-5, so that explicit legislative clarification is desirable.

The ban on unlawful insider trading plays an important role with respect to the U.S. capital markets. Economists have shown that an insider trading prohibition plays a useful role in addressing dysfunctional consequences from permitting those in possession of material non-public information from exploiting their unique positions of access—adverse selection in markets, agency cost problems, threats to corporate privacy, and the like. But just as important, the prohibition performs an expressive function in signaling to the people of the U.S. and around the world that our markets are open, transparent and fair, and not rigged in favor of the economically or politically powerful. It is part of the American brand of deep and liquid capital markets that invite participation by ordinary retail investors as well as large financial institutions. Public trust in the openness and fairness of marketplace institutions is important for economic stability and growth.

Countries that have credibly committed to the enforcement of an insider trading prohibition have more robust capital markets than those that do not.[1] Just the perception (whether or not accurate) that Congress is "above" the prohibition that applies broadly outside of Capitol Hill threatens our long-standing commitment to fair and open markets.

The law of insider trading requires balance. Information is the lifeblood of markets, and we want those who have generated their own private information about the value of traded securities to seek to profit from it. The competitiveness of our markets—and their crucial role in private capital formation—depends on their efficiency, and so the law should not discourage productive trading. As I will explain more fully below, our insider trading law seeks this balance by limiting liability largely to those who breach a fiduciary-like duty to the true "owner(s)" of the information by trading or tipping while in possession of information that is both material and non-public. Putting aside the legal issues, I am not aware of any argument that either the fairness or efficiency of our markets is enhanced by letting a government official step in front of the investing public to take advantage of information that has come to them in connection with their official duties. Even the strongest critics of U.S. insider trading law as applied in the private sector, like the well-known legal economist Henry Manne and his contemporary academic disciples, find no cause to permit insider trading inside the government.[2]

So, there is really no doubt that insider trading by members of Congress or their staffs should be proscribed. The only question is whether it already is, to which I now turn.

The Existing Insider Trading Prohibition

In 1934, when the principal legislation designed to bring regulation to securities trading in the U.S. was enacted, Congress expressed substantial concern about insider

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[1] See Battacharaya & Daouk, *The World Price of Insider Trading*, JOURNAL OF FINANCE, vol. 57, p. 75 (2002).

[2] See HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966), p. 184.

trading abuses, but addressed them in a very narrow way. Section 16 of the Securities Exchange Act requires the reporting of trades by a limited category of insiders—those who are officers, directors, or large shareholders of public companies—and requires the disgorgement of short-swing trading profits made by such persons. From Section 16 alone, one might perhaps infer that Congress is not covered by (or has "exempted itself" from) the law of insider trading. But Section 16 does not cover the vast majority of the American investing public either.

It was quickly understood that this limited statutory response to insider trading was inadequate to the task of promoting fair and open markets. Some years later, the SEC took the position that it is *fraudulent* for insiders to unfairly exploit positions of access to information, whether or not covered by Section 16, and gradually the courts came to agree. It is now clear that the basic antifraud provision of the Securities Exchange Act, Section 10(b) as implemented by SEC Rule 10b-5, provides the main prohibition against insider trading. But Rule 10b-5's potency with respect to insider trading derives from SEC and judicial interpretation of a general antifraud rule, not express legislative action. Congress has by legislation enhanced the penalties for insider trading violations under Rule 10b-5, but—perhaps unfortunately—left the definition of what constitutes fraudulent insider trading to the courts and the SEC.

Section 10(b) and Rule 10b-5 apply to "any person" who engages in the fraudulent or manipulative acts subject to prohibition. There are no exemptions for anyone, which readily disposes of the misimpression that Congress is not subject to this form of insider trading law. Anyone who intentionally commits securities fraud, whether by insider trading or otherwise, violates federal law. The question is what *constitutes* fraudulent insider trading.

In its early years, insider trading law as articulated by the lower courts under Rule 10b-5 was fairly open-ended, applying expansively to any unfair exploitation of privileged access to information. In 1980, the Supreme Court—in an opinion by Justice Lewis Powell—imposed more restraint on the prohibition by holding that persons who trade while in possession of material nonpublic information act fraudulently only to the extent that they are subject to a pre-existing duty of trust and confidence vis-à-vis those

with whom they trade.[3] Absent such a duty, traders are free to pursue profitable advantage. The most obviously situation where such a duty exists, as Justice Powell recognized, is when corporate insiders trade with shareholders of their own corporation—the "owners" for whom the insiders work.

Many insiders who seek to exploit information do not trade for themselves but rather tip friends or family members in order to enrich them. In 1983, again speaking through Justice Powell, the Supreme Court said that "tippers" and "tippees" violate Rule 10b-5 if they act jointly in such a way that the insider breaches a fiduciary-like duty by seeking his or her *own personal benefit* from the tip—whether pecuniary benefit, reputational benefit, or simply by making a gift of the information.[4] This corruption element was designed to assure that bona fide communications in the securities markets are not chilled by the insider trading prohibition. Where selfish gain is the objective, on the other hand, insiders cannot pass on the information outside the company.

These legal principles—which we refer to today as the "classical" approach—require the presence of an insider of the company whose shares were being traded, as either trader or tipper. In the eyes of the SEC and many others, this threatened a large gap in insider trading regulation as applied to persons privy to inside information that affects the value of stock of *other* companies—for example, an investment banker who buys stock in a company that is going to be subject of a takeover bid, or a government official who knows of action about to be taken (e.g., an antitrust action) against a particular company. These people may be fiduciaries, but not vis-à-vis the issuer of the securities in question. To address this, the SEC began to argue that the deception element of Rule 10b-5 can be met by showing that a person was entrusted with confidential information by the "owner" of that information, and breached that trust by secretly misappropriating it for personal gain, either by trading or tipping. This was a controversial move because in many cases the fiduciary duty in question was disconnected from the corporate setting where most insider trading occurs. Lower courts

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[3] Chiarella v. United States, 445 U.S. 222 (1980).

[4] Dirks v. SEC, 463 U.S. 646 (1983).

split about the validity of this so-called "misappropriation theory" of insider trading, but in 1997 a divided Supreme Court upheld the theory as applied to a partner in a law firm who traded in the stock of a takeover target that he learned from the firm's client, the bidder in that takeover battle.[5] The Court said that so long as a fiduciary relationship exists, the person who trades deceives the source of the information by pretending to act as a loyal agent while in fact acting selfishly. When that deception—"feigning loyalty"—involves trading in securities, it constitutes securities fraud.

With the law's reach broadened this way, the SEC or criminal prosecutors can now bring an insider trading case against a person who trades or tips while in possession of material nonpublic information by showing one of two things: that such person either owed a fiduciary-like duty to the person or persons on the other side of the trade and breached that duty by failing to disclose, or owed a fiduciary-like duty to the source of the information and breached that duty by secretly misappropriating that information for personal gain. Nearly all insider trading prosecutions or enforcement actions involve one of these two well-established theories.[6]

Insider Trading in Congress

Some cases against members of Congress could be fairly straightforward under the law just described. For instance, if a senator attended a dinner party with the CEO of a public company who improperly (i.e., for personal benefit) shared a tip with everyone at the table, the senator would be no more free to act on that tip than anyone else in attendance. Or information given to a Member of Congress where the Member agreed to respect the confidentiality of the information in question (e.g., a voluntary submission by

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[5] United States v. O'Hagan, 521 U.S. 642 (1997).

[6] There is also a special insider trading prohibition (Rule 14e-3) adopted by the SEC to address tender offers. This on its face applies to any person, and requires that the information in question be derived either from the bidder or the target company. In contrast to the law under Rule 10b-5, there is no explicit fiduciary duty requirement.

an issuer where the member agreed to respect the issuer's rights to that information) would trigger the misappropriation theory via SEC Rule 10b5-2.[7]

However, many cases involving Members of Congress would not fall so neatly into place, especially as they involve pending or contemplated legislative activity. To take the quintessential example, suppose a senator was seeking favorable legislative treatment for a company in his or her state and had now found the votes for such a deal. Could the senator buy stock or options in that company? Or suppose that the senator had just succeeded in gaining consensus to the inclusion of legislative language in a bill that would reduce the intellectual property protection for certain biopharmaceutical companies. Could the senator sell short or sell put options on those stocks (or trade exchange traded funds, indexes or futures to the same result)?

The SEC's challenges in making this case are easy to spot. Under the misappropriation theory described above, it would have to prove that the senator breached a fiduciary or fiduciary-like duty owed to some person or entity who entrusted that information to him or her, "feigning loyalty" while in fact acting corruptly. But as elected officials, members of Congress are not employees or agents in any conventional sense, and so it becomes difficult to identify a separate owner of the information to which they owe a legally enforceable fiduciary duty of loyalty. Under our constitutional system, duly elected Members have a status separate and distinct from that of partner, agent or employee, far different from those with whom in mind the misappropriation theory was devised. Information they glean from their own legislative activities does not necessarily *belong* to someone else, and existing insider trading law does not prohibit a person from taking advantage of his or her own information. Because of this, a number of commentators have concluded that existing insider trading prohibitions do not reach this sort of trading or tipping on Capitol Hill.[8]

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[7] Rule 10b5-2 describes certain kinds of relationships that give rise to an expectation of trust or confidence under the misappropriation theory. The rule has been challenged as exceeding the SEC's rulemaking power in litigation to the extent that it seeks to create a fiduciary-like duty based simply on a confidentiality agreement.

[8] See Bainbridge, *Insider Trading Inside the Beltway*, JOURNAL OF CORPORATION LAW, vol. 36, p. 281 (2011). Similar views can be found in a number of other writings. See, e.g., Macey & O'Hara, *Regulation*

That is contestable, of course. Long ago, with reference to the "classical" theory, I suggested that all government officials might owe a fiduciary-like duty to the citizens of the United States generally that could support a duty to disclose.[9] And as Professor Donna Nagy has ably argued much more recently, there is precedent for saying that members owe duties both to the public and Congress as a distinct institution that would support a duty to disclose under either the classical or misappropriation theories.[10] Existing ethics codes covering Members of both the House and Senate specifically address the duty to respect legislative confidences. Because she is also testifying today, I will leave it to her to elaborate on this.

As an SEC enforcement lawyer or criminal prosecutor, I would willingly embrace these arguments in favor of a fiduciary-like duty in making my case. Indeed, if I were a judge I would probably find them persuasive enough to apply to most forms of Congressional insider trading. But I have qualms about whether this is what all, or even most, of today's federal courts would do if confronted with the types of cases I described.

In recent years, the Supreme Court in particular has articulated a severely restrained approach to applying Rule 10b-5 in novel or ambiguous situations involving important policy issues, saying that it is for Congress, not the courts, to extend the Rule's reach. While these cases have largely involved private litigation, the negative effect on the scope of the SEC's reach has been substantial. We have by told by the Court, for example, that Rule 10b-5 does not apply to those who knowingly aid and abet securities fraud,[11] or to securities transactions that are executed outside United States borders[12]—both of which, thankfully, Congress quickly rectified as applied to SEC enforcement

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and Scholarship: Constant Companions or Occasional Bedfellows?, YALE JOURNAL ON REGULATION, vol. 26, p. 86 (2009); Jerke, *Comment: Cashing In on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 158, p. 1451 (2010).

[9] Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, CALIFORNIA LAW REVIEW, vol. 70, pp. 1, 34-35 (1982).

[10] Nagy, *Insider Trading, Congressional Officials and Duties of Entrustment*, BOSTON UNIVERSITY LAW REVIEW, vol. 91, p. 1105 (2011).

[11] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).

[12] Morrison v. National Australia Bank, 130 S.Ct. 2869 (2010).

actions. More recently, the Court held that a mutual fund adviser does not "make" a misrepresentation even if it knowingly wrote the false report, so long as the report was filed under the name of the mutual fund itself[13]—a decision, I believe, that deserves the same fate. In all these cases, the Court stressed that Congress should take on these scope issues, not leave them to the judiciary.

I can readily foresee a similar response to Congressional insider trading. That issue is far enough removed from conventional insider trading on Wall Street and Main Street so that the fiduciary-based tools usually employed do not work cleanly, and constitutional issues such as the Speech and Debate Clause lurk in the shadows. The risk is even greater now that the issue has captured Congress' and the public's attention, leading to hearings such as these. A refusal on the part of Congress to act in the face of this interest might well be interpreted by the courts as an additional reason for judicial restraint.

These same impediments, on the other hand, do not apply with respect to insider trading by Congressional staff members. As employees, they are more conventionally agents for the members or committees whom they serve. The SEC has brought numerous cases against government officials (or those connected to government officials) for trading or tipping, and I doubt that cases against staff members pose special legal challenges. Of course, one might imagine a staff member—particularly on a member's personal staff—arguing that insider trading was implicitly condoned in his or her particular office (or implicitly, maybe in Congress generally), so that profiting from information would not really involve any "feigned loyalty." But the presumption, at least, is a legally enforceable expectation of loyalty with respect to Congressional confidences, and I suspect that arguments to the contrary would not receive a sympathetic response from many judges. That said, there is no reason why legislation designed to address Congressional insider trading should not apply to staff as well.

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[13] Janus Capital Group Inc. v. First Derivative Traders, 131 S.Ct. 2296 (2011).

The Appropriate Legislative Response

For these reasons, I strongly support efforts to clarify that our insider trading prohibition applies to members of Congress and their staffs. This should be coupled with a prompt and effective requirement that Members and staff report trading activity in securities and related financial instruments that they beneficially own.

I do have some concerns with how the pending STOCK Act bills have been drafted, however, though I have not done a thorough line-by-line analysis at this point.[14] In some significant respects, the standards for liability may be overbroad (though I recognize that the legislation would be implemented and hence the overbreadth possibly cured by agency rulemaking). For instance:

(a) The definition of "material nonpublic information" refers to something that does not exist—an SEC rule defining that term[15]—and then speaks of *any* information that is gained by reason of status as a member of Congress or employee that the person knows or should know has not been made available to the general public. Missing is a qualifier that limits the insider trading prohibition to information significant enough to influence a reasonable investor—meaning that receipt of even the most trivial information, if nonpublic, would impose a ban on trading.

(b) The ban on trading by persons who obtain information from members of Congress or staff has no reference to how or why such information was communicated to them, and hence would have an unduly broad sweep.

On the other hand, there are elements that seem seriously under-inclusive, which is especially troubling if this legislation is deemed as a matter of statutory interpretation

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[14] I will limit these comments to securities-based insider trading in Congress, even though I recognize that the bills would apply to federal employees more generally. I fully support the effort in these bills to cause the Commodities Futures Trading Commission to address insider trading in non-securities financial instruments. As you may be aware, the Dodd-Frank Act of 2010 substantially expanded the CFTC's reach with respect to insider trading, including a prohibition (section 746) dealing explicitly with tipping and trading by government officials.

[15] The word "material" is defined in an SEC rule (Rule 405), but not with reference to insider trading.

the exclusive statement of Congressional member and staff responsibilities.[16] For example:

(a) There is no explicit prohibition on tipping, no matter how deliberate the improper intent to benefit the recipient might be.[17]

(b) The trigger to responsibility is that the information must relate to "pending or prospective legislative action," which would not cover confidential briefings, information relating to government contracts, etc., of which the member or staff learn through their service. Just by way of one example, a Member might privately learn of a forthcoming antitrust action by the Justice Department based on discussions with officials of that agency, which would not involve pending or prospective legislation.

(c) That the pending or prospective legislative action must relate to the securities of the issuer leaves open trading in non-issuer specific instruments like exchange traded funds, or in securities of issuers who are not the subject of legislation but directly or indirectly the beneficiary or victim of some pending governmental action that the Member or staff has learned about on the job.

Given that the intent of this legislation—and public expectations—are to impose an effective insider trading ban on Congress and its staff, it would be quite troublesome for Congress to enact legislation that had the effect of protecting Members and staff from liability that would readily follow as insider trading law is applied generally.

There is a much simpler route to an effective Congressional insider trading prohibition, which would avoid these drafting challenges. First, the legislation should articulate a duty on the part of members of Congress and their staffs to respect the confidentiality of material nonpublic information they gain in the scope of their legislative service and not seek to profit directly or indirectly therefrom. It should then provide that a fraudulent breach of such duty in connection with the purchase or sale of a

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[16] I would in any event state that the Congressional prohibition supplements rather than preempts insider trading law of general applicability.

[17] Section 746 of the Dodd-Frank Act, applying to tipping by government officials of commodities-related information, bans the imparting of material nonpublic information by an official "in his personal capacity and for personal gain with intent to assist another person, directly or indirectly, to use the information."

security constitutes a violation of the Securities Exchange Act of 1934, subjecting the person to the same liabilities and remedies as any other person who violates that Act by misusing material nonpublic information.

This approach would conform the prohibition against Congressional insider trading with the prohibition applied to the rest of the investing public. The large body of precedent on the meaning of insider trading apart from the question of duty would be incorporated. With respect to materiality, for example, the information in question would have to be sufficiently concrete in terms of likelihood of occurrence and magnitude of impact in order to trigger the ban on trading or tipping. Like other investors, Members and staff would remain free to buy and sell securities based on their general insight about particular stocks, industries or markets—even if that is derived from their legislative work—so long as they do not possess discrete information acquired in the course of Congressional service that the law would treat as material.

Existing law also does a reasonably good job of limiting tipping liability, so that members and their staff need not fear a chill in terms of communicating with the public about legislative activity. While courts disagree about the precise articulation of tipper-tippee liability in misappropriation cases, the standard is clearly one of intentionally misusing the information, typically for personal gain. This required element of corruption protects bona fide communications under existing insider trading law. Indeed, the relative freedom to engage in non-corrupt private communications under existing law was the reason why the SEC felt it necessary to impose a separate obligation on high-ranking corporate insiders to refrain from selective disclosure to favored investors in Regulation FD. Reg FD only applies in the corporate setting, and would not affect bona fide (i.e., non-corrupt) private communications on Capitol Hill. If anything, I would worry that existing law permits too much private communication, rather than too little.

To be sure, there are ambiguities in existing law relating to materiality, "non-publicness" and scienter that would be imported into the law of Congressional insider trading (and which may already be present to the extent that existing law is applicable). This is partly a consequence of the fact that there is no statutory definition of insider trading to create a coherent normative framework, which I think is unfortunate. But

Congress should be on the same footing as the investing public, and any resolution of the ambiguities should be in the form of legislation that applies to insider trading cases generally.

Conclusion

The idea that Members of Congress or their staffs can freely step ahead of ordinary investors to profit from information acquired as a result of their legislative roles is disturbing, to say the least. While current insider trading law is more potent with regard to such activity than some of the public commentary on this issue suggests, Congress should act eliminate any doubt and state clearly that both the trading and tipping prohibitions apply to Members and staff. It would be extremely unfortunate were the SEC or prosecutors to bring an action and have the Member or staff person raise the defense, which they surely would, that service in Congress carries with it no fiduciary-like duty to respect governmental confidences. That would be the last headline Congress should want to see.

The SEC deserves resolution of this as well. An insider trading case against a Member (or even a powerful staff person) will always be a matter of great political sensitivity, likely to be brought only to the extent that the case—legally and factually—is very strong. The external pressures to bring such cases, or not bring them, will inevitably be great when any suspicions arise. Leaving any ambiguity as to the question of whether, and to what extent, the insider trading on Capitol Hill is unlawful is hardly an encouragement to those matters that deserve to be courageously investigated and pursued. Conversely, an explicit statement by Congress that its Members and staff are subject to a duty of trust and confidence would make plain, to the SEC and the American public, that Congress expects no special privilege or treatment with respect to the rules of fair play in the U.S. capital markets.