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

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

December 1, 2011

Chairman Lieberman, Ranking Member Collins, and Members of the Committee on Homeland Security and Governmental Affairs: Thank you for inviting me to submit written testimony as part of your hearing on "Insider Trading and Congressional Accountability." 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. That article, which appeared in the May 2011 issue of the Boston University Law Review, is entitled "Insider Trading, Congressional Officials, and Duties of Entrustment." I have attached it to this testimony.

The article sought to debunk what at the time was becoming an 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 is already illegal under existing law. Based on my research, I would expect a federal district court to hold Members of Congress and legislative staffers liable for any securities trading that is based on material nonpublic information obtained through congressional service, if the Securities and Exchange Commission (SEC) in a civil case, or the Department of Justice (DOJ) in a criminal case, successfully proved the facts alleged. I acknowledge, however, that many distinguished securities law scholars see shades of gray in existing law,[1] and at least one such scholar has concluded that "the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted."[2]

Applicability of Existing Law to Members of Congress and Their Staff

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 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 DOJ also prosecutes insider trading as a criminal violation of either Rule 10b-5 or the federal statutes prohibiting mail fraud and wire fraud. Thus, in the vast majority of instances, insider trading is illegal only insofar as it can be deemed a fraudulent act or practice.[3] 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.

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. Professor Donald Langevoort's testimony in this hearing provides a summary of

---

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

[2] Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011).

[3] 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.

Congress' initial attempt to address the problem of insider trading through Section 16(b) of the Exchange Act and summarizes the three principal U.S. Supreme Court decisions establishing the scope of Section 10(b) and Rule 10b-5's insider trading prohibition. In view of his insightful analysis, I will not reiterate that essential background.

Instead, in setting out the existing Rule 10b-5 prohibition for insider trading, I will simply cut to the chase: According to the Supreme Court, insider trading is fraudulent when a person trades securities on the basis of material nonpublic information in breach of a fiduciary-like disclosure duty owed either to the person(s) on the other side of the trade (the "abstain or disclose" or "classical theory" established in *Chiarella v. United States*, 445 U.S. 222 (1980) and *Dirks v. SEC,* 463 U.S.646 (1983)) or to the source of the information (the "misappropriation theory" endorsed in *United States v. O'Hagan*, 521 U.S. 642 (1997)). The *Chiarella*, *Dirks*, and *O'Hagan* decisions likewise explain that the requisite fiduciary-like duty to disclose arises from a "relationship of trust and confidence."

The Supreme Court has also ruled unanimously on two occasions that insider trading can constitute a violation of the federal mail fraud or wire fraud statutes, 18 U.S.C. §§ 1341 and 1343. 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.[4]

Few securities law scholars would dispute that these theories of insider trading liability are broad and malleable, although opinions differ drastically as to whether elastic interpretations of anti-fraud prohibitions should be heralded or scorned. Courts have construed Rule 10b-5 and/or the federal mail and wire fraud statutes to impose civil and criminal liability in hundreds of insider trading cases involving a wide variety of persons including:

[4] 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").

- officers and directors who traded on corporate information;
- family members who traded on information conveyed to them in confidence by spouses or relatives;
- employees who traded on their employer's information;
- attorneys, accountants, and investment bankers who traded on client information; and
- a host of federal and state government officials who traded on information obtained through government service -- including a Federal Food and Drug Administration chemist who pleaded guilty last month and now awaits a likely prison sentence, and a state Lottery Commission Director who was convicted for trading securities on the basis of nonpublic government contract information constituting property belonging to the state and citizens of West Virginia.[5]

Prosecutors and courts have cast a tremendously wide net. They have even applied Rule 10b-5's misappropriation theory to reach an electrician who traded on material nonpublic information that he overheard while at a company repairing its wiring.[6] Prosecutors have also brought charges against a government affairs consultant who had tipped information that had been subject to a news embargo by the Treasury Department.[7] In these two cases and the hundreds of others in the categories set out above, the linchpin has been a securities trader (or tipper) who breached a duty of entrustment by secretly profiting from the use of material nonpublic information that rightfully belongs to somebody else. Although that linchpin might not be readily apparent from the facts of all of these cases (as I have observed in my scholarship),[8] the SEC and DOJ 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.[9]

---

[5] United States v. Bryan, 58 F.3d 933, 943 (4th Cir. 1995) (citing *Carpenter* v. U.S., 484 U.S. at 26, for the proposition that "confidential information is 'property'").

[6] SEC v. Falbo, 14 F. Supp. 2d 508, 522-24 (S.D.N.Y. 1998) (holding that although he was not a traditional fiduciary, an electrical contractor nonetheless was placed "in a position of trust and confidence" that he violated when he "used for personal benefit information obtained during the course of his association").

[7] SEC v. Davis, Litigation Release No. 18322, 81 SEC Docket 2952 (Sept. 4, 2003) (announcing guilty plea and civil settlement with the SEC); see also SEC v. Nothern, 598 F. Supp. 2d 167, 173 (D. Mass. 2009) (denying summary judgment motion brought by one of the recipients of the consultant's tips).

[8] 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*).

[9] The government's ability to satisfy its burden of proof in insider trading cases premised on the misappropriation theory was facilitated considerably in 2000, when the SEC promulgated Rule 10b5-2, which sets forth three nonexclusive situations in which a "a duty of trust and confidence" shall be presumed:

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 Senators and Representatives 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 Senators and Representatives 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 Senator or Representative – 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 status of the trader (or tipper) or the "reasonable and legitimate expectations" of the particular persons communicating the information to the individual Senator or Representative.

Given the Constitution's repeated reference to public offices being "of trust," and Members' oath of office to "faithfully discharge" their duties, there should be little doubt that Senators and Representatives owe fiduciary-like duties of trust and confidence to a host of parties. 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 House's own constitutionally specified authority to punish its Members as well as through prosecutions by the Executive Branch under

---

(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 . . . ; and

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

17 C.F.R. § 240.10b5-2.

criminal and civil statutes. For example, in connection with conduct involving kickbacks or bribes, the DOJ 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.[10] 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 relatively straightforward cases as well as more complex cases. 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 Senator who learns from a Committee Chair that an aircraft manufacturer will be receiving a multi-million dollar defense contract in an Appropriations Bill. If that Senator were to buy shares of stock in the aircraft manufacturer based on that material nonpublic information, that Senator 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 Senate, and the fellow Member (the Chairman of the Committee) who conveyed that information with a reasonable and legitimate expectation of confidentiality.[11] Likewise, if the Senator 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 Senator's stock purchases would still constitute a fraud and deceit on the United States and the public as well as on Congress and the Senate, but instead of a fellow Member, the

[10] 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).

[11] There is also a compelling argument that could be made for this Senator'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 Senator 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.

Senator's undisclosed securities trading based on his nonpublic knowledge would 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 an emolument of office belonging to the individual Senator 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 be contradicted by 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."[12]

A more complex case could involve a Senator 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 Senator'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 Senator and the board member would be, in the words of the Supreme 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 DOJ 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 secret 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 DOJ 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

[12] Code of Ethics for U.S. Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

alleged staff salary kickbacks, misappropriation of goods worth over $40,000, and misappropriation of funds by exchanging stamp vouchers for cash.[13]

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 instructions 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 a government prosecutor's claim that Rule 10b-5 is violated by a Member's undisclosed self-serving use of material nonpublic congressional knowledge.[14] 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 STOCK Act bills S. 1871 and 1903, to which I shall now turn.

The Legislative Response

Legislative efforts like those found in STOCK Act bills S. 1871 and S. 1903 seek to explicitly proscribe insider trading by Members of Congress, legislative staffers, and other federal employees. These bills strive 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 prohibitions in these bills risk sending an alternative message that is antithetical to the principle of uniform application: Such explicit statutory prohibitions could imply that Rule 10b-5's fiduciary-focused anti-fraud prohibition is hopelessly vague and uncertain as it applies to Congress, and hence must

---

[13] 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).

[14] Moreover, if pressed to speculate, I would go so far as to predict the SEC or DOJ'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 DOJ's Rule 10b-5 enforcement authority. See, e.g., United States v. O'Hagan, 521 U.S. 642 (1997) (endorsing Rule 10b-5's misappropriation theory as it was presented by the government with a six Justice majority); SEC v. Zandford, 535 U.S. 813 (2002) (accepting the SEC's argument that Section 10(b)'s "in connection with" requirement should be read broadly to impose liability against a broker who misappropriated the proceeds from the sale of securities in his clients' account in a unanimous opinion); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 770 (2008) (holding that private plaintiffs cannot establish reliance and thus cannot state a claim under Rule 10b-5 against participants in a scheme to defraud, but observing that "if business operations are used, as alleged here, to affect securities markets, the SEC enforcement power may reach the culpable actors").

be fixed, but that such vagaries and uncertainties are acceptable for others who trade in the capital market. I applaud and endorse the motivation behind the proposed legislation, but believe an alternative approach exists that would accomplish its 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 untaken 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."[15]

Yet, these "court-drawn parameters of insider trading" have not proven to be particularly effective when applied to *nontraditional* insider trading cases. Such 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 are nonetheless subject to the Rule 10b5-1(1)'s prohibition because they breached an arms-length promise to maintain information in confidence (such as the case involving the government affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department, discussed *supra*). These "court-drawn parameters of insider trading" are also ineffective whenever there is reason to doubt the fiduciary bona fides in a particular relationship (such as in many misappropriation cases involving business associates and friends, or in the case involving the electrician, discussed *supra*). Indeed, as Professor Thomas Hazen reminds us, "the absence of a clear definition of insider trading under federal securities law has led to hundreds of decisions grappling with the issue."[16] Without explicit legislation, courts will have no choice but to continue muddling through "the tortuous path of Rule 10b-5 liability for insider trading." *Id.*

---

[15] H.R. REP. NO. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048.

[16] Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883, 889 (2010). See also Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that the federal prohibition of insider trading "has been developed within the framework of federal securities fraud" and concluding that "the resulting case law contains logical as well as interpretive flaws").

Thus, rather than addressing one manifestation of the problem through legislative efforts such as STOCK Act bills S. 1871 and S. 1903, 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. 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.

But if Congress again chooses to reject the idea of a generally applicable statutory definition and prohibition of insider trading, there are a number of immediate fixes that could conform STOCK Act bills S. 1871 and S. 1903 to the stated goal of prohibiting Members and legislative staffers from using material nonpublic information to enrich their personal investment portfolios. First and foremost, the language in the bills should clarify that the Act *does not* constitute an exclusive statement of responsibility for Members and legislative staffers. Without such clarification, there is a very real risk that a STOCK Act could be read to preempt the application of Rule 10b-5 and the mail and wire fraud statutes regarding instances of congressional insider trading. This risk of preemption is particularly troubling because, as I read S. 1871 and S. 1903, the bills fail to reach a host of hypothetical situations involving congressional insider trading that would almost certainly fall within Rule 10b-5 as well as the federal mail and wire fraud statutes.

Much of the under-inclusiveness stems from S. 1871 and S. 1903's language authorizing the SEC to proscribe securities 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 a STOCK Act would reach a Senator 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 Senator if he learned of a multi-million dollar defense contract through a confidential briefing by the Secretary of Defense.

Likewise, the STOCK Acts would not seem to prohibit a Senator, 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, a STOCK Act likely would not reach a Senator 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 bills' 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 Acts, however, only authorize 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.

In short, provisions such as these would actually create gaps that do not exist under current law. And if these express statutory provisions were interpreted to preempt application of Rule 10b-5 and the federal mail and wire fraud statutes, then congressional enactment of a 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.

Conclusion

S. 1871 and S. 1903 would explicitly ban some instances of insider trading by Members of Congress, legislative staffers, and other federal employees. But neither of these STOCK Acts will 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 clarified that Rule 10b-5 and the federal mail and wire fraud statutes do indeed apply to securities trading by Members of Congress and legislative staffers. The current controversy can serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. Although these STOCK Acts should receive thoughtful consideration in the weeks and months ahead, congressional attention to insider trading 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.