

Statement to the Committee on Homeland Security & Governmental Affairs, United States Senate, on “Insider Trading and Congressional Accountability”

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Good morning Chairman Lieberman, Ranking Member Collins, and Members of the Committee, and thank you for the opportunity to appear before you to discuss the important issue of insider trading and congressional accountability.

In my testimony and prepared remarks I have been asked to 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, and I will focus on this area. 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 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 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 some 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 constitutional concerns.

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, Senate Rule XXIX.5, 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 – 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. For example, to my understanding the rules of this Committee provide for the confidential treatment of: any testimony given before the Committee in executive session; classified information; and controlled unclassified 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.

Paragraph 5 of Senate Rule XXIX may appear to impose on Members and staff of the Senate a general obligation of confidentiality with regard to Senate business. This paragraph provides that:

Any Senator, officer, or employee of the Senate who shall disclose the secret or confidential business or proceedings of the Senate, including the business and proceedings of the committees, subcommittees, and offices of the Senate, shall be liable, if a Senator, to suffer expulsion from the body; and if an officer or employee, to dismissal from the service of the Senate, and to punishment for contempt.

Rule XXIX generally addresses “Executive Sessions,” so the sanctions set forth in paragraph 5 would manifestly apply to violations of the “injunction of secrecy,” set forth elsewhere in Rule XXIX, covering business conducted by the Senate in closed Executive session. Beyond such instances, however, this provision refers to the “the secret or confidential business or proceedings of the Senate” but does not address or define which “business or proceedings” this includes. Is it all “business and proceedings of the committees, subcommittees, and offices of the Senate”?

The legislative history of this provision – which was incorporated in Senate Rule XXIX through the adoption by the Senate of S. Res. 363 on October 8, 1992 – notes, somewhat circularly, that, “[a]s used throughout rule XXIX, the words secret and confidential refer to all information the Senate treats as confidential, including information received in closed session, information obtained in the confidential phases of investigations, and classified national security information.” While this legislative history also makes clear that the Senate Ethics Committee has jurisdiction to consider all allegations of violations of paragraph 5 of Rule XXIX, such jurisdiction “should be reserved for grave breaches of confidentiality that cannot be resolved by the committee or offices in which those breaches occur.” So the rule, in large part, leaves it to individual committees and offices to determine what Senate information should be considered to be “confidential.” The situation in the House is similar in that there is no general, institution-wide definition as to what information should be considered “confidential.”

Where does this lack of any institution-wide definition of “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 1 of Senate Rule XXXVII (on "Conflicts of Interest"):

A Member, officer, or employee of the Senate shall not receive any compensation, nor shall he permit any compensation to accrue to his beneficial interest from any source, the receipt or accrual of which would occur by virtue of influence improperly exerted from his position as a Member, Officer, or employee.

The House "Code of Official Conduct," at Rule XXIII, paragraph 3, 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. However, in the Senate, at least, application of this 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 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.¹

Similarly, the discussion in the *House Ethics Manual*, at page 186, of the parallel 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.”² 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.³

Two other provision of Senate Rule XXXVII, on “Conflicts of Interest,” bear discussion here. Paragraph 3 of Rule XXXVII provides that

No officer or employee shall engage in any outside business or professional activity or employment for compensation unless he has reported in writing when such activity or employment commences and on May 15 of each year thereafter so long as such activity or employment continues, the nature of such activity or employment to his supervisor. The supervisor shall then, in the discharge of his duties, take such action as he considers necessary for the avoidance of conflict of interest or interference with duties to the Senate.

¹ S. Rep. No. 95-49, The “Nelson Report.”

² *Id.*

³ 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 . . .”

This rule has been consistently read by the Ethics Committee to apply to an outside occupation or to outside employment, whether for pay or not. It has not been read, in my experience, as having potential application to the personal securities trading of a Member or employee.

On the other hand, paragraph 7 of Senate Rule XXXVII does have direct application to the extent to which employees of Senate committees may hold or trade in securities posing a potential conflict with official duties. This paragraph provides that

An employee on the staff of a committee who is compensated at a rate in excess of \$25,000 per annum and employed for more than ninety days in a calendar year shall divest himself of any substantial holdings which may be directly affected by the actions of the committee for which he works, unless the Select Committee [on Ethics], after consultation with the employee's supervisor, grants permission in writing to retain such holdings or the employee makes other arrangements acceptable to the Select Committee and the employee's supervisor to avoid participation in committee actions where there is a conflict of interest, or the appearance thereof.

As discussed further below in connection with the disclosure provisions of the STOCK Act, as a historical matter the remedy of divestment has not been the preferred approach taken to addressing potential conflicts of interest posed by the financial holdings of Members and employees of the legislative branch. Essentially, paragraph 7 of Senate Rule XXXVII stands alone in requiring divestment under certain circumstances by Senate committee staff. Could a similar approach be taken regarding the holdings of employees of the personal offices of Senators? This would be more difficult to do in that the work of the personal office and, at least, of the senior staffers in a personal office is not confined to one issue area or economic sector. This same difficulty would be compounded if Senators were required to divest financial holdings that could be affected by their official actions. A Senator's official and representative duties comprehend all areas of potential legislation, all economic and industry sectors. If divestment were required for Members to avoid potential financial conflicts, what holdings would they not be required to divest?

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 Senate Ethics Committee or the House Ethics Committee, 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 none of the specific provisions discussed above were applicable, these allegations would be diligently pursued and investigated by the Committees as, potentially, constituting conduct reflecting discreditably on the institution.

The STOCK Act Disclosure Provisions

The versions of the STOCK Act that I have reviewed would each 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.

As mentioned in my remarks above, in the legislative branch, 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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