PREVENTING UNFAIR TRADING BY GOVERNMENT OFFICIALS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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PREVENTING UNFAIR TRADING BY GOVERNMENT OFFICIALS

Monday, July 13, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Dennis Moore, [chairman of the subcommittee] presiding.

Members present: Representatives Moore and Biggert.

Chairman MOORE OF KANSAS. This hearing of the Subcommittee on Oversight and Investigations of the House Financial Services Committee will come to order. Our hearing this afternoon is entitled, "Preventing Unfair Trading by Government Officials."

Normally, we begin our subcommittee hearings with members' opening statements, up to 10 minutes per side, and then we hear testimony from our first panel of witnesses. I understand one of our witnesses, the chairwoman of the House Rules Committee, Congresswoman Slaughter, has her own hearing that she will be chairing that she needs to leave for in a few minutes.

So I ask unanimous consent that we go slightly out of order. I will give my opening statement, followed by Ranking Member Biggert, and then we will hear from Congresswoman Slaughter, so she can provide her testimony and be excused.

Is that okay with you?

Ms. SLAUGHTER. Thank you.

Chairman MOORE OF KANSAS. I will then recognize any other subcommittee member who wants to give a brief statement within the remaining time for opening statements, if more members show up, and then invite Congressman Baird, the chief sponsor of H.R. 682, to give his testimony and see if there are any questions before I invite our second panel of witnesses to testify.

Members will each have up to 5 minutes to question our witnesses. Without objection, all members' opening statements will be made a part of the record.

Without objection, I ask that written testimony from the Securities and Exchange Commission be made a part of the record.

I now recognize myself for up to 5 minutes for an opening statement.

In May, we learned from the Wall Street Journal that Federal prosecutors are investigating whether two SEC Enforcement lawyers had violated insider trading laws. The newspaper obtained a redacted copy of a report from the inspector general of the SEC, Mr. David Kotz, who will testify on this report and his role as independent watchdog of the Commission.

His report concluded that the lawyers violated the Agency's internal rules, although the employees have denied any wrongdoing. In addition to 11 recommendations the IG made to the SEC, the IG also recommended that the SEC take disciplinary action against the two employees.

In a written statement provided by the SEC for this hearing they have, "deferred consideration of an appropriate response to this recommendation based on what we understand to be a pending criminal inquiry by the United States Attorney's Office."

As a former district attorney, I fully respect that everyone is presumed innocent until proven guilty. While we let Federal law enforcement do their jobs, I did not want to wait to discuss the larger public policy questions that this case invokes: Should government officials trade on information that they have access to that the general public does not? If not, what additional rules, regulations or laws are required to address this concern?

Our Nation's Federal Government was founded on the principle of separation of powers as well as checks and balances. How do we maintain those important principles while ensuring there is a level playing field in the marketplace with respect to the investments by any government official, including Members of Congress? And while this is not true for most government officials, we should acknowledge that a few individuals, like the Federal Reserve Chairman or President of the United States, will move the market simply by the words they use in a speech.

No one is proposing this, but should their speechwriters be banned from investing in all individual stocks out of fear that they may unfairly profit from their jobs, or is that going too far? What about reporters who compete to break news of a pending announcement by the government, or a lobbyist who is pushing for legislation that will provide tax relief for a certain industry; how will we guard against unfair trading practices of those individuals as well?

This debate raises a lot of tough questions, but I hope we can examine all sides of this issue to better understand what the problem is and how responsible solutions may prevent unfair trading by government officials. There will always be a few bad apples unfortunately, but no government official should believe that they are above the law. Most government employees are public servants with the best intentions, working hard every day to serve the American people.

I do want to commend our first two witnesses and colleagues, Congresswoman Slaughter and Congressman Baird, for proposing a response to these questions by drafting H.R. 682, the Stop Trading on Congressional Knowledge Act. I look forward to hearing from them why they drafted the bill and how they see it addressing these important concerns.

In addition to the SEC's Inspector General, who will focus on his investigation in the second panel, I am interested to know what our three professors testifying have learned through their research and experiences and what recommendations, if any, they may have for this committee and for Congress on these issues.

I now recognize for 5 minutes our distinguished ranking member of the subcommittee, my colleague and friend from Illinois, Ranking Member Judy Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman, for holding today's hearing. It is great to see our colleagues on the other side of the witness table. I have been there myself, and it is rather odd sometimes.

But welcome. In the interest of time, and to accommodate Chairman Slaughter's schedule, I will be brief. And I would like to thank you both for being here and also thank today's witnesses for joining us today.

Today's topic, "Preventing Unfair Trading by Government Officials," I think is critical to this committee, which has oversight over so many issues, and this certainly is one that we need to look at. We have to make sure that we can preserve the integrity of all branches and levels of government and to preserve the integrity of our financial market.

So I look forward to hearing from the witnesses, what they know about the extent of insider trading within and beyond the Federal Government. I think this evidence will be important for us to determine what actions—such as those that are being undertaken by the SEC—must be taken to make sure that we don't have insider trading.

So with that, I yield back and I look forward to hearing from the witnesses.

Chairman MOORE OF KANSAS. Thank you very much. And I am pleased to introduce our first panel of witnesses for this afternoon's hearing.

First, we will hear from our colleague, Congresswoman Louise Slaughter, who is serving her 12th term representing the 28th District of New York. A microbiologist with a masters degree in public health, Congresswoman Slaughter is the first woman to serve as chairwoman of the powerful House Rules Committee.

After any additional opening statements from subcommittee members are given, if additional members arrive, Congressman Brian Baird will testify. He, like me, was elected in 1998 and also represents the Third District of his State. Congressman Baird represents his Washington constituents and chairs the Energy and Environment Subcommittee of the Science and Technology Committee.

Without objection, any written statements you have will be made a part of the record. You will each be recognized for a 5-minute statement.

Congresswoman Slaughter, you are recognized, please for 5 minutes.

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

Ms. SLAUGHTER. Thank you, Mr. Chairman, and Mrs. Biggert. I am delighted to appear here along with Mr. Baird. I consider I am with three of the brightest lights of Congress.

Thank you so much for holding this important hearing and giving me the opportunity to testify. I hope our discussion will lead to the timely and decisive passage of this legislation to close the insider trading loophole and bring transparency to a rapidly expanding political intelligence industry.

Mr. Baird and I first introduced the Stock Act in 2006 after increasing reports of Members of Congress or their staffs abusing their official status in access to information for private gain first surfaced. Indeed, a 2004 study by Professor Alan Ziobrowski of Georgia State University, whom I am pleased is testifying here today, confirmed that United States Senators received returns on their investments that were approximately 25 percent higher than typical Americans were able to achieve.

While various reports of Members and staff using information improperly for financial gain, and hard data showing that Senators were realizing significantly higher returns on investment than the average investor do not prove the existence of a widespread abuse of power and trust, they do reveal serious loopholes and a potential for abuse that require immediate action and preventive measures.

Furthermore, political intelligence firms that provide investors with inside information about a pending legislative action, information that can be used to inform investment decisions, had been operating largely in secret and without controls. Only a handful of political intelligence firms existed in the 1970's, but in the past few decades, the industry has bloomed. By 2006, the industry brought in an estimated $40 million a year.

Mr. Chairman, there was more than enough reason to introduce the legislation in 2006 to crack down on insider trading by Members and staff and to bring accountability to the political intelligence industry.

Since then, we have entered into the worst economic crisis since the Great Depression and the implications of failing to act immediately are great. Congress and the Federal Government are now so enmeshed in the operations of our financial markets that the potential for abuse by Members of Congress, congressional staff, and Federal employees is staggering.

A liquidity crunch that began in August 2007 helped to set off a chain of events leading to the near collapse of the entire global financial system in September of 2008 and marked the beginning of an unprecedented involvement of the Federal Government in our financial system. This has created an unprecedented opportunity for lawmakers and Federal Government employees to use the knowledge obtained from their official status for private financial gain. Between the Federal Reserve's massive injections of liquidity into the markets and its role in bailing out, or choosing not to bail out, Bear Stearns and Lehman Brothers. For instance, the Treasury's role in implementing the $700 billion Troubled Asset Relief Program (TARP) and Congress' role in legislating TARP, Congress and Federal employees have had early access to so much sensitive information that can seriously affect the stock market that we must not wait any longer to close these loopholes.

Moreover, the upcoming financial market regulatory reform will bring with it greater opportunity for those with early access to information to profit on an immense scale.

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 with no regulation or oversight. They focus not on influencing Congress, but rather gathering information from Members or staff on forthcoming legislative action in order to give their clients an advantage over other investors.

With leading experts noting that political intelligence businesses have quadrupled since 2003, these businesses are now merging as a key factor in the lobby industry and should be regulated accordingly. Such an important and increasingly relevant business should certainly be required to make its activities known to the public.

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

I sincerely believe that the vast majority of Members of Congress, congressional staff, and Federal employees are here to serve the best interests of their constituents and the public, not to line their pockets. But 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 a democratic process.

Mr. Chairman and Mrs. Biggert, once again let me thank you for holding this hearing to shed light on what I consider a most 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, and I yield back the balance of my time.

Chairman MOORE OF KANSAS. Thank you, Congresswoman Slaughter.

And if you have questions—I am going to forgo mine, but I understand Congresswoman Slaughter has a few minutes to take questions if you have questions.

Mrs. BIGGERT. Congresswoman Slaughter, how would we define nonpublic information? For example, for a Member of Congress, what would be something that under this bill would be illegal?

Ms. SLAUGHTER. We have heard stories, and many have printed in the press about Members of Congress and their staffs using their own computers, the government's computers, in their working offices in order to play the stock market day after day.

There is a story about asbestos. When, shortly before an asbestos law was to be passed or not passed, as crazy as it turned out to be, that information was leaked and within days the stock on asbestos rose precipitously. These are things we come into contact with, information like this, frequently, particularly those who work for certain committees.

It is critically important that they understand that part of their job—just as we all know that we do not put what our constituents tell us out in general knowledge—is that this is information that should be held closely because of the effect that it can have on the market.

We have had other instances, as I pointed out before, of people who are making money as they work for Congress in particular offices—leadership offices or others—where they would be recipients of such information.

Mrs. BIGGERT. Well, those people who would have every day to go on the stock market, I think probably their office isn't busy enough. It seems like we have not enough time to even get rid of some of our e-mails.

Ms. SLAUGHTER. Isn't that the truth?

I guess they have first things first. Using that information, for some, I suspect, was more important.

Mrs. BIGGERT. Do you think that would lead then just to everyone having to have a blind trust.

Ms. SLAUGHTER. No, I don't think so at all. The fact is that we have never discussed this issue. I think this is something that really needs to be part of the Code of Ethics of the House and the Senate. I would like to see it there, something that is written, and make it explicit to everybody who works for us, including interns, that they may not trade on any information that they get in their congressional office that would affect the markets in any way or benefit them personally.

I find it hard, and I am sure most people in our age brackets do, that you have to go that far, but I think it is well worth it to do that. But I do think that there should be a law against it because of nonregulation of these intelligence lobbying firms has really grown so large.

And the idea that they might take an intern or someone out to dinner—I know they are not going to take us because we passed that law, but that they might be doing that in return for information is also a pretty scary thing.

So we need to regulate them more and tell them—frankly, I don't like the whole idea of people making $40 million a year off information that is obtained from Congress for their clients.

Mrs. BIGGERT. I think that most offices have a policy that what is said in that office stays in that office. But obviously that is not enough.

Ms. SLAUGHTER. If we have it as regulation or as law, as I point out, it is far more important to me that we regulate these outside firms. But if we have that, that gives us as Members of Congress who put so much of our trust into people who work for us in our office, a chance to understand that is a basis for firing and maybe other kinds of action.

In the first place, I think all of us know that nobody should be using the Federal computers for such work, but that is minor in comparison to what they get for it.

Mrs. BIGGERT. Thank you. I yield back.

Ms. SLAUGHTER. You are welcome.

Chairman MOORE OF KANSAS. Thank you for your testimony, Congresswoman Slaughter. You are excused. And at this time, I would like to—can you make it in time to your next hearing?

Ms. SLAUGHTER. I can. And it is on the overuse of antibiotics so that we can fight MRSA. Thank you.

Chairman MOORE OF KANSAS. Congressman Baird, you are now recognized for 5 minutes for your testimony, sir.

STATEMENT OF THE HONORABLE BRIAN BAIRD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. BAIRD. Thank you, Chairman Moore, and Ranking Member Biggert. And thank you, colleagues on the subcommittee. I also want to thank our witnesses today. I have had the privilege of reading their testimony and find it very insightful.

I also want to acknowledge Tim Walz, our colleague, who has been very active in this issue and has been a great help. And I want to introduce into the record letters from Public Citizen and U.S. PIRG, and acknowledge that in addition to those organizations, Common Cause, Democracy 21, and The League of Women Voters have expressed support for this legislation.

The reason we are here today really is, to some extent, people have lost faith in us, in the political system and in the financial institutions. And this bill is about trying to restore at least a modicum of that faith back.

It goes with our jobs as legislators that we will have access to information that others do not; classified briefings, participation in late night committee hearings, meetings in closed conference reports, personal conversations with Administration officials or others all can give us information that is not yet public. Some of that information will have significant value. And because we have access to information that is potentially of such great value, we have, I think, a dual responsibility.

I should also note we not only access information, we create information. When we are in a conference report or conference committee and we decide that something will make it to the Floor, that is potentially very consequential from a financial perspective. And because of that dual responsibility of access to and the creation of information we must not betray the trust the people put in us and must not betray our own integrity.

The essence of our bill is simple. It would make it explicit in law and in our ethical codes that Members of Congress and their staffs could not make financial transactions on the basis of information that they know or have reason to believe is not available to the general public.

Further, Members of Congress or their staffs should not share nonpublic information with others if there is reason to believe that the recipient of the information will use that information for financial transactions. So too, recipients who receive from Members of Congress or staff information known or reasonably believed to be nonpublic should not make financial transactions based on that knowledge.

To help ensure that such actions do not occur or can be identified if they do take place, greater transparency and immediacy of reporting should be required of Members of Congress, key staff, and entities such as lobbying firms or so-called political intelligence firms.

Finally, we would recommend very strongly to Congress that we follow the example of every major corporation, Federal agency, and many law firms by establishing explicit ethical prohibitions and consequences for violation of these principles and creating information dissemination and training measures to ensure that all staff are informed about the ethical standards and applicable laws and affirm in writing at the time of employment that they will comply.

I should note that most major corporations do this, many law firms do it, but I have yet to meet a single Member of Congress or their staff who was informed explicitly about the issue of insider trading, the consequences or legal ramifications thereof; and certainly I don't remember having seen my staff sign a document about that as they would have to if they worked for a corporation.

I am not an attorney, but I do have a nose and I know when things smell bad. Here is something that smells bad.

Imagine a Member of Congress involved in final conference negotiations on a major piece of legislation. During closed discussion it is agreed upon that certain language which would substantially favor a particular investment will be included in the conference report that is scheduled to be released the following day and will be voted on shortly thereafter. Based on that knowledge of nonpublic information, the Member of Congress instructs his or her broker to make specific market trades to take advantage of that nonpublic information.

Consider a second example: A senior staffer in charge of drafting a manager's amendment for a bill scheduled for a Floor vote the next afternoon, the staff member discusses provisions of the bill with a fellow staffer and says, this is not yet public, but fill in the blank with the information. The recipient of the information then goes out and makes investments on that.

I spent a substantial amount of time reviewing relevant laws and precedents that apply to insider trading. It is my understanding that neither Federal law nor House rules specifically and sufficiently explicitly address this issue as it applies to Members of Congress and staff.

Now, I am sometimes asked, well, how do we know this is a problem, how do we know somebody is engaging in it? Suppose you were the manager of a bank. You come into your bank one evening and you discover that the back door of the bank has been left open. The next day, you take this up with your security people and you say, it troubles me a little bit that the back door was left open. And your security people say, no, sir, as far as we know, nobody has come in through that back door yet and taken any money. And you say, well, how do you know they haven't? And they say, well, we really haven't checked to be perfectly honest. And you say, well, what if they did? And the answer is, well, we are not even sure that would be illegal.

You would be negligent as the manager of that bank if you didn't fix all three of those problems. And as managers of this institution, I would suggest we need to fix all three.

We don't believe the bill is perfect. We think the information from the witnesses can improve it. We are grateful for their insights and we look forward to the wisdom of the committee members in improving this.

The one thing Ms. Slaughter and I are absolutely certain of is, this is a significant problem that needs to be addressed; the sooner we address it, the better—better for us as an institution and better for the financial markets.

And I thank you for the time.

Chairman MOORE OF KANSAS. Congressman Baird, thank you for your testimony.

I am going to ask Congresswoman Biggert if you have any questions. You have 5 minutes for questions.

Mrs. BIGGERT. I understand what you are getting at. It is just—I guess it is tying it down. You know, when you talked about classified information, I mean, that is easy for us. We know that we go in and we have to put our beepers aside, our phones, everything, when we go into a classified briefing and know that we are not going to talk about that—although it seems sometimes, we come out and it is on CNN. But besides that, it is still, we don't talk about it and don't bring it up.

But this "nonpublic," I think is hard. Where you draw the line, I think, is something that is very important to be spelled out there, because it is a little bit different. You don't always know that you know something.

Mr. BAIRD. Right.

Mrs. BIGGERT. Is that true?

Mr. BAIRD. It is a legitimate question. The challenge right now is, because there is no consequence right now, it is somewhat irrelevant whether something is nonpublic or public.

Our reading of the law, in consultation with experts, Congresswoman, is that right now, sort of anything goes; and you can basically say the key issues—and I will let our legal experts talk more about this—are questions of duty and misappropriation of information. Right now our duty is not necessarily clearly enough spelled out in our ethical standards, so it is not even clear that if you specifically add something labeled "nonpublic"—I mean, literally stamped on it "nonpublic"—it is not 100 percent clear in our ethical standards that it is constrained from release.

The issue really is for a legal proceeding to establish—the way the SEC works oftentimes is sort of going backwards and saying, okay, so-and-so made an enormous trade or an unexpected level of trade right before something did become public; why did they make that trade before something did become public?

The same kind of procedure can apply to our staff members. And then you work backwards and say, well, you were in this meeting with the Administration; show us where the Administration had made that information public, show us where the conference report had been published prior to the time you made the trade.

Let's suppose the conference committee is meeting, it is agreed upon, it is a closed meeting or there is a closed conversation. Nothing is released publicly until a certain time. The trade happened before that time. At some point you can say, how could you possibly have known that if you hadn't been in the meeting? You were in the meeting, you hadn't seen it made public; it is presumptive therefore.

By informing people of that risk—and by the way, these are serious legal consequences and civil consequences—we help prepare people for avoiding that and create conditions, if they willfully and intentionally violate that standard, there are consequences for them.

Mrs. BIGGERT. Thank you. I yield back.

Chairman MOORE OF KANSAS. Thank you. I thank our colleagues for their testimony.

Our first panel is now excused, and I will invite the second panel to take their seats.

As is our committee's custom when we have other members testify, I ask unanimous consent that Congressman Baird be invited to join us on the dais if he is able to do so and wishes to. Any objection?

Without objection, I am pleased to introduce our second panel of witnesses for this afternoon's hearing. For this panel, we will first hear from the Inspector General of the Securities and Exchange Commission, David Kotz. Mr. Kotz has been asked to focus on his recent investigation of the SEC employees.

On the broader policy issues we will hear from Professor Alan Ziobrowski, who is an associate professor at J. Mack Robinson College of Business at Georgia State University.

Third on our panel is Professor Peter Henning from Wayne State University Law School.

Finally, we will hear testimony from Professor J.W. Verret, an assistant professor of law at George Mason University School of Law and a Senior Scholar for the Mercatus Center Financial Markets Working Group.

Thanks to all of you for being here. Without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute statement summarizing your written testimony.

Mr. Kotz, you are recognized, sir, for 5 minutes.

STATEMENT OF H. DAVID KOTZ, INSPECTOR GENERAL, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. KOTZ. Good afternoon. Thank you for the opportunity to testify today before this subcommittee on the subject of preventing unfair trading by government officials as the Inspector General of the Securities and Exchange Commission. In my testimony today, I am representing the Office of Inspector General, and the views that I express are those of my office and do not necessarily reflect the views of the Commission.

The mission of the Office of Inspector General is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC. The SEC and Office of Inspector General has staff in two major areas: audits and investigations. The Office of Audits conducts, coordinates, and supervises independent audits and evaluations related to the Commission's internal programs and operation. Over the past year, we have issued numerous audit reports involving issues critical to SEC operations and the investing public, including a comprehensive report analyzing the Commission's oversight of the SEC's consolidated supervised entity program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers.

Our Office of Investigations examines allegations of violations of statutes, rules, and regulations and other misconduct by Commission staff and contractors. Over the past year-and-a-half, we have issued investigative reports regarding, among other things, claims of improper preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, lack of impartiality, and the performance of official duties and the unauthorized disclosure of information.

In addition to the work I just described, we are conducting a wide-ranging investigation and evaluation of matters related to Bernard Madoff and affiliated entities. We have made substantial progress on our investigation and plan to issue shortly a comprehensive investigative report detailing all the examinations and investigations that the SEC conducted of Madoff from 1992 until the present.

It is with this background in mind that I wish to discuss an investigation that we recently concluded relating to the securities transactions of two SEC Enforcement attorneys over a 2-year period. Our Office received information from the SEC Ethics Office that a particular Enforcement attorney was trading securities very frequently. As we began investigating this Enforcement attorney's trading activity, we identified another Enforcement attorney who was a friend of this individual and with whom the first attorney often discussed securities transactions and open enforcement investigations during regular weekly lunches and via e-mail. We conducted a year-long investigation of these Enforcement attorneys, which encompassed a comprehensive review and analysis of more than 2 years of brokerage records, ethics filings, security transaction filings, and e-mail records.

On March 3, 2009, we issued our report of investigation to the Agency. Our investigation revealed suspicious conduct, appearances of improprieties, and evidence of possible trading based upon nonpublic information on the part of the two SEC Enforcement attorneys. Because of the seriousness of the information that our investigation uncovered, we referred the matter to the United States Attorney's Office of the District of Columbia's Fraud and Public Corruption Section, which, together with the FBI, is currently conducting an investigation of possible criminal and civil violations. Because of this joint U.S. attorney-FBI investigation, I am somewhat limited in my ability to discuss the details of this matter.

In addition to suspicions of insider trading, our investigation found that the Enforcement attorneys committed numerous violations of the SEC's securities reporting requirements. For example, although SEC rules require employees to file a notification form within 5 business days of the purchase or sale of securities, these Enforcement lawyers failed to file these forms for certain transactions. Moreover, although the Office of Government Ethics Form 450 requires the reporting of an employee's security holdings with a value greater than $1,000 at the end of each calendar year, or the generated income of more than $200 per year, the Enforcement attorneys failed to report such transactions or earnings that were over these limits. They also found that one of the Enforcement attorneys failed to clear numerous stock transactions through an agency database prior to purchasing stocks.

Our investigation further found that generally, although the SEC is charged with prosecuting cases of violations of the Federal securities laws, including the investigation and prosecution of insider trading on the part of individuals and companies in the private sector, the SEC had essentially no compliance system in place to ensure that its own employees, with tremendous amounts of nonpublic information at their disposal, did not engage in insider trading themselves. The existing disclosure requirements and compliance system were based on the honor system, and there was no way to determine if an employee failed to report a securities transaction as required.

No spot checks were conducted, and the SEC did not obtain duplicate brokerage account statements. In addition, there was little to no oversight or checking of the reports that employees filed to determine their accuracy or even whether an employee had reported it at all. Moreover, different offices in the SEC received the various types of reports and did not routinely share that information with each other.

We also found a poor understanding and lax enforcement of the securities transactions reporting requirements. For example, most of the Enforcement attorneys who traded and we investigated testified that no one had ever questioned their reported securities holdings or transactions in the decades they worked at the SEC. Moreover, both managers who were responsible for reviewing the OGE Form 450 testified they did not recall ever questioning any SEC employees with respect to their reported securities holdings.

Our investigation also found that the Enforcement attorneys we investigated routinely discussed stocks and investment strategies in e-mails and in public. They maintained separate folders entitled “Stocks” in their SEC e-mail accounts.

Chairman MOORE OF KANSAS. Mr. Kotz, your time is up. I would ask, with the consent of the other members of the panel here, that you have an additional 2 minutes. Is that satisfactory?

Without objection, you have an additional 2 minutes, and your full testimony will be received in the record, sir.

Mr. KOTZ. On most days, they sent e-mails from those accounts about stocks and their own stock transactions.

We discovered that one of the Enforcement attorneys traded often and even testified that the financial markets were her main hobby and passion. We found that this attorney spent much of her work day e-mailing her co-workers about various stock transactions.

Our investigation also disclosed that one of the Enforcement attorneys sent e-mails to his brother and sister-in-law from his SEC e-mail account during the workday, recommending particular stocks.

Our report recommended that the SEC take disciplinary action against the two Enforcement attorneys who, we found, violated the rules. We also provided the Commission with 11 specific recommendations to ensure adequate monitoring of employees’ securities transactions. These recommendations included establishing one primary office to monitor employees’ securities transactions, instituting an integrated computerized system for tracking and reporting purposes, obtaining duplicate copies of brokerage record confirmations for each security transaction, requiring employees to certify in writing that they do not have nonpublic information, ensuring that the forms SEC employees are required to file are checked with the existing database, requiring SEC employee supervisors to review a list of pending cases to compare with a list of the securities reported, conducting regular and thorough spot checks for compliance purposes, developing a clear, written policy on the confidentiality of enforcement investigations, and establishing comprehensive and more frequent training.

Our investigation underscored the need for the SEC to revamp completely its current process for monitoring SEC employees' securities transactions. In response to our report on May 22, 2009, SEC Chairman Mary Schapiro announced that the SEC would be taking measures to address the problems we identified. These measures include drafting a new set of internal rules governing securities transactions for all SEC employees that will require preclearance of all trades and, for the first time, prohibit staff from trading in the securities of a company under SEC investigation.

Chairman Schapiro also announced that the SEC was contracting with an outside firm to develop a computer compliance system to track, audit, and oversee employees' securities transactions. Chairman Schapiro further stated that she signed an order consolidating responsibility for oversight of employees' securities transactions and authorized the hiring of a chief compliance officer.

We are pleased that the SEC is planning to take concrete steps to address the issues identified in our investigation. These steps, if implemented, would satisfy the concerns raised in our report and even, in a few instances, go beyond our recommended actions.

Chairman MOORE OF KANSAS. Excuse me. I am going to have to ask you to submit—

Mr. KOTZ. I am done.

[The prepared statement of Mr. Kotz can be found on page 38 of the appendix.]

Chairman MOORE OF KANSAS. You are done. Very well, sir. I then have a couple of questions or at least a question for you.

I am sorry; we will take the other witnesses first.

Professor Ziobrowski, if you would please, sir.

STATEMENT OF ALAN J. ZIOBROWSKI, Ph.D., ASSOCIATE PROFESSOR, J. MACK ROBINSON COLLEGE OF BUSINESS, GEORGIA STATE UNIVERSITY

Mr. ZIOBROWSKI. Thank you, Mr. Chairman, and the other members of this subcommittee, for the opportunity to present my views on the subject of congressional conflict of interest.

In 1995, my colleagues and I began a 10-year project to examine the common stock transactions of U.S. Senators and Members of the U.S. House of Representatives. The object of the study was to measure the abnormal returns earned by legislators on their common stock investments.

The concept of abnormal returns is fundamental to the science of finance. Despite claims by stockbrokers, financial analysts, and all types of financial pundits, many years of financial research have shown that the ability of investors to consistently beat the market when armed only with information available in the public domain is virtually nonexistent. The evidence is, in fact, so strong that academics generally regard any individual or group of individuals who possess that ability to be inside traders or, at the very least, people trading with an informational advantage, that is, they are assumed to be trading on the basis of information not available to other market participants. We do not necessarily know the source or the nature of the information they possess, however, we are quite certain that they know things the rest of us do not know.

Using standard methodology, we included nearly 6,000 transactions over 6 years for Senators and over 8,000 transactions for Members of the House during a 17-year period. In both cases, we found conclusive evidence that legislators possess an informational advantage, and trade based on that information. Collectively, Senators beat the market by approximately 1 percent per month or 12 percent a year. Members of the House beat the market by half-a-percent a month or 6 percent per year.

To put these numbers in their proper perspective, it has been reported that corporate insiders who trade common stock in their own respective companies earned abnormal returns roughly equal to those of the House and much less than those of the U.S. Senate.

Although not an objective of this study, our research also gave me the opportunity to examine financial disclosure and its efficacy at discouraging conflicts of interest. I found that access to congressional financial disclosure reports can be difficult, personally intimidating, and even expensive. Furthermore, the reports are often missing, difficult to read or understand, and erroneous.

But all these shortcomings aside, the most obvious problem with the current system is that it fails to link financial disclosure to legislative behavior. Without an intimate knowledge of a legislator's voting record and the bills under consideration, it is impossible for an American to draw a meaningful conclusion regarding the conflict of interest.

With respect to H.R. 682, I am generally supportive of including Members of Congress and their staffs under the insider trading statutes. In my opinion, it will likely reduce trading on confidential information. However, it is naive to assume that the practice will be totally eliminated. After all, corporate insiders are still able to earn significant abnormal returns, despite being bound by such laws for many years.

With that in mind, I would therefore recommend one significant change to the bill. Consistent with the corporate insider reporting requirements, Members of Congress should be required to report common stock transactions within days not months.

Furthermore, the report should be filed with the SEC for rapid dissemination to the public. This would not eliminate the insider trades, but it would partially level the playing field for other market participants. By following the day-to-day trading activities of Congress, market participants could use this information in formulating their own investment strategies.

I realize that there were other questions which were asked of me by the Chair when inviting me to this hearing. However, my 5 minutes are up and I have tried to address these other questions in my written testimony.

But I will be glad to discuss them further during the question-and-answer session. Thank you.

[The prepared statement of Professor Ziobrowski can be found on page 51 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Professor Ziobrowski.

And, Professor Henning, you are next, sir, if you would.

STATEMENT OF PETER J. HENNING, PROFESSOR OF LAW, WAYNE STATE UNIVERSITY LAW SCHOOL

Mr. HENNING. Thank you, Chairman Moore, Representative Biggert, and Representative Baird for giving me this opportunity. Before I began teaching at Wayne State University Law School in Detroit, I was a staff attorney with the SEC for 4 years in the Division of Enforcement, and then worked for 3 years in the United States Department of Justice. I would like to just talk briefly about two issues here today with regard to what has been discussed before.

Inspector General Kotz discussed the status of the investigation that showed certainly troublesome trading by members of the Enforcement Division staff. When I first read about his report my reaction was, how could a member of Enforcement do anything that stupid?

Now my response is, in listening to his description of measures that would be taken, I would recommend something much simpler. Rather than the current rules, it should simply be to—and Congress or the Commission could do this—prohibit anyone at the SEC, from the commissioners on down, from buying or selling the shares of publicly traded companies or any entity subject to SEC regulation while they are employed there. A simple bright-line rule would be the best way to go.

Now, there is the possibility someone would be hired or become a Commissioner in a situation in which they already had shares of stock. The rules are in place there for disposing of those shares. However, as long as someone is working at the SEC, that person should not be buying and selling shares of public companies or companies that are directly regulated by the SEC. No ifs, ands, or buts about it; a bright-line rule would handle this problem much better.

It also would not cost the SEC, I suspect, any of its employees or the people who wanted to work there or who were working there at the time. If your goal is to play the market by investing in individual company stocks, then you can pursue that avocation, but you can't work at the SEC. That would be a much better and simpler way to handle that issue.

Now, with regard to H.R. 682, I would just like to highlight two points here with regard to the statute. One potential gap in the statute is that in extending the ban to nonemployees, those who would be, in the parlance of the securities laws, "tippees," there is no clear prohibition on tipping by these particular people. For example, say an interest group representative received nonpublic information about pending legislation that would have a particular impact on a company or industry, and that person tells a friend so that he or she can profitably trade on it. The bill or the legislative history should make it clear that a person who received that type of information about a legislative action would be prohibited from disclosing the information to another person so that person could trade on the shares. So it is not just Members of Congress and their staffs who would be covered, and those who might receive that information, but those who, in turn, might receive the information.

Also, I would point out that in H.R. 682, the reference to that "tippee" is if that person knows the information came from a Member of Congress or a member of the staff.

Now, in the leading U.S. Supreme Court case on tipping/tippee liability, the Supreme Court said that person is liable if he or she knows or should know. And using the terminology "should know" is broader; that is an objective test saying, do you know or should you know that you are receiving it? That would, in fact, expand the prohibition and would cut off a defense of, for example, lack of knowledge or mistake. So that certainly would be one thing to consider.

Another caution that I would raise just briefly—and I discuss this more extensively in the prepared testimony—is that if the statute were to be passed, it would authorize the SEC and the Commodity Futures Trading Commission to initiate investigations. Also, too, you understand that any violation of SEC or CFTC rules can also trigger a criminal investigation that would be by the United States Department of Justice—and based on my experience, those investigations are quite thorough—that could involve testimony or interviews with Members of Congress and staff.

And I would simply point out that this could raise issues with regard to the protections of the Speech or Debate clause, and that, in fact, could be a rather substantial issue.

There was an opinion issued just this past Thursday by the District of Columbia Court of Appeals in re grand jury subpoenas in which the Department of Justice tried to get Ethics Committee documents, and you are talking about, in Speech or Debate, a nightmare. So just to note that in your consideration.

Thank you very much.

[The prepared statement of Professor Henning can be found on page 28 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Professor Henning.

And I now recognize for 5 minutes Professor Verret, if you would, sir.

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW, AND SENIOR SCHOLAR, MERCATUS CENTER FINANCIAL MARKETS WORKING GROUP

Mr. VERRET. Chairman Moore, Ranking Member Biggert, and distinguished members of the panel, I want to thank you for the opportunity to testify today. My name is J.W. Verret. I am a senior scholar at the Mercatus Center at George Mason University, and I am also a law professor there, where I teach securities regulation. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of State and local authority in corporate governance.

I commend this committee's interest in the conflicts faced by legislators trading in the market. I also appreciate concerns that have been raised today about trading by individuals serving in executive agencies. However, changes to congressional ethics rules and agency policies can address those concerns far more efficiently and effectively than the sweeping changes to the Securities Exchange Act included in section 2 of today's bill, which limits a private investor from trading on information obtained through government sources.

Today, I will highlight some of the risks posed by section 2 of today's bill. I will also bring to your attention a special immunity provision in the Securities Exchange Act that currently protects insider trading by the Treasury Department, something this bill does not address.

When considering the SEC's mission to protect capital markets, it is important to remember that capital markets have winners and they have losers as part of the rules of the game. If that were not the case, then no investor would have an incentive to expend the time and resources to become informed about investments, and the efficiency of capital markets so important to our standard of living would disappear.

By targeting investors who seek information about how pending regulation may affect the companies they are invested in, section 2 of this bill penalizes resourceful investors and hinders investment managers and pension fund trustees from fulfilling their duties to their investors to maximize returns.

The prospect of sweeping financial regulatory reform and the Federal Government's controlling ownership in over 200 companies has introduced a level of political risk never before seen in American capital markets. The SEC's mandate to protect capital formation is not implicated when investors stay informed about this political risk. Quite the opposite; informed trades actually enhance the efficiency of capital markets.

I am also concerned that using insider trading as a vehicle to address this concern would have the unintended effect of actually harming the effectiveness and legitimacy of current insider trading law and investigations. This bill would expand the definition of "insider trading" in a way that would abandon its original foundation in fiduciary duty principles.

Now that I have addressed some concerns with what this bill does, I would like to highlight a danger to capital markets that this bill does not address.

The Treasury Department enjoins immunity from insider trading liability. Section 3(c) of the Securities Exchange Act reads in part, "No provision of this title shall apply to any executive department or employee of any such department acting in the course of his official duty as such, unless such provision makes specific reference to such department." As today's bill does not specifically mention the Department of Treasury or the Federal Reserve, it would not amend section 3 to cover transactions in TARP securities by government agencies.

Through TARP, the Treasury Department obtained a controlling interest in most of the automotive and financial sectors. The goal was to help increase the stock price of TARP firms and help them raise private capital eventually. I am concerned that the prospect of insider trading by Treasury officials acting in their official capacity will cause shares in those companies to trade at a discount and also threaten Treasury's ability to eventually privatize these businesses.

To be clear, even if today's bill passes, staffers of the Treasury and the Federal Reserve who trade shares on behalf of the Federal

Government will still be able to engage in insider trading and what is more—and this is the interesting part—this type of violation would not need any expansion of insider trading law to address. It would already be covered under the traditional, classical theory of insider trading but, for the very special exemption that the Federal Government enjoys under section 3(c) of the Exchange Act.

The securities laws are a finely woven fabric. Care must be taken to ensure that change in one area doesn't harm the design of the entire system. For this reason, I would urge this committee to strike section 2 from this bill. I would also recommend it consider amending section 3(c) of the Exchange Act such that the exemption no longer applies to trading shares by Treasury and by the Federal Reserve using funds authorized under the Emergency Economic Stability Act.

I thank you for the opportunity to testify and I look forward to answering your questions.

[The prepared statement of Professor Verret can be found on page 48 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Professor Verret.

I appreciate the testimony of the witnesses, and I now recognize myself for 5 minutes for questions.

Mr. Kotz, you note in your testimony that you are pleased by the Commission's announced actions taken in response to your report if they are correctly implemented. Do you believe that these actions, if performed several years ago, would have prevented the matter you investigated from happening?

Mr. KOTZ. Yes, I do, if those procedures were in place.

I mean, there are rules in place at the SEC; the problem is, there was no monitoring of those rules. If there was monitoring of those rules, those rules would have been able to be addressed as soon as these individuals began this trading.

We found out about it from the Ethics Office and followed up and did an investigation. But it would have been dealt with much earlier had there been a monitoring compliance system in place.

Chairman MOORE OF KANSAS. Thank you.

Professor Henning, a former SEC official proposes that Congress should prohibit anyone at the SEC from buying or selling shares of publicly traded companies and any entities subject to SEC regulation.

Do you believe that is necessary, sir?

Mr. HENNING. Yes, I believe it is, that it will eliminate—very much limit the possibility. You can never stop someone from tipping, of course, but at least it would send a clear signal to anyone who works at the SEC, don't trade, don't do this, and if you do, you are stepping over a very clear line.

Chairman MOORE OF KANSAS. Thank you.

Professor Henning, with your experience working in the SEC on insider trading cases and as a law professor, I think you made some good points in your testimony with respect to the definition of material nonpublic information.

Since this definition has been well-defined by case law in the Commission's use of the Supreme Court's flexible definition, would it make more sense to remove that provision from H.R. 682? Is there anything to be gained by codifying that definition, or will we make the law more confusing for insider trading cases?

Mr. HENNING. One possible—the problem is, if it were simply codified for this area and not others, that it could have—as Professor Verret said, you have to be very careful. When you tinker with one part of this—this is a very complex web; when you tinker with one part, it has an effect somewhere else. And, frankly, the Supreme Court's definition in the two leading cases is so broad that anything can fit under for materiality. The courts are very used to it.

So I think it would be better to simply say, "material nonpublic information." What the courts would then do is, they would look at the Supreme Court cases and say, we are going to follow what the Supreme Court has said.

Chairman MOORE OF KANSAS. Thank you, sir.

Professor Ziobrowski, I am interested in the recommendations you make at the end of your testimony, that rules associated with blind trusts should be tightened.

Would you describe the problem? And do you have any suggestions on how Congress should do that, sir?

Mr. ZIOBROWSKI. Actually, I am not going to pretend I am a lawyer and try and tell you how to tighten the laws. But the fact of the matter is that there is evidence that—particularly, I think, in the first case, where there was evidence that we had reason to believe that he knew what was in the blind trust—if you are going to have a blind trust, it has to be truly and absolutely "blind," meaning you don't know what is in it.

And that, again from a legal standpoint, how you write that up is not my bailiwick, but you do need to be there.

Chairman MOORE OF KANSAS. Thank you, sir.

At this time, I will recognize Ranking Member Biggert for questions for 5 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Inspector General Kotz, when was your Case Report No. 481, which recommended 11 changes to ensure adequate monitoring of employees' future securities transactions, when was it issued?

Mr. KOTZ. In the beginning of March.

Mrs. BIGGERT. In the SEC's written testimony submitted for the record, they mention that on May 22, 2009, they submitted to the Office of Government Ethics proposed new rules. Have you received these proposed new rules and do they address your concerns?

Mr. KOTZ. We have received information about the new system that the SEC is putting into place. We haven't seen all the parts of it yet. They are still in the process of putting that together.

As designed, it does address our recommendations—and in fact in a couple of cases even goes further than our recommendations—but we plan to scrutinize the implementation of this system because it is important to have a system that is designed appropriately, but then also implemented appropriately. So we plan to follow up and ensure that, as implemented, it will address all the concerns in our report.

Mrs. BIGGERT. Then Mr. Verret, why are the Treasury Department and the Federal Reserve employees granted immunity?

Mr. VERRET. I can only guess that in 1934, the thought was that the Federal Government had before and probably—maybe they didn't know this in the future, but during World War II, the government owned a lot of companies basically that they ran. And I guess the thought was we don't have to worry about those pesky securities laws when you run these companies.

I think that is a long time past. And what we are dealing with now is, I think everybody agrees, hopefully short-term nationalization of companies. At least I hope everybody agrees that it will be short-term nationalization.

And so the issue is, between now and the time we hopefully eventually privatize these nationalized companies—effectively nationalized companies, in Citigroup and AIG and General Motors, that between now and then there is always the prospect that the ultimate both control shareholder and informed shareholder—who, by the way, also regulates the companies—the ultimate insider will engage in insider trading because of the protections of section 3(c).

Mrs. BIGGERT. Do they have any safeguards in place to prevent insider trading by officials or their staff?

Mr. VERRET. Well, I would imagine there are probably some sort of ethics rules, although we have already seen some allegations that regulators might have perhaps not exactly followed the securities laws during the crisis and in the aftermath of the crisis. So I think it is very possible that Treasury officials will use inside information to trade top shares.

Mrs. BIGGERT. Well, we have the TARP program now. Do you have any concerns that, with this immunity, that this could be a problem?

Mr. VERRET. I think so, absolutely. And I think in addition to the special immunity carved out in section 3(c) of the Exchange Act, the Federal Government also enjoys a special type of immunity as a shareholder that other shareholders don't get. In State corporate law, if you are a shareholder that controls a company, you are treated just like a director or an officer. You run that company, so you have a fiduciary duty to the other shareholders in the company not to use it for some purpose that harms the rest of the shareholders. The Treasury Department, as a shareholder, enjoys immunity from control person liability under State corporate law. And so to that extent, we could see, potentially, by Treasury using the company to, for instance, subsidize lending in a certain type of State.

One thing we see in Italy, frankly, in terms of government ownership in private companies, we see Italian banks in the south subsidize lending versus the north because that is where the ruling coalition of Parliament gets all of their power. So I think it is not crazy to think we could see subsidized lending, for instance, in battleground States by TARP shares. So I think those sorts of things would be covered if Treasury weren't immune from control person liability, but since it is, it is very possible.

Mrs. BIGGERT. Do you see the price, that billions of dollars in the financial institutions stock that are owned by the U.S. Government, that there could be a change in that?

Mr. VERRET. Yes. It could definitely hurt the long-term stock price, absolutely.

Mrs. BIGGERT. Thank you.

I have one more question, but maybe we will have another round.

Chairman MOORE OF KANSAS. Go ahead.

Mrs. BIGGERT. Mr. Kotz, on December 16, 2008, former SEC Chairman Chris Cox asked you to investigate the SEC's examination and oversight of Madoff. And I understand that you will be releasing your office findings next month. Unfortunately, Congress won't be in session when you release your report. So now that Madoff has admitted his guilt and been sentenced to 150 years in prison for the thousands of seniors and American families who lost their life savings, I think they deserve an answer as to what the SEC knew and what they knew about Madoff. After 7 months of investigation, what can you tell us about the SEC's failure to uncover the Madoff Ponzi scheme?

Mr. KOTZ. Sure. We are planning to provide that comprehensive review. The report will detail all of the different investigations and examinations that occurred by the SEC of Bernard Madoff and related entities from the period of time of 1992 until December 2008, when Mr. Madoff confessed. So it is going to be a very long and comprehensive report. We have interviewed over 100 witnesses, we have looked at literally millions of e-mails, and we are in the process of finalizing the report. We wanted to make sure that the report, when issued, would be fully comprehensive and thorough. And so it has taken some time, but for such a large topic of different audits, examinations, and investigations that were multiple in nature over a period of almost 20 years, we needed the time in order to get the full story.

The report that we issue at the end of August will address all the issues relating to the SEC's interactions with Bernard Madoff and related entities.

Mrs. BIGGERT. Well, since the Inspector General doesn't investigate the alleged security laws violations, were you or any of your predecessors ever informed about any of the allegations made against Mr. Madoff and the SEC's failure to investigate him?

Mr. KOTZ. No. There was never any complaint or even hint of anything that came to the Office of the Inspector General at the SEC.

Mrs. BIGGERT. Thank you. I yield back.

Chairman MOORE OF KANSAS. Thank you, Congresswoman.

I will now recognize Congressman Baird for 5 minutes, sir.

Mr. BAIRD. I thank the chairman and the ranking member for allowing me to participate. Again, I would thank the witnesses for their interesting testimony. I particularly appreciate the points made about materiality. We have heard that from others since we introduced the bill, I think we can create that; it probably does create problems elsewhere, oversight of insider trading. And also the suggestion by Professor Henning about nondisclosure requirements for tippees I think is also particularly helpful.

To cut to the chase, many people say, why would you need this legislation that Congresswoman Slaughter and I have proposed? Let me just start with this simple question, yes or no.

Do you think current transparency requirements in the House financial reporting are adequate to allow people to identify if there has been any insider trading or not? And just go down the row.

Mr. KOTZ. Well, I haven't analyzed that process within the House, but I would certainly say that clearer procedures put in place will allow for a much better process than is in place now.

Mr. ZIOBROWSKI. If we are talking about financial disclosure, I still, as I have indicated in my testimony, have a great deal of problem between the notion of filling out financial disclosure forms and what people actually do in the office. In other words, for one thing, just because you own a stock doesn't mean that you are going to do things to cause that stock to go up. So the fact of the matter is that there really isn't any—and you would almost have to be, as an American, almost have to be an expert. If we are looking at this from the standpoint of a voter, there is no way as a voter you could simply look at an FDR and decide whether or not there is a conflict of interest. You really have to be intimately familiar with every vote that Member has cast, and you have to be intimately familiar with the details of the bill they voted on.

Mr. BAIRD. But the media do it right now. I mean, we wait a year before we report what our trades were. And some of you mentioned in your testimony, if you are an investment firm, you have to report within 48 hours.That would be, frankly, my preference. We actually extended it to 90 days in this bill as a compromise, I would rather go back to 48 hours.

Professor Henning?

Mr. HENNING. Certainly, I am never going to oppose transparency. That is a terrific idea, and it will be the press that will monitor it.

I guess the greater problem that occurs in insider trading is not so much when people do it on their own, but when people tip and feed the information. When you see the various insider trading cases that come out of Wall Street, it is not just one person trading; that is, they tell three or four others, and you have a ring. And then, of course, transparency is unlikely to show. But still, that is a very good starting point.

I think you made a very good point in your testimony that everyone needs to know that this is wrong and that you can't do this. Every company and law firm that I am familiar with makes their people do it quarterly. That is a very important piece of paper that they have, and that is a very good starting point. Are you going to be able to stop a thief? Ultimately, no. But it would be a very good starting point.

Mr. VERRET. Congressman, to answer your question, as a taxpayer and a voter, I like some of the thoughts behind this bill. I would just offer that I am only a securities law expert, and I think this is not an issue of securities law. That Washington insider is not the same thing as a corporate insider. And insider trading laws are only built around looking at corporate insider trading; they are not built around looking at Washington insider trading.

So I am glad to hear that discussions are going on about congressional ethics rules, about agency policies about this issue, but this is not insider trading for the purposes of the securities laws.

Mr. BAIRD. That is an excellent point. But that is precisely why we need something like this, in my judgment. My understanding, in talking to a number of legal scholars, is that we might be able to address this just by much more clearly defining within our House ethics codes what our duty is. And having defined that duty more explicitly and trained our staff, it might then open it up to securities law enforcement because there are other cases, which are examples, where SEC has been able to take action against government employees because they had a clear-cut duty or they engaged in misappropriation of information.

And so what we are trying to get at here is, you know, I said I am not an attorney, but I do know what smells bad. And when you go to a town hall and you say, should a Member of Congress who has nonpublic information that you or your neighbor could not get, should they be able to make a trade and make a personal profit or give information to their brother-in-law or somebody? The answer is "no" in the minds of the general public. That is not why they sent us here.

So the second question for me is, does our current ethical standard, to the best of your knowledge, and preparation of our staff, or lack thereof, adequately prevent what is tantamount to insider trading, even if not technically under current law defined as insider trading? Does it protect the integrity of the markets?

Professor Henning?

Mr. HENNING. I would say—and again, I don't want to—I don't have any information that this is rampant or happening a great deal. I think if it happens once it is a problem, and so the ethics rules need to be clear. And so often the ethics rules in any area are not particularly clear, but it should be clear that you cannot use any information that you glean from your job for your own personal benefit.

I agree with Professor Verret that this is not classic insider trading, but it is—congressional information can have such an impact on the markets now, and especially at this point in time, that it has to be made clear, not just on Capitol Hill, but to government employees anywhere—

Mr. BAIRD. Exactly.

Mr. HENNING. —that you cannot use this information to benefit yourself or to tip others. That does have to be made clear.

Mr. BAIRD. Let me, if I may, Mr. Chairman, Professor Verret, in your testimony you said section 2 of the bill penalizes—

Chairman MOORE OF KANSAS. Without objection, you are recognized for 2 more minutes.

Mr. BAIRD. Thank you very much.

Section 2 of the bill penalizes resourceful investors. Could one not also argue that the traditional insider trading case penalizes resourceful investors if resourceful is meaning to gather information not yet known by the public, and particularly purposely not known by the public, classified information within a company, doesn't that make you just particularly canny and resourceful?

Mr. VERRET. Well, unless it relates to trades based on information obtained by an investor's fiduciary. So it is not about duties to sort of the general public, it is about duties to a specific set of investors at a specific company. And insider trading law has definitely expanded over the years. I think probably the most controversial expansion is the one you just mentioned, the misappropriation doctrine. And I take your point that changes in ethical rules and secrecy requirements might bring some of what you are talking about under the misappropriation doctrine. I understand that. Although the misappropriation doctrine certainly is controversial in the academic literature, but it would not apply to the political intelligence operations. In other words, tipping to a tippee where you don't expect some direct benefit wouldn't fall under the misappropriation doctrine. So a lot of what political intelligence sort of operatives—if you want to use that word—do would not even fall under misappropriation.

Mr. BAIRD. If I talk to a committee staff member who gives me information, and I make an investment based on that information, and I take a portion of the profits of that information and pump it back into a 527 or a campaign committee, does that apply?

Mr. VERRET. I am not sure whether it would or not. But I would bring you back to the question, would that violate other laws already on the books?

Mr. BAIRD. I am not sure; that is the question. And that is what we are trying to get at here is, the fact that you are saying I am not sure is part of the question.

Mr. VERRET. I think that direct set of facts that you have given me might potentially risk current liability under the misappropriation doctrine, but I think it is uncertain.

Mr. BAIRD. And that is my point, if it is uncertain, we ought to correct it. And I know you have other questions, Mr. Chairman.

Chairman MOORE OF KANSAS. Thank you, Congressman Baird. Thank you, Ranking Member Biggert. And I want to thank our witnesses, some of whom traveled a long way for their testimony today.

Today's hearing gives us a better perspective of the access to valuable and sensitive information that officials may have throughout the government. The vast majority of public servants, I think we all would agree, are hardworking individuals who enjoy the privilege of serving the American people. But no government official, no matter what their position, is or should be above the law. We need to continue to carefully explore these issues, including the best process to guard against any unfair use by any government official of inside information.

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

This hearing is adjourned. And again, I thank the members of the panel and the witnesses for their participation. Thank you all.

[Whereupon, at 3:12 p.m., the hearing was adjourned.]

A P P E N D I X

July 13, 2009

Subcommittee on Oversight and Investigations
House Financial Services Committee
July 13, 2009

"Preventing Unfair Trading by Government Officials"

Opening Statement from Chairman Dennis Moore [KS-03]

In May, we learned from the Wall Street Journal that federal prosecutors are investigating whether two SEC enforcement lawyers had violated insider trading laws. The newspaper obtained a redacted copy of a report from the Inspector General of the SEC, Mr. David Kotz, who will testify on this report and his role as an independent watchdog of the Commission.

His report concluded that the lawyers violated the agency's internal rules, although the employees have denied any wrongdoing. In addition to eleven recommendations the I.G. made to the SEC, the I.G. also recommended that the SEC take disciplinary action against the two employees.

In a written statement provided by the SEC for this hearing, they have "deferred consideration of an appropriate response to this recommendation based on what we understand to be a pending criminal inquiry by the U.S. Attorney's Office." As a former District Attorney, I fully respect that everyone is presumed innocent until proven guilty. While we let federal law enforcement officials do their jobs, I did not want to wait to discuss the larger public policy questions that this case invokes.

Should government officials trade on information that they have access to that the general public does not? If not, what additional rules, regulations or laws are required to address this concern?

Our nation's federal government was founded on the principle of separation of powers as well as checks and balances. How do we maintain those important principles while ensuring there's a level playing field in the marketplace with respect to investments by any government official, including Members of Congress?

And while this is not true for most government officials, we should acknowledge that a few individuals – like the Federal Reserve Chairman or President of the United States – will move the market simply by the words they use in a speech. No one is proposing this, but should their speechwriters be banned from investing in all individual stocks out of fear that they may unfairly profit from their jobs or is that going too far? What about the reporters that compete to break news of a pending announcement by the government? Or a lobbyist that is pushing for legislation that will provide tax relief for a certain industry? How would we guard against unfair trading practices of those individuals as well?

This debate raises a lot of tough questions. But I hope we can examine all sides of this issue to better understand what the problem is and how responsible solutions may prevent unfair trading by government officials. There will always be a few bad apples, unfortunately, and no government official should believe that they are above the law. But most, if not nearly all, government employees are public servants with the best intentions, working hard every day to serve the American people.

I do want to commend our first two witnesses and colleagues – Congresswoman Slaughter and Congressman Baird – for proposing a response to these questions by drafting H.R. 682, the Stop Trading on Congressional Knowledge Act. I look forward to hearing from them why they drafted the bill, and how they see it addressing these important concerns.

In addition to the SEC's Inspector General who will focus on his investigation in the second panel, I am interested to know what our three professors testifying have learned through their research and experiences, and what recommendations, if any, they may have to this committee and to Congress on these issues.

Testimony of Peter J. Henning
Professor of Law, Wayne State University Law School, Before the Subcommittee on Oversight and Investigations of the House Financial Services Committee on "Preventing Unfair Trading by Government Officials"
July 13, 2009

Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee on Oversight and Investigations:

Thank you for the kind invitation to testify before the Subcommittee on Oversight and Investigations on the STOCK Act (H.R. 682) and related issues concerning trading by Members of Congress, their staff, and other government officials and employees while in possession of material non-public information obtained through their positions in the federal government.

I am a Professor of Law at Wayne State University Law School in Detroit, Michigan, where I have been on the faculty since 1994. I teach and write in the areas of White Collar Crime, Securities Regulation, and Professional Responsibility, all of which are relevant to the topic of the hearing today. Prior to joining the Wayne State University faculty, I worked for four years (1987-1991) as a staff attorney in the Division of Enforcement of the United States Securities & Exchange Commission (SEC), and then for three years (1991-1994) for the United States Department of Justice in the Fraud Section of the Criminal Division. While I was at the SEC, I participated in the investigation and civil prosecution of insider trading cases. I have a particular interest in insider trading because of my experience and scholarly interests.

The STOCK Act will, *inter alia*, extend the prohibition on insider trading to Members of Congress, their staff, and other federal employees. This is important legislation that recognizes information with the potential for significant market impact can come from a variety of sources beyond just the company whose securities are traded and Wall Street. Those who serve in government must uphold the highest standards of integrity, and H.R. 682 will help ensure that there is a means to enforce the insider trading laws in an area in which there have been few cases and some uncertainty regarding the scope of the prohibition.

I appreciate the opportunity to address four issues in connection with the Subcommittee's hearing:

1. The Scope of the Insider Trading Prohibition;
2. Insider Trading and the SEC Staff;
3. The STOCK Act (H.R. 682);
4. Favoring Personal Financial Interests.

1. The Scope of the Insider Trading Prohibition

While the prohibition on insider trading is well known, the statutory basis for it is surprisingly skimpy. The law has largely been developed by the judiciary rather than Congress. Insider trading is a form of securities fraud that is prohibited by Rule 10b-5 (17 C.F.R. § 240.10b-5), which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The Rule is based on § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)), which outlaws the use of any "manipulative or deceptive device or contrivance" in purchasing or selling securities. The text of Rule 10b-5 says nothing specifically about insider trading, and the SEC first pursued such cases in the 1960s. Since then, it has found widespread support in the federal courts, which have shaped its contours over the years, and in Congress, which has enhanced the SEC's authority to seek penalties for such violations.

The Supreme Court's two seminal decisions in the field are *Chiarella v. United States*, 445 U.S. 222 (1980), and *United States v. O'Hagan*, 521 U.S. 642 (1997). Taken together, they require the government to prove a defendant (civil or criminal) breached a fiduciary duty, or other duty of trust and confidence, by trading on the basis of material nonpublic information. The fiduciary duty can be owed to the corporation whose securities are traded (*Chiaralla*), or to any other party from which the information was misappropriated (*O'Hagan*). The key issue in an insider trading case, particularly a misappropriation case, is identifying the duty owed to the source of the information, and then establishing that the trading was on the basis of that information.

Members of Congress, their staff, and other federal government employees have the same fiduciary duty that any employee owes to his or her employer to preserve the confidentiality of information and not engage self-aggrandizement to the detriment of the employer. Using information received as part of one's job and then trading on it in the markets is clearly wrong because it breaches the employee's fiduciary duty to put the employer's interests first.

As with any legal prohibition that is developed through judicial decisions, the contours of the doctrine are not completely clear. The law of insider trading first developed around classic corporate insiders, like officers and directors of companies, and those who work directly with companies in relation to their transactions and operations, like lawyers, accountants, and even printers. As the cases move further afield, however, the law becomes more nebulous, and it has never been decided whether information a Member of Congress or their staff have about pending legislation is covered by Rule 10b-5's prohibition. The information arising from the legislative process is different from the usual insider trading case that involves issues directly relevant to a corporation's operations or prospects.

Insider trading cases involving government employees have arisen from the federal government's own issuance of securities, *i.e.* Treasury bonds. For example, there have been cases brought against government employees for tipping others about pending government actions in the Treasury bond market. *See In re Blythe & Co.*, 43 S.E.C. 1037 (1969); *United States v. Rough*, No. 88-425 (D.N.J. 1988). This type of trading (or tipping) fits comfortably in the insider trading paradigm of a person learning information about a pending transaction and then buying (or selling) in advance of public disclosure.

In the current economic environment, in which the federal government has gotten involved in the operations of corporations to an unprecedented degree, there is a greater opportunity for a government employee who has highly material information that will impact the securities and commodities markets to trade on it. This is not traditional corporate inside information, so the application of Rule 10b-5 to trading on such information could be subject to a successful challenge.

H.R. 682 fills a potential gap that could develop in the law if a court were to find that trading on legislative or governmental information fell outside of the insider trading prohibition of Rule 10b-5. The legislation makes it clear that Congress wants the SEC and Commodity Futures Trading Commission (CFTC) to extend the ban on insider trading to an area about which it is not clear whether current law would apply. This change would ensure that in a future civil enforcement action or criminal prosecution the argument that the law of insider trading cannot be stretched to information generated on Capitol Hill or inside a federal agency will fail.

2. Insider Trading and the SEC Staff

SEC Inspector General H. David Kotz's Semiannual Report to Congress, submitted in 2009, refers to an investigation of securities purchases and sales by members of the Enforcement Division staff that may have involved trading on material nonpublic information obtained in relation to their duties at the Commission. The SEC's Conduct Regulation 5 (17 C.F.R. § 200.735-5(a)(2)) clearly prohibits trading on inside information and tipping. For example, it states:

> Members and employees are prohibited from recommending or suggesting the purchase or sale of securities:
>
> (i) Based on non-public information gained in the course of employment; or
>
> (ii) Which a member or employee could not purchase because of the restrictions of this rule, in any circumstance in which the member or employee could reasonably expect to benefit from the recommendation, or to anyone over whom the member or employee has or may have control or substantial influence.

The Commission's rules require that any securities purchased be held for six months, and that staff members may not buy options or futures contracts, which are often used in insider trading schemes. H.R. 682 makes it clear that a violation of Rule 10b-5 would subject a SEC staff member to civil and criminal sanctions in addition to any employment-related action that could be taken for a violation of the internal Conduct Regulations.

While that would be a positive result, in my opinion it does not go far enough. When I worked in the Enforcement Division, my colleagues and I stayed away from investing in the shares of individual companies because of the risk that there could be even the slightest hint of an appearance of impropriety. Moreover, we were never sure when a company might come up in an investigation, and so rather than risk having to recuse ourselves from a case we did not invest in individual companies.

Rather than the current rules that restrict investments in individual company stock, I believe the Commission – or Congress – should prohibit anyone at the SEC, from the Commissioners on down, from buying or selling the shares of publicly-traded companies or any entity subject to SEC regulation while they are employed there.[1] Given its role in policing the securities markets, the SEC needs to be completely above reproach, and such a prohibition would avoid any possible temptation to trade on information garnered from work at the Commission.

[1] For those who own shares of a company before joining the Commission, the usual government rules on placing investments in a trust or disposing of them properly would still apply. Thus, a person would not be locked into an investment just because he or she came to the SEC.

The number of investment-related options available to investors has expanded significantly in the past decade, particularly with the advent of exchange-traded funds (ETF) that allow an investor to purchase an investment in a basket of companies in a particular industry or sector. The possibility that a staff member might use confidential SEC information to trade in an ETF or mutual fund is quite small because the return would be so diffuse that any gain (or loss avoided) would in all likelihood be insignificant.

While a prohibition on owning the shares of individual companies or regulated entities would place a greater restriction on SEC staff than on those in any other branch, department, or agency of the federal government, the opportunity to work at the Commission is a privilege. The cost of such a rule would be minor, at best, and I doubt it would affect the ability of the SEC to recruit or retain talented staff members because they could still invest in ETFs and mutual funds within the Commission's current guidelines. To the extent someone would rather "play the market" by investing in individual company shares than work at the Commission, I suspect that is a loss the SEC could suffer rather easily.

3. The STOCK Act (H.R. 682)

A. Tipper/Tippee Liability

In addition to clarifying the scope of the insider trading prohibition, the STOCK Act effectively expands insider trading law related to tipping others about material nonpublic information on which they trade. Under the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), to hold a person liable as a tippee the government must show the fiduciary relationship of the tipper to the source of the information, that there was a *quid pro quo* in passing the information, and the tippee knew or should have known of the tipper's breach of duty in passing the information. The *quid pro quo* can be shown by a monetary reward or other pecuniary benefit to the tipper, that the information was a gift by the tipper to family or friends, or that the tipper realizes some reputational benefit from passing the information.

Section 2(a) of H.R. 682 omits the *quid pro quo* element by directing the Commission to adopt a rule that prohibits trading while in possession of information "obtained from a Member or employee of Congress, and such person knows that the information was so obtained." This change makes it easier to establish the elements of a violation because the government would not have to prove any benefit passed between the tipper and tippee, only that the tippee knew the source of the information. Another insider trading prohibition related to tender offers is Rule 14e-3 (17 C.F.R. § 240.14e-3), and it dispenses with the *quid pro quo* requirement, so the STOCK Act's approach to the tipper/tippee situation would not represent a radical departure in insider trading law.

Dispensing with the *quid pro quo* element would also be important to extend the prohibition to non-government workers who participate in the legislative process. There may be substantial involvement by non-governmental persons and organizations in the drafting of bills and the effort to seek their enactment, which is a normal and quite acceptable part of the process by which our laws are made. Those participating in the legislative process who are not employed directly by Congress can come within the insider trading prohibition of H.R. 682 if they receive the information from a congressional source and then trade on it, even if there is no *quid pro quo* provided to the source.

In the law of insider trading, the Supreme Court recognized those who have come to be known as "temporary insiders" and are also covered by the obligation not to trade on material nonpublic information. In *Dirks*, the Court stated,

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

I doubt that those who participate in the legislative process would be viewed by a court along the same lines as a lawyer or investment banker retained to assist a client in a merger, for example. An interest group is not considered to have a fiduciary relationship with Congress when its representative suggests language for a bill, nor would consultations with an organization to gain its support be viewed as privileged or otherwise subject to a duty of trust and confidence. Therefore, the extension of the prohibition to those who obtain the information from a Member or employee of Congress and know the source of that information can bring these outside groups within the prohibition.

One potential gap in H.R. 682 in extending the insider trading ban to non-employees who participate in the legislative process is that there is no clear prohibition on tipping by these people. For example, an interest group representative may receive nonpublic information about pending legislation that will have a significant impact on a particular company or industry, and that person tells a friend so that he or she can profitably trade on the information. Under the Supreme Court's tipper analysis in *Dirks*, the tippee "steps into the shoes" of the tipper by providing the *quid pro quo*, but it is not clear whether that same approach would apply to tipping legislative information. The bill could be clarified so that a person who received material nonpublic information about legislative action would be explicitly prohibited from disclosing the information to another for the purpose of that person trading on the information, and the person receiving the information who knows (or should know) its source also could not trade or tip.

The tippee liability section appears to impose a higher intent element than the Supreme Court adopted in *Dirks*. The Court stated that "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee *knows or should know* that there has been a breach." (Italics added). The STOCK Act, however, provides that the person is liable if he or she *"knows"* that the information was obtained from a Member of Congress or their staff. This appears to require proof of actual knowledge of the source of the information, rather than the less restrictive objective reasonableness test that would impose liability if a person "should know" the source of the information.

It may be worth considering whether this change in the intent level for tippee liability was done for the purpose of requiring proof of actual knowledge, because that would make it more difficult to pursue a case successfully when the government must prove a defendant's subjective intent, for example by allowing a defendant to offer a mistake or ignorance defense.

B. Material Nonpublic Information

The STOCK Act covers trading while in possession of "material nonpublic information, as defined by the Commission . . . ." To this point, the SEC has not adopted a definition of materiality, and it is not clear whether the bill would require the Commission to adopt one. The term "material" has been given a broad reading by the Supreme Court to cover information for which there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or invest. *Basic Inc. v. Levinson*, 485 U.S. 224, (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). This has been a workable definition that the courts and Commission have extensive experience applying, and any regulatory definition would likely mimic the Supreme Court's language.

The Supreme Court's definition of materiality is quite flexible, and its application to legislative actions would require a determination of the point in the process when information rises to the level of being material to a reasonable investor. As the members of the Committee are keenly aware, the path of legislation can be quite tortured, and it is rarely clear at what point a bill has progressed to the point that it is likely to become law and, in turn, affect a company. Courts generally apply the probability/magnitude test, which considers the likelihood of the action and its impact on the corporation. Under the SEC rule that would be adopted pursuant to the STOCK Act, there would need to be a determination of the probability of the particular legislative act and its importance to the company whose shares were traded.

Given the fact that the legislative process involves so many different inputs and considerations, it might be helpful if the legislative history of the Act provided some examples of situations in which the information would and would not be material to give the courts and the SEC some guidance as to the circumstances in which the prohibition should be applied.

C. "Legislative Action" and the Speech or Debate Clause

The legislation refers to trading while in possession of material nonpublic information about "any pending or prospective legislative action" relating to a company's stock. The term "legislative action" is not defined in the statute, although its meaning is fairly clear in judicial decisions. In *United States v. Brewster*, 408 U.S. 501 (1972), the Supreme Court stated, "A legislative act has consistently been defined as an act generally done in Congress in relation to the business before it."

By adding new provisions to the Securities Exchange Act of 1934 and the Commodities Exchange Act, both the SEC and CFTC will be authorized to initiate investigations of Members of Congress and their staff for possible violations of the rules adopted pursuant to the law. While the two agencies are the front-line for enforcing the insider trading prohibition, a violation of the new rules related to legislative actions could trigger a criminal investigation because any violation of SEC and CFTC rules can be prosecuted in a criminal case by the Department of Justice. 7 U.S.C. § 13; 15 U.S.C. § 78ff.

The STOCK Act would open Congress to investigations by the Executive Branch if there is credible information of a violation of the rules adopted pursuant to the legislation. In my experience, both SEC and Department of Justice investigations are quite thorough, involving extensive review of documents, e-mails, telephone records, and financial information. An SEC case usually consists of both investigative testimony, in which the witness is placed under oath, and subpoenas for documents. A criminal investigation often includes grand jury testimony and subpoenas for records, although a search warrant can be executed to seize evidence, which is even more intrusive.

The key focus in an insider trading investigation is determining when the person trading (or tipping) obtained the information, and how it was transmitted. From there, a determination of the "materiality" of the information – its importance to investors – must be made, so the probability of the particular legislative act and its potential impact on the company whose shares were traded would have to be ascertained. Making these assessments may involve examining information from a number of sources, including interviews and testimony from Members of Congress, their personal staff, and committee staff in addition to reviewing documents and records about the legislative process.

The possibility of an investigation involving Members of Congress raises issues related to the protection afforded by the Speech or Debate Clause of the Constitution, which provides that "for any Speech or Debate in either House, [Senators and Representatives] shall not be questioned in any other Place." U.S. CONST. ART. I, § 6, cl. 1. In *Brewster*, the Supreme Court explained the scope of the constitutional protection to mean that "a Member of Congress may be prosecuted under a criminal statute provided that the Government's case does not rely on legislative acts or the motivation for legislative acts." In *Gravel v. United States*, 408 U.S. 606 (1972), the Supreme Court extended the constitutional protection to congressional staff members in certain circumstances, holding "that the Speech or Debate Clause applies not only to a Member but also to his aides insofar as the conduct of the latter would be a protected legislative act if performed by the Member himself."

An individual Member of Congress can waive the constitutional protection afforded those in the Legislative Branch from inquiry into legislative acts, but any waiver must be express. The STOCK Act would not operate as such a waiver, but it would authorize inquiry by the SEC, CFTC, and Department of Justice into trading on material nonpublic information by those who work for the Congress. That inquiry can easily trigger constitutional issues regarding the protection afforded by the Speech or Debate Clause. The recent decision of the United States Court of Appeals for the District of Columbia Circuit in *In re: Grand Jury Subpoenas* (unsealed July 9, 2009) shows just how complex the Speech or Debate Clause issue can be when the Executive Branch seeks materials from a Member of Congress related to legislative acts.

4. Favoring Personal Financial Interests

The final point I wish to address concerns the interesting question whether a Member of Congress who owns shares in a company with investments in his or her district, or which comes within the jurisdiction of a committee on which the Member serves, would be acting improperly by supporting a program in the district that also helps the company or considering legislation in committee that might enhance its financial prospects. The insider trading prohibition in the STOCK Act only applies to the purchase or sale of a company's securities on the basis of material nonpublic information. It does not address the potential conflict of interest arising from legislative action that can favor a company in which the Member already owns shares. In other words, absent buying or selling stock, there is no insider trading so H.R. 682 would not apply.

The federal statute governing conflicts of interest by favoring one's personal financial interests, or those of one's family, is 18 U.S.C. § 208(a), enacted in 1962. That provision, however, only covers employees of the Executive Branch and those who work for the Federal Reserve, not Members of Congress or their staff.

The issue of conflicts of interest is broader than just insider trading, which is one type of conflict but only applicable in a narrow set of circumstances. It may be worth considering whether further study of the issue of financial conflicts of interest involving Members of Congress and their staff should be undertaken to ensure that legislative authority is not misused for personal benefit. The same issues related to the Speech or Debate Clause outlined above would also apply if some form of § 208 were applied to Members of Congress and their staff.

Thank you for the opportunity to address the Subcommittee on this important topic, and I am happy to respond to any questions the Members may have at this time or in the future. I have submitted a copy of my C.V. for your information. I have no direct interest in the legislation, and do not represent clients in any matters related to the subject of this hearing.

Testimony of H. David Kotz
Inspector General of the
Securities and Exchange Commission

Before the Subcommittee on Oversight and Investigations, Committee on Financial Services U.S. House of Representatives

Monday July 13, 2009
2:00 p.m.

Introduction

Good afternoon. Thank you for the opportunity to testify today before this Subcommittee on the subject of "Preventing Unfair Trading by Government Officials" as the Inspector General of the Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the members of the Subcommittee in the SEC and the Office of Inspector General. In my testimony today, I am representing the Office of Inspector General, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks this afternoon by discussing the role of my Office and the oversight efforts we have undertaken during the past year. The mission of the Office of Inspector General is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC Office of Inspector General includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our Office of Audits conducts, coordinates and supervises independent audits and evaluations related to the Commission's internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

Over the past year, we have issued numerous audit reports involving issues critical to SEC operations and the investing public, including a comprehensive report analyzing the Commission's oversight of the SEC's Consolidated Supervised Entity (CSE) program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers, and providing a detailed examination of the adequacy of the Commission's monitoring of Bear Stearns, including the factors that led to its collapse. In the past few months, we have also completed audits of the $178 million in disgorgement waivers that the SEC Division of Enforcement (Enforcement) granted between October 2005 and May 2008, and Enforcement's practices and procedures for responding to and processing naked short selling complaints. We anticipate issuing several additional audit reports in the next few months, including a comprehensive analysis of the SEC's oversight of the Nationally Recognized Statistical Rating Organizations.

Our Office of Investigations examines allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The Office of Investigations conducts thorough and independent investigations into allegations received in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation (FBI) as appropriate.

Several of these investigations conducted by our staff have involved senior-level Commission employees and represent matters of great concern to the Commission, Congressional officials and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removals. Specifically, over the past year and a half, we have issued investigative reports regarding, inter alia, claims of improper preferential treatment given to prominent persons, retaliatory termination, the Division of Enforcement's failures to pursue Enforcement investigations vigorously or in a timely manner, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms, lack of impartiality in the performance of official duties, unauthorized disclosure of non-public information related to an Enforcement investigation, and the misuse of official position, government resources and official time.

In addition to the work I just described, we are conducting a wide-ranging investigation and evaluation of matters related to Bernard Madoff and affiliated entities. We have made substantial progress in our investigation and plan to issue shortly a comprehensive investigative report detailing all the examinations and investigations that the SEC conducted of Madoff or Madoff-related entities from 1992 until the present, and analyzing the reasons why the SEC did not uncover the Madoff Ponzi scheme, notwithstanding these examinations and investigations. We have already interviewed over 100 witnesses and reviewed millions of e-mails and documents in connection with these investigative efforts. We also plan to issue two additional reports providing specific and detailed recommendations for improvement of both the SEC's Division of

Enforcement and the Office of Compliance Inspections and Examinations, which will incorporate the findings from our investigative report.

The Investigation of the Securities Transactions of Enforcement Attorneys

It is with this background in mind that I wish to discuss an investigation that we recently concluded relating to the securities transactions of two SEC Enforcement attorneys over a two-year period. Our office received information from the SEC's Ethics Office that a particular Enforcement attorney was trading securities very frequently. As we began investigating this Enforcement attorney's trading activity, we identified another Enforcement attorney who was a friend of this individual and with whom the first attorney often discussed securities transactions and open Enforcement investigations during regular weekly lunches and via e-mail.

We conducted a year-long investigation of these Enforcement attorneys, which encompassed a comprehensive review and analysis of more than two years of brokerage records, ethics filings, securities transaction filings, and e-mail records. We also took sworn, on-the-record testimony of numerous SEC Enforcement attorneys, and conducted interviews of several other SEC staff members.

On March 3, 2009, we issued our report of investigation to the agency. Our investigation revealed suspicious conduct, appearances of improprieties, and evidence of possible trading based on non-public information on the part of the two SEC Enforcement attorneys. Because of the seriousness of the information that our investigation uncovered, we referred the matter to the United States Attorney's Office of the District of Columbia's Fraud and Public Corruption Section, which, together with the FBI, is conducting an investigation of possible criminal and civil violations. Because this joint U.S. Attorney/FBI investigation is ongoing, I am somewhat limited in my ability to discuss the details of this matter.

In addition to the suspicions of insider trading, our investigation found that the Enforcement attorneys committed numerous violations of the SEC's securities reporting requirements. For example, although SEC rules require employees to file a notification form within five business days of the purchase or sale of every security, these Enforcement lawyers failed to file these forms for certain transactions. Moreover, although the Office of Government Ethics (OGE) Form 450 requires the reporting of an employee's security holdings with a value greater than $1,000 at the end of each calendar year or that generated income of more than $200 during the year, the Enforcement attorneys failed to report certain transactions or earnings that were over these limits on their OGE Form 450s during the two-year period we reviewed during our investigation. We also found that the one of the Enforcement attorneys failed to clear numerous stock transactions through an agency database prior to purchasing stocks.

Our investigation further found generally that, although the SEC is charged with prosecuting cases of violations of the federal securities laws, including the investigation and prosecution of insider trading on the part of individuals and companies in the private sector, the SEC had essentially no compliance system in place to ensure that its own employees, with tremendous amounts of non-public information at their disposal, did not engage in insider trading themselves. The existing disclosure requirements and compliance system were based on the honor system, and there was no way to determine if an employee failed to report a securities transaction as required. No spot checks were conducted, and the SEC did not obtain duplicate brokerage account statements. In addition, there was little to no oversight or checking of the reports that employees filed to determine their accuracy or even whether an employee had reported at all. Moreover, different SEC offices received the various types of reports and did not routinely share that information with each other.

We also found a poor understanding and lax enforcement of the securities transaction reporting requirements. For example, both of the Enforcement attorneys whose trading we investigated testified that no one had ever questioned their reported securities holdings or transactions in the decades they worked at the SEC and traded securities. Moreover, both managers who were responsible for reviewing these attorneys' annual OGE Form 450s testified that they did not recall ever questioning any SEC employees with respect to their reported securities holdings. In addition, we found that the Enforcement attorneys and supervisors who provided information during our investigation lacked a basic understanding of the requirements in place that govern Commission employees' reporting of securities transactions.

Our investigation also found that Enforcement personnel, both managers and staff, had different interpretations of the confidentiality policy regarding Enforcement investigations and whether they could discuss their investigative matters with one another. We found that the Enforcement attorneys we investigated routinely discussed stocks and investment strategies in e-mails and in public. They maintained separate folders entitled, "Stocks," in their SEC e-mail accounts and, on most days, sent e-mails from those accounts about stocks and their own stock transactions. We discovered that one of the Enforcement attorneys traded often, and even testified that the financial markets were her main hobby and passion. We found that this attorney spent much of her work day e-mailing her co-workers about various stocks. We also found that these Enforcement attorneys shared many of the same investments and had regular weekly lunch meetings where they often discussed the stock market, their own securities transactions, and their SEC work and investigative cases.

Our investigation also disclosed that one of the Enforcement attorneys sent e-mails to his brother and sister-in-law from his SEC e-mail account during the work day recommending particular stocks, and sometimes informing them that the other Enforcement employee had recommended those stocks as well.

Our report recommended that the SEC take disciplinary action against the two Enforcement attorneys who we found violated the SEC's securities transactions requirements. We also provided the Commission with 11 specific recommendations to ensure adequate monitoring of employees' future securities transactions. These recommendations included establishing one primary office to monitor employees' securities transactions; instituting an integrated, computerized system for tracking and reporting purposes; obtaining duplicate copies of brokerage record confirmations for each securities transaction for every SEC employee; requiring employees to certify in writing that they do not have non-public information related to each security transaction they conduct and report; ensuring that the forms SEC employees are required to file are checked with the existing database; requiring SEC employees' supervisor to review a list of pending cases to compare with a list of the securities reported by the employees; conducting regular and thorough spot checks for compliance purposes; developing a clear, written policy on the confidentiality of Enforcement investigations; and establishing comprehensive and more frequent training on all aspects of the SEC's rules regarding employees' securities transactions.

SEC Response to the OIG's Report of Investigation

Our investigation underscored the need for the SEC to revamp completely its current process for monitoring SEC employees' securities transactions. In response to our report, on May 22, 2009, SEC Chairman Mary Schapiro announced that the SEC would be taking measures to address the problems we identified. These measures include drafting a new set of internal rules governing securities transactions for all SEC employees that will require pre-clearance of all trades and, for the first time, prohibit staff from trading in the securities of companies under SEC investigation regardless of whether the employee has personal knowledge of the investigation. Chairman Schapiro also announced that the SEC was contracting with an outside firm to develop a computer compliance system to track, audit and oversee employees' securities transactions and financial disclosure in real time. Chairman Schapiro further stated that she signed an order consolidating responsibility for oversight of employees' securities transactions and financial disclosure reporting within the Ethics Office and authorized the hiring of a Chief Compliance Officer.

The OIG is pleased that the SEC is planning to take concrete steps to address the serious issues identified by our investigation. These steps, if implemented, would satisfy the concerns raised in our report, and would even, in a few instances, go beyond the OIG's recommended actions. We plan to scrutinize carefully the new processes and system that the SEC intends to implement to ensure that they operate effectively and as planned.

Concluding Remarks

In conclusion, we appreciate the Subcommittee's interest in the SEC and our Office. I believe that the Committee's and Congress's involvement with the SEC is beneficial to strengthen the accountability and effectiveness of the Commission. Thank you.

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The Legitimacy of Political Intelligence Trading and the Threat of Insider Trading by the Treasury Department

TESTIMONY

J.W. Verret, Assistant Professor
George Mason University School of Law

Before the House Committee on Financial Services
Subcommittee on Oversight and Investigations Hearing entitled
"Preventing Unfair Trading by Government Officials"

2:00 p.m. on Monday, July 13, 2009
2128 Rayburn House Office Building

Chairman Moore, Ranking Member Biggert, and distinguished members of the Subcommittee, it is a privilege to testify in this forum today. My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

I have no professional opinion as a securities lawyer regarding trading by members of Congress or their staff. As a citizen and a taxpayer, however, I commend this Committee's interest in the conflicts faced by legislators trading in the market. I also appreciate concerns that have been raised about trading by individuals serving in executive agencies, particularly SEC Enforcement Staff.

However, changes to Congressional ethics rules and agency policies can address those concerns far more efficiently than the sweeping changes to the Securities Exchange Act included in Section 2 of this bill. Today I will highlight some of the risks posed by Section 2, which limits a private investor from trading on information obtained from government sources. I will also bring to your attention a special immunity provision in the Securities Exchange Act that currently protects insider trading by the Treasury Department, something this bill does not address.

When considering the SEC's mission to protect capital markets, it is important to remember that capital markets have winners and losers, that's part of the rules of the game. If that were not the case, then no investor would have an incentive to expend time and resources to become informed about investments, and the efficiency of capital markets, so important to our standard of living, would disappear.

By targeting investors who seek information about how pending regulation may affect their companies, Section 2 of this bill penalizes resourceful investors. It also inhibits investment managers and pension fund trustees from fulfilling their duties to their investors to maximize returns.

The prospect of sweeping financial regulatory reform and the federal government's controlling ownership in a variety of publicly traded companies, including Citigroup, Bank of America, and nearly two hundred other banks has introduced a level of political risk never before seen in American capital markets.

The SEC's mandate to protect capital formation and investors is not implicated when investors stay informed about this political risk, using information obtained through political intelligence services, or through researching laws by speaking with members of Congress, their staff, and executive agency staff. Quite the opposite, informed trades actually enhance the efficiency of capital markets.

I am also concerned that using insider trading as a vehicle to address this committee's concerns would have the unintended effect of actually harming the effectiveness and legitimacy of current insider trading law. This bill would expand the definition of insider trading in a way that abandons its original foundation in fiduciary duty principles and returns to a time prior to the U.S. v. Chiarella case, when the SEC espoused a dangerous position that all trades made in which one party has superior knowledge to another were prohibited.

Now that I have addressed some concerns with what this bill does, I would like to highlight a danger to capital markets that this bill does not address. The Treasury Department enjoys immunity from insider trading liability. Section 3(c) of the Securities Exchange Act also exempts employees acting in their official capacity from the Exchange Act. Section 3(c) reads in part "No provision of this title shall apply to any executive department... or employee of any such department,... acting in the course of his official duty as such,... unless such provision makes specific reference to such department." As this bill does not specifically mention the Department of the Treasury, it would not amend Section 3(c).

Through TARP, the Treasury Department obtained a controlling interest in most of the automotive and financial sectors. The goal was to help increase the stock price of TARP firms and help them raise private capital. I am concerned that the prospect of insider trading by Treasury officials acting in their official capacity will cause share of those companies to trade at a discount and also threaten Treasury's ability to eventually privatize these businesses.

To be clear, even if this bill passes, staffers at the Treasury and the Federal Reserve who trade shares on behalf of the federal government will still be able to engage in insider trading. What is more, this type of violation would not need any expansion of insider trading law to address. It would already be covered under the traditional, classical theory of insider trading but for the special exemption the federal government enjoys under Section 3(c).

The securities laws are a finely interwoven fabric of complex regulations. When amending them, care must be taken to ensure that a change in one area does not harm the design of the system as a whole. For this reason I would urge this Committee to strike Section 2 from this bill. I would also recommend that this Committee consider amending Section 3(c) of the Exchange Act such that the exemption no longer applies to trading shares purchased by the Federal Reserve or the Treasury Department using funds authorized under the Emergency Economic Stability Act.

I thank you for the opportunity to testify, and I look forward to answering your questions.

Statement of Proposed Testimony
House Subcommittee on Oversight and Investigations
Hearing on Preventing Unfair Trading by Government Officials
By
Alan J. Ziobrowski, Ph.D.
July 13, 2009

I'd like to begin by thanking the Chairman and other members of this subcommittee for the opportunity to testify on the subject of public disclosure and Congressional conflict of interest. The current system, as I have come to understand it, is complex, severely flawed and in need of serious restructuring. Although I am personally convinced that creating a set of rules which would completely eliminate conflicts of interest by government officials is likely impossible, I do believe the system could be greatly improved by the implementation of some relatively simple and low cost changes.

I began my involvement in this area some 14 years ago quite by accident. While surfing television channels one evening in May, 1995, I stumbled across an ABC network program called "Day One". The story basically presented a study by Professor Greg Boller at the University of Memphis whose research had revealed "that the practice of stock purchases *(by members of Congress)* somehow coinciding with legislative activity is fairly sizable". Representatives Sonny Montgomery, Nancy Johnson, and Bob Michel were interviewed for the piece, generally arguing that this was merely accidental coincidence although the former House Republican leader, Bob Michel, did observe that "...you get a lot of temptation around here and a lot of opportunities to have conflict of interest." Personally, I found the story unfair. Admittedly the situation didn't look good but, in fact, no evidence was offered that members of Congress had actually profited from these investments. However the story provided me with the seed for an idea to test whether or not members of Congress do earn "abnormal returns" from their stock transactions.

The concept of abnormal returns is fundamental in the science of finance. Despite claims by stockbrokers, financial analysts, and all types of financial pundits, many years of academic research has shown that the ability of investors to consistently "beat the market" when armed only with information available in the public domain is virtually nonexistent. Time does not permit an explanation here. However, I have attached an article which I wrote in 2005 to explain why beating the market is so difficult. The evidence is, in fact, so strong that academics generally regard any individual or group of individuals who possess that ability to be "inside traders" or, at the very least, people trading with an informational advantage. That is, they are assumed to be trading on the basis of information not available to other regular market participants. We do not necessarily know the source, or the nature of the information they possess, however we are quite certain that they know things the rest of us do not know.

The most important ingredient in a good abnormal return analysis is an accurate record of stock market transactions. This would include the dates members of Congress bought stock, the dates they sold stock and how much they bought or sold. For this we used the Financial Disclosure Reports (FDRs) which each of you submit annually.

Getting the FDRs turned out to be a challenge. Because "The Ethics in Government Act was written to provide the public with a tool to determine if senior government officials might have conflicts in matters in which they determine public policy", as a member of "the public" I assumed that I could easily obtain copies of the FDRs. I also assumed that the information contained in the FDRs would be precise, sufficiently detailed and accurate. I was wrong on all counts.

We began with the House of Representatives (1985) for the simple reason that the House publishes their reports in several volumes and distributes them to Federal document depositories every year. Thus access is free to all and the House FDRs are widely available. However, this is not to suggest that the information on these forms was easy to use, complete or even accurate. The information on the forms is not computerized. Thus the information had to be manually read and physically entered into our computer database, a task that literally took years. The care used to fill out FDRs varied widely and they were frequently difficult if not impossible to read. Many were handwritten. Some FDRs were missing. We also found that many FDRs were incomplete or inaccurate. Assets would inexplicably disappear from one year to the next or conversely assets would suddenly appear without a record of a transaction in either case. Finally the value of transactions was reported only within very broad ranges. I would suggest that "Over $1,000,000" is rather imprecise.

The Senate was another matter altogether. In addition to the problems described above, the Senate offered new obstacles. Senate FDRs are not published or distributed. They are housed at the Senate Office of Public Records. After having filed our first request for Senate FDRs in September 1998, we were advised that the Senate Office of Public Records only retained FDRs for 6 years. After 6 years, all Senate FDRs were destroyed. Furthermore, they required $0.20 per page to copy the FDRs. This amounted to approximately $300 per year or over $1800 for the entire 6 year set. Lastly, they required a written request signed by me officially "requesting to review the documents". Naturally I appealed the decision (particularly the $1800) citing the practices of the House as precedent. I was subsequently advised that the House was "in violation of the statute." Once published in a library, House FDRs could not be destroyed after 6 years as required by law. They further argued that library publication made it impossible to keep a written record of every person who viewed these documents which was also mandated by statute. Lastly, our appeal for a cost waiver was denied since "Facilitation of financial analysis was not the intent or goal of the Act." After 15 months of wrangling and intervention by Senator Max Cleland, I finally gave up. With Senator Cleland's help, I found copies of some Senate FDRs from other organizations who had already purchased them and some we ultimately purchased from the Senate Office of Public Records at $0.20 per page. The final cost was substantial.

At this juncture I would like to make an important point. If "The objectives of financial disclosure are to inform the public about the financial interests of government officials in order to increase public confidence in the integrity of government and to deter potential conflicts of interest" as stated in the House Ethics Manual, then **financial disclosure, as it is currently practiced, is a dismal failure.** From my personal experience, I found that access to the FDRs, in particular the Senate FDRs, is difficult unless you happen to live in Washington. It is intimidating since records are kept of everyone who reviews them. And it can be expensive. Some FDRs are invariably missing and when you find them they are often difficult to read, incomplete or just wrong (untrustworthy). But all these shortcomings aside, the most significant problem is that the system fails to link financial disclosure to legislative behavior. I would submit that an FDR without an accompanying voting record is useless. A member of Congress may own a thousand shares of the XYZ Company. But if he or she does nothing to intentionally support the legislative interests of XYZ, there would, in fact, be no real conflict of interest whatsoever. Taking this one step further, even an abbreviated voting record is insufficient. Significant changes in the law which may benefit or hurt an industry or a company are often neatly hidden away in vastly larger unrelated legislation in much the same fashion as "cash-for-clunkers" was recently attached to a large national defense appropriation. Thus to fairly judge the conflicts of interest for my Representative or my Senator, I must not only have a copy of his or her FDR, I must also be intimately familiar with the details of every piece of legislation that he or she has ever voted for or against. I would argue that this is an impossible standard for any American. At best, financial disclosure is harmless aside from a false sense of trust it may provide. But to argue that it deters conflicts of interest is profoundly naïve.

Returning to the results of our study, the procedure for calculating abnormal returns is well established in the academic literature. In simple terms, we used stock price data available from the University of Chicago, made some technical adjustments and then compared the profits earned by members of Congress to profits earned by the market as a whole. The difference is the abnormal return. Finally, we tested to see if that difference was statistically significant or merely random. Precise details of the analysis can be found in our paper which is available on the internet.

The results of our studies were conclusive. Common stock investments made by Senators beat the market by approximately 1% per month or 12% per year from 1993 to 1998. Common stock investments made by members of the House of Representatives earned a lower abnormal return of approximately 1/2% per month or 6% per year from 1985 to 2001. To put these numbers in their proper perspective, a recent study by Professors Jeng, Metrick and Zeckhauser showed that, corporate insiders earned an abnormal return of 1/2% per month when trading shares of their own respective company's stock from 1975 to 1996, roughly equal to the returns earned by members of the House and much less than the abnormal returns earned by Senators. Finally, although in studies of this type one can never totally eliminate the possibility of random luck, after statistical analysis we can state with a 95% confidence level that some members of Congress are trading with a substantial informational advantage.

I would further note that the results and conclusions of the "Senate study" have gained widespread acceptance among financial academicians throughout the country. In addition to being published by the *Journal of Financial and Quantitative Analysis (JFQA)*, one of the most well respected academic journals in finance, the Senate study was named "Best Paper of the Year" by JFQA's editorial board which is made up of many of the most distinguished professors in the finance field. Ironically, the House study has never been published. The reason most commonly given by academic journals when refusing to publish is that the House study contains nothing new. "It has already been clearly established that members of Congress trade with an informational advantage." Thus the House study adds nothing to the "body of knowledge."

With respect to H.R. 682, I confess I am neither an attorney nor am I an expert on insider trading. That having been said, I am generally supportive of making insider trading illegal for members of Congress and their staffs. It is likely to have some positive effect. However, historically speaking, convicting an individual of insider trading has always been a difficult task. The threshold of "beyond reasonable doubt" is extremely high. In my view, the vast majority of insider trading goes undetected as evidenced by the fact that corporate insiders continue to earn significant abnormal returns despite the best efforts of the SEC to monitor their trading activities. Thus I am doubtful that making insider trading by members of Congress illegal will eliminate the problem.

That being the case, I would offer a change to H.R. 682 which would also not eliminate the Congressional insider trades but would help level the playing field for other investors and improve confidence in the markets. Specifically, the 90-day transaction reporting requirement in H.R. 682 is much too long. For decades, financial analysts have tracked the trading activities of corporate insiders for signals about the financial health of the companies they manage. Large scale buying activity by the corporate insiders of a company is regarded as a positive indication of a forthcoming but, as yet, nonpublic event which is likely to produce significant stock price growth in the future. Conversely, large scale selling activity by the corporate insiders potentially signals the existence of a serious nonpublic problem known only to the insiders which is likely to depress the company's stock price. Many investors watch these signals and react accordingly. For this reason, among others, current law requires corporate insiders (corporate officers, directors, and beneficiary owners) to report to the SEC within two business days after they trade the stocks of their own companies. The SEC then makes this information public almost immediately.

I would suggest that members of Congress should be required to abide by the same rule. Investors could then carefully monitor the day-to-day trading activity of Congress and react accordingly. In essence, if you can't beat them, join them. I would further suggest that these reports should be made to the SEC, not the Clerk of the House of Representatives or the Secretary of the Senate. The SEC is charged with enforcement of insider trading laws, has the expertise to monitor trading activities and is well equipped to distribute the Congressional trading information to the public rapidly.

Another matter that I ran into during this Congressional journey was the subject of blind trusts. A blind trust is an excellent vehicle for members of Congress to utilize if they wish to be immune to charges of conflict of interest. However, such trusts must be truly blind. The term blind meaning that the legislator has absolutely no idea what assets are held in trust. A number of members of Congress claim "blind trust" on their FDRs, thus avoiding certain reporting requirements. However the Senator Frist case proved to be a perfect example of a flawed blind trust. I would suggest that the rules be tightened to clearly define a blind trust making them absolutely blind.

I was also asked to comment on the practice of members of Congress investing in a major company in his or her district. I'm in favor of it. It aligns the interest of the Member with the interests of the community he or she serves in a similar way that stock options align the interest of the corporate executive with the interest of the stockholders. If anything, this practice should be encouraged, not discouraged.

To summarize my testimony:

1. I find the financial disclosure statutes to be a totally ineffective means of dealing with conflicts of interest. Financial disclosure reports can be difficult to get, expensive, hard to understand, and erroneous. Furthermore the system ignores the necessary linkages between the personal financial interests of the government official and the actual behavior of the government official. It is the legislative actions of the government official that concern us, not what he or she owns.

2. The evidence is overwhelming that some members of Congress trade common stock based on nonpublic information. Unfortunately, I see no way of completely eliminating the practice.

3. I support H.R.682 with modification. Although H.R.682 is unlikely to eliminate conflicts of interest, it should reduce it. However, the bill should be changed so that government officials should be required to report transactions within two business days to the SEC with the intention that such transactions be made public as quickly as possible. This regulation is consistent with reporting requirements imposed on corporate insiders. While doing little to eliminate conflicts of interest, it puts ordinary investors on a more equal footing with government officials.

4. Rules associated with blind trusts should be tightened. A blind trust should be truly blind.

5. I have no objection to legislators investing in businesses located in his or her district or state. It financially aligns the interest of the legislator with the community he or she represents. I believe this is consistent with the intentions of the Founding Fathers.

Again, I thank you for this opportunity to present my views to this subcommittee.

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STOCKS SOARING FOR SENATORS

USA Today Magazine (May 2005, pp. 16-17)

"Senators' stocks beat the market by 12%" (Financial Times, February 25, 2004). So what? Isn't beating the market what everyone tries to do? That's the main reason most people read the Financial Times in the first place. We hire stock brokers, listen to the experts on CNNfn, watch Wall Street Week on PBS and buy books that teach us how to pick stocks because we're all trying to beat the market. When we choose a mutual fund, we're looking for portfolio managers that will do better than the average. Shouldn't U.S. Senators be able to hire the very best financial advisors available?

Logically speaking, the argument that "experts" should be able to predict which stocks will be winners and which stocks will be losers is profoundly seductive. It is deceptively obvious that money managers, who study the ups and downs of the market, examine the balance sheets of companies in minute detail, follow the latest innovations in products and technology, and use all the other sophisticated tools and techniques at their disposal, should be in the best possible position to forecast future stock prices. But alas, like so many other "no-brainers," this one is also blatantly false.

For decades, academics have known that "beating the market" is a virtually impossible task. We refer to this as the efficient market hypothesis. In a nutshell, the efficient market hypothesis says that if you're using only publicly available information, you are very unlikely to beat the market by a significant amount. Public information is anything you, your broker or your portfolio manager normally have access to, including corporate financial statements, publications like the Wall Street Journal and Baron's, anything you see on TV, everything available on the internet, every book in the library and anything else I might have left out that is in the public domain. You might be especially lucky (or unlucky) for brief periods of time in much the same way as you might get lucky for one night at a blackjack table. But over the long haul you'll likely be very close to the market average.

The key to understanding the efficient market hypothesis is understanding the difference between a great company and a great stock. Suppose your broker calls to tell you about a great company. The company has a strong balance sheet, brilliant management team, and a fabulous product which is poised to take off in the next 12 months. He wants you to buy the stock. For the sake of argument, let us further suppose that your broker is right on target. This is undoubtedly an outstanding company, but is it an outstanding investment opportunity? Sadly, it's highly unlikely. You believe you've been given a hot stock tip. In fact, you've been given very old news, relatively speaking.

As with virtually all publicly traded companies, the value of this company's stock is constantly being analyzed and reanalyzed with high speed computers using all available public information by hundreds of portfolio managers and analysts who are making *recommendations to thousands of clients. In many cases, these recommendations are acted upon immediately, sometimes via computer trading. By the time you've heard about this company, the institutional investors and thousands of people have already bought millions of shares because they've come to the same conclusion, it's a great company. The price of the stock has been pushed up so high that it is no longer a bargain and in some cases perhaps no longer even reasonable. At this point, the company must earn an exceptional profit if investors are to receive even an average return. Anything less would likely disappoint investors, causing a sell-off and the share price to tumble. This adjustment to new information doesn't take weeks or days as you might imagine; it usually takes only minutes or seconds. In a sense, if you got the recommendation from your broker, the expert, you might as well be the last guy on earth to know about this great company.*

The stock market reacts to publicly released news almost instantaneously. We call this ability to immediately respond to new information market efficiency, thus the name the efficient market hypothesis. As you might imagine, scientists love to test hypotheses and this one is no exception. Without boring you with the details, the efficient market hypothesis has been tested literally hundreds of times by hundreds of scientists. To date, every credible study concludes the same thing. The common stock market is extremely efficient, despite suggestions to the contrary made by financial service companies.

If the technical discussion hasn't convinced you, let me try a little common sense. If you could consistently pick the winning horses at the racetrack wouldn't it lower the odds and reduce the payout if you told other people which horses to bet on? If you had a system for beating the house in Las Vegas wouldn't you kill the goose that laid the golden egg if you wrote a book showing others how to do it? If you had a fool proof scheme of picking winning stocks, why would you share that information with me for a lousy 6% commission? Rest assured that if I could pick stocks with that kind of accuracy, I'd be on a beach in Tahiti armed only with my laptop computer and a phone so that I could call in orders to my broker.

Now I know what you're thinking. What about guys like Warren Buffet or Peter Lynch? How do you explain them? Frankly, we don't. Maybe they know something, and maybe they don't. Consider this. Granted many of the stocks they have chosen have done very well over the years. But there are very few that have done nearly that well. Statistically speaking, there are always outliers in any random distribution. Although most will hover around the average, a few will always be way below average and a few will be way above average. This is not necessarily skill, but can reasonably be attributed to chance. Can the person with the winning $200 million lottery ticket legitimately claim to be an expert lottery number picker just because he won?

For many people, the efficient market hypothesis is a depressing thought. It suggests that no matter how much research you do, no matter how hard you work, no matter what system you use, your common stock returns are essentially beyond your control. You are a passenger and can never be the driver. However for many others, including myself, the efficient market hypothesis is quite comforting. It also suggests that you don't need to *hire high priced money managers, or read the latest research, or constantly watch the experts on television, since you are likely to keep pace with the very best by simply investing at random. No matter how ignorant you are in your stock picks, you almost can't make a mistake. Personally, I think that's kind of nice for a change, one less thing to worry about.*

This discussion quite naturally brings us back to our Senators. If the market is so efficient, how are these guys able to repeatedly beat the market by such a large amount? To answer that question, let's remember that the markets are only efficient with respect to public information. Nobody said anything about confidential or private information.

Every company has secrets. Corporate executives may have secrets about new products under development, secrets about changes in management, or secrets about mergers and acquisitions. Some of these secrets could have a substantial impact on the share price of a company's stock. However, to keep the markets fair, we have laws that make it illegal for these executives and other employees to trade stock in their company after they learn about such important secrets, a practice commonly known as insider trading. Nonetheless, a study of corporate insiders suggests that they do cheat some, typically beating the market by about 6% annually.

Like corporate executives, Senators also have access to valuable secrets. Senators may have secrets about likely changes in the tax laws, secrets about government contracts, secrets about research funded by the government, or secrets about trade negotiations to name just a few possibilities. Like insider information, any of these secrets may have profound ramifications for the various companies or industries involved. In addition, Senators have the power to help or hurt individual companies and industries by changing the laws. This can also impact share price.

But unlike corporate executives, our Senators can trade common stocks without restriction. They can buy or sell as much stock as they want, whenever they want. They may vote on issues in which they have a personal financial interest. Furthermore, Senators are not required to report their transactions to the SEC like corporate insiders. When we looked at their annual Financial Disclosure Forms, we found that about a third of the Senators trade common stock each year. The average "trading" Senator buys and sells stock more than 10 times each year. About 80% of their transactions are less than $15,000.

In fairness to the Senators, it must be acknowledged that just because they have the power to make unfair profits in the stock market doesn't mean they use it. Two-thirds of the Senators don't trade stocks at all and so far, not a single Senator has admitted trading stocks based on confidential information he or she obtained on the job. But the evidence is rather compelling. In beating the market by 12% per year, the chance that they were merely lucky is very small. Conversely, the likelihood that some Senators used privileged information in making their investment decisions is very high.

Recognizing that some Senators use their position to beat the market does however raise some interesting issues. For example, do we really care? Compared to equivalent private sector jobs, the salary for being a Senator is pretty low. Maybe excessive stock market profits should be viewed as a form of well-deserved, additional compensation for the work they do.

There would also seem to be a clear difference between passive investments based on confidential information obtained incidentally to the performance of their job and active stock manipulation. As an example of a passive investment, Senator A learns during secret committee hearings that the XYZ Company will be awarded a $10 billion defense contract so he buys the stock knowing the stock price will soar after the announcement. Senator A is arguably just piggybacking onto a stock that will rise with or without his involvement. In the other case, Senator B uses all his influence to help the XYZ Company win a $10 billion defense contract. Senator B makes a large profit on the stock because he interfered in the bidding process perhaps to the detriment of taxpayers. Can we distinguish between Senators A and B? Should we?

Could companies be using inside information to bribe Senators? How would we know?

What if the Senator owns a lot of stock in companies from her home state? Wouldn't that give her additional incentive to work especially hard for the economy, people, and businesses in her state? Isn't that a good thing?

Finally, if we decide to regulate their stock trades, what limitations should we impose? Immediate disclosure of all transactions like the SEC requires of corporate executives? We might not know why they're buying but at least we'd know what they're buying. Blind trusts could be required where Senators would have no control or knowledge of their stock trades. But is it fair to penalize people for serving their country? Should we let them vote or sit on committees when their actions may affect stocks in their portfolio? If not, doesn't this disenfranchise the people they represent in the Senate?

If the final analysis, this study may not be important because of what we learned about the Senators. As my boss so bluntly told me, "This isn't news at all. You merely proved what most people already know." As someone said more than 100 years ago, if your congressman comes back from Washington and he isn't a millionaire, you should vote him out of office because he must be a complete fool. Perhaps the most important contribution of this research is that it will force us to confront these questions and ultimately deal with them.

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Abnormal Returns from the Common Stock Investments of the U.S. Senate

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Abstract

The actions of the federal government can have a profound impact on financial markets. As prominent participants in the government decision making process, U.S. Senators are likely to have knowledge of forthcoming government actions before the information becomes public. This could provide them with an informational advantage over other investors. We test for abnormal returns from the common stock investments of members of the U.S. Senate during the period 1993–1998. We document that a portfolio that mimics the purchases of U.S. Senators beats the market by 85 basis points per month, while a portfolio that mimics the sales of Senators lags the market by 12 basis points per month. The large difference in the returns of stocks bought and sold (nearly one percentage point per month) is economically large and reliably positive.

I. Introduction

Decisions made by the federal government often have serious implications for corporate profitability and are therefore of keen interest to the financial markets. U.S. Senators are among the most important participants in that decision process by virtue of their role as lawmakers and overseers of most federal agencies. Senators may also be embedded in social networks that provide them with access to valuable information. As such, Senators might be able to capitalize on this superior information through stock trading. Yet, despite their access to special information, neither federal law nor *The Senate Code of Official Conduct* places any unusual restrictions on the Senators' common stock transactions. According to the *U.S. Senate Ethics Manual*, "The strong presumption would be that

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the Member was working for legislation because of the public interest and the needs of his constituents and that his own financial interest was only incidentally related . . . ."

However, public choice theory (see Buchanan and Tollison (1984)) suggests that such a presumption is unrealistic. That people act to maximize their personal utility in their public capacities as well as their private lives is the most fundamental principle of public choice theory. Thus, voters can be expected to make choices that they anticipate will maximize benefits to them personally or minimize costs. Of more relevance to this study, their elected government officials can be expected to behave likewise. As an example, it is well documented that as a member of Congress in the 1940s and 1950s, Lyndon B. Johnson frequently used his political influence at the Federal Communication Commission to obtain licenses for his radio and television stations and to block competition from invading his markets in Texas. Johnson's influence allowed him to ultimately grow an initial investment of $17,500 into a multi-media company worth millions.[1]

There is no academic literature dealing with Congressional common stock returns. The only related literature is Boller (1995), who investigated a random sample of Congressional delegates (both Senators and Members of the U.S. House of Representatives) and found that 75% of them invested in companies that could be directly affected by ongoing legislative activity. However, this result merely suggests a potential conflict of interest. His research did not demonstrate that these investments yielded unusually large returns.

Our goal in this research is to determine if the Senators' investments tend to outperform the overall market. Such a finding would support the notion that Senators use their informational advantage for personal gain. We test whether the common stocks purchased and sold by U.S. Senators exhibit abnormal returns. Assuming returns are truly "incidental," we hypothesize that U.S. Senators should not earn statistically significant positive abnormal returns on their common stock acquisitions (the null). Rejection of the null, i.e., a finding of statistically significant positive abnormal returns, would suggest that Senators are trading stock based on information that is unavailable to the public, thereby using their unique position to increase their personal wealth.

Federal law requires all Senators to disclose their common stock transactions annually in a Financial Disclosure Report (FDR). We use an event study methodology to measure abnormal returns for common stock acquisitions and sales reported by the Senators in their FDRs during the period 1993 through 1998. The trigger events in our study are the stock purchases and sales made by the Senators. Since these transactions were not publicly reported until long after they occurred (anywhere from five to 17 months later), the subsequent returns of these stocks could not have been market reactions to the actual transactions themselves. Any statistically significant abnormal returns therefore would likely be the result of reactions to events anticipated by Senators and which motivated their transactions.

We find that the behavior of common stocks purchased and sold by Senators indicates that Senators trade with a substantial informational advantage. Using the calendar-time portfolio approach with the Fama-French three-factor model

[1]See Dallek (1991) and other biographies of Lyndon B. Johnson for more details.

and the Capital Asset Pricing Model (CAPM), a portfolio that mimics the purchases of U.S. Senators on a trade-weighted basis outperforms the market by 85 basis points per month, while a portfolio that mimics the sales of Senators underperforms the market by 12 basis points per month. For Senate stock purchase transactions, the abnormal returns are both economically large and statistically significant. When measuring cumulative daily abnormal returns we find that the cumulative daily abnormal return from common stocks purchased by Senators is more than 25% during the 12 calendar months immediately following acquisition. Common stocks sold by Senators exhibit slightly positive cumulative abnormal returns throughout the year following the sale. But during the 12 months prior to sale, the cumulative daily abnormal return is also over 25%, peaking close to the time of sale.

We also analyze the data for several subsamples to examine the sensitivity of the results to the Senators' party affiliation and seniority. When transactions made by the Senators are separated by political party, we find no statistically significant differences between the abnormal returns of Democrats and Republicans. However, seniority is a significant factor. The common stock investments of Senators with the least seniority (serving less than seven years) outperform the investments of the most senior Senators (serving more than 16 years) by a statistically significant margin.

II. Data and Research Design

Many of the Senate FDRs used in this study were obtained from the Web site www.opensecrets.org. However, the FDRs available at the site covered only current members of the Senate and only three years of data were provided at the time of data acquisition. Therefore, it was necessary to acquire additional FDRs from the Senate Printing Office.

In the FDRs, Senators identify all common stock purchases or sales, together with the date of the transactions and the approximate value of the transactions. We look only at assets not held in blind trusts since Senators do not report the holdings or transactions on any assets held in qualified blind trusts. The data have some serious limitations. First, although each report is personally signed and authenticated by the Senator, none of the FDRs are audited for accuracy by any government agency or organization outside the government. Therefore, we cannot verify the accuracy or completeness of these reports. Second, the care used to fill out these reports varies widely. Some are typed, some are handwritten, some include monthly financial statements from their brokerage firms, and some use abbreviations and terms that are impossible to decipher. Thus, extraction of the data was frequently difficult and despite our best efforts may have resulted in occasional errors. Third, the available data do not permit us to measure the magnitude of profits earned by individual Senators. Senators report the dollar volume of transactions only within broad ranges ($1,001 to $15,000, $15,001 to $50,000, $50,001 to $100,000, $100,001 to $250,000, $250,001 to $500,000, $500,001 to $1,000,000 and over $1,000,000). The broad ranges also present problems for trade-size-weighted analysis.

The database includes common stock transactions made by the Senators, their spouses, and their dependent children. The transactions have been recorded with the name of the Senator, the transaction date, and the approximate value of the transaction. Assets were matched by name with CUSIP numbers from the Center for Research and Security Prices (CRSP) databases.

Without knowing any details about the information the Senators may possess, we cannot assume that abnormal returns would necessarily be seen within days or even weeks of the stock purchase. Furthermore, the timing of abnormal performance is likely to vary across securities depending on the political and economic issues under discussion and the companies or industries affected. We therefore examine returns for a full calendar year (255 trading days) after the acquisition or sale of the stock. Abnormal performance is measured using the calendar-time portfolio approach with the Fama-French three-factor model and CAPM as recommended by Mitchell and Stafford (2000).

Initially, we begin with 6,052 transactions. Before analysis we apply several screens to the data. Only U.S. common stocks are included in the study. These screens eliminate, among other things, all preferred stock, ADRs, REITs, foreign stocks, and mutual funds. We also eliminate all initial public offerings (IPOs) from the sample.[2] In total, 360 observations are eliminated for the reasons given above. Among the surviving transactions, approximately 59% of the stocks are listed on the NYSE, 40% are traded on the NASDAQ, and about 1% are listed on the ASE.

After separating the transactions into purchases and sales, we begin by calculating the cumulative abnormal return, CAR, for the buy sample and sell sample on each event-day from day −255 to day +255, where $t = 0$ is the transaction day. First, daily average abnormal return for the sample transactions is calculated as

$$\overline{\mathrm{AR}} = \sum_{i=1}^{N} w_i (R_{it} - R_{mt}), \tag{1}$$

where N is the number of transactions in the sample (buy or sell), R_{it} is the return from sample transaction i on trading day t, R_{mt} is the return on the CRSP value-weighted market index for trading day t, and w_i is the trade weight of transaction i. As indicated previously, Senators report transaction amounts only within broad ranges. We therefore estimate the value of their trades using the midpoint of the range reported by the Senators for all transactions less than $250,000. For all transactions above $250,000, we assume a transaction size equal to $250,000. Next, we compute the cumulative abnormal returns (CAR) for day t as:

$$\mathrm{CAR}_t = \sum_{T=-255}^{t} \overline{\mathrm{AR}}_T, \tag{1a}$$

where t ranges from day −255 to +255. Although we do not rely on the CARs as a basis for our main statistical inferences, they do provide an indication as to

[2]IPOs were excluded because of the possibility that Senators were allocated these shares during the IPO process. Loughran and Ritter (1995) have shown that IPOs typically earn a high return on the first trading day but under-perform the market thereafter. Thus, though they may prove to be poor long-term investments, these losses are more than likely compensated for by the large first-day returns earned by many IPOs.

whether the Senators' portfolio outperformed the market. We compute CARs for both the buy and sell samples.

The calendar-time portfolio method for detecting long-run abnormal returns was first used by Jaffe (1974) and Mandelker (1974) and is strongly recommended by Fama (1998). To briefly explain, for each calendar day a calendar-time portfolio is constructed including all those stocks that have an event date within the prior 255 days. The portfolio return is then calculated as

$$(2) \qquad R_{p,t} = \sum_{i=1}^{N} c_{i,t} R_{i,t} \Big/ \sum_{i=1}^{N} c_{i,t},$$

where $R_{p,t}$ is the portfolio return on day t and $c_{i,t}$ is the compound value of transaction i from the event date to $t-1$. For an equal-weighted portfolio, the initial value of transaction i is set at \$1. To calculate the trade-weighted portfolio, we replace the weight of \$1 on the purchase date with the value of the trade. As before, we again estimate the value of their trades using the midpoint of the range reported by the Senators for all transactions less than \$250,000. For all transactions above \$250,000, we assume a transaction size equal to \$250,000.

We obtain daily portfolio return series for four calendar-time portfolios: an equally-weighted portfolio of the buy transactions, a trade-size-weighted portfolio of the buy transactions, an equally-weighted portfolio of the sell transactions, and a trade-size-weighted portfolio of the sell transactions. The time span of these return series is from January 1, 1993 to December 31, 1998.

To draw statistical inferences, we compound daily returns to yield monthly returns. We then calculate portfolio excess returns by subtracting the risk-free rate from the monthly return series. We regress the portfolio excess return series on two models: the CAPM and the Fama-French three-factor model. The CAPM is shown in equation (3),

$$(3) \qquad R_{p,t} - R_{f,t} = \alpha_i + \beta_i (R_{m,t} - R_{f,t}) + \varepsilon_{p,t},$$

where $R_{p,t}$ is the monthly calendar-time portfolio return at month t, $R_{m,t}$ is the monthly return on the CRSP value-weighted index at month t, $R_{f,t}$ is the risk-free rate at month t, α_i, and β_i are the regression parameters, and $\varepsilon_{p,t}$ is the error term. The intercept, α, measures the average monthly abnormal return.

The Fama-French three-factor model is shown in equation (4),

$$(4) \qquad R_{p,t} - R_{f,t} = \alpha_i + \beta_i (R_{m,t} - R_{f,t}) + s_p \mathrm{SMB}_t + h_p \mathrm{HML}_t + \varepsilon_{p,t}.$$

The regression parameters for the Fama-French model are α_i, β_i, s_p, and h_p. The three factors β_i, s_p, and h_p are zero-investment portfolios representing the excess return of the market ($R_m - R_f$), the difference between a portfolio of small stocks and a portfolio of big stocks (SMB), and the difference between a portfolio of high book-to-market stocks and a portfolio of low book-to-market stocks (HML), respectively. See Fama and French (1993) for details on the construction of the factors. The intercept, α_i (Fama-French alpha), again measures the average monthly abnormal return, given the model. Data on the Fama-French three-factor model (R_{mt}, SMB, and HML) are obtained from Ken French's Web site (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/). Under our null hypothesis that the Senators' portfolios do not exhibit significant abnormal returns, the regression intercept (α_i) is non-distinguishable from zero for both models. Rejecting this null hypothesis would indicate that there is a non-zero abnormal return associated with the Senators' portfolio.

III. Results

Table 1 shows a breakdown of the common stock buy and sell transactions in the Senate sample. We divide the transactions by year showing the number of active traders each year, the mean number of transactions per trader, and the median number of transactions per trader. Only a minority of Senators buy individual common stocks, never more than 38% in any one year. The median number of buy transactions each year per trader is between three and seven, suggesting Senators do not buy common stocks often. But the average number of buy transactions each year per trader is much higher, ranging between 11 and 29 purchases per trader each year. This indicates that there is a small group of Senators who are quite active in the stock market. The vast majority of purchase transactions are less than \$15,000 (71%) with 18% between \$15,000 and \$50,000, 4% between \$50,000 and \$100,000, and the remaining 7% are larger than \$100,000. The sell transactions show a very similar pattern. The most active traders in descending order were Senators Claiborne Pell of Rhode Island, John Warner of Virginia, John Danforth of Missouri, and Barbara Boxer of California, who collectively accounted for nearly half of all the transactions in the sample.

TABLE 1

Frequency of Transactions by U.S. Senators

	Year					
	1993	1994	1995	1996	1997	1998
Panel A. Buy Transactions						
Total no. of transactions	721	499	553	556	355	458
No. of traders	25	26	25	36	31	38
Average no. of transactions/trader	28.9	19.2	22.1	15.5	11.5	13.9
Median no. of transactions/trader	5	3.5	3	4	7	5
Min. no. of transactions/trader	1	1	1	1	1	1
Max. no. of transactions/trader	298	187	262	304	70	165
Transactions \$15,000 or less	586	400	342	341	198	373
Transactions \$15,001 to \$50,000	76	50	122	163	87	74
Transactions \$50,001 to \$100,000	25	19	24	19	17	7
Transactions more than \$100,000	34	30	65	33	53	4
Panel B. Sell Transactions						
Total no. of transactions	390	542	550	459	308	295
No. of traders	22	24	25	33	34	29
Avg. no. of transactions/trader	17.8	22.6	22.0	13.9	9.1	10.2
Median no. of transactions/trader	4	3.5	8	3	3	4
Min. no. of transactions/trader	1	1	1	1	1	1
Max. no. of transactions/trader	192	239	257	237	79	88
Transactions \$15,000 or less	269	402	310	317	148	187
Transactions \$15,001 to \$50,000	63	89	111	83	115	74
Transactions \$50,001 to \$100,000	23	16	44	15	19	5
Transactions more than \$100,000	35	35	85	44	26	29

Table 1 shows the number of common stock buy and sell transactions made by members of the U.S. Senate during every year that was included in the final study sample. Traders for each year are the numbers of individual Senators who made one or more of the transactions included in the final sample.

Figure 1 presents graphs of the daily CARs for the samples of buy and sell transactions. For the 12 months prior to acquisition, common stocks purchased by Senators exhibit relatively small positive CARs (3.4%). After being acquired, the CARs increase to 28.6% during the next calendar year. The CARs for the sample of sell transactions are equally interesting. The CARs after sale by the Senators are nearly zero. However, prior to sale, we see another large run-up in the CARs during the 12 months before the event-day (25.1%). These results clearly support the notion that members of the Senate trade with a substantial informational advantage over ordinary investors. The results suggest that Senators knew when to buy their common stocks and when to sell. Because of the well-documented statistical problems associated with the use of event-time abnormal returns, we do not formally test the statistical significance of the CARs. To formally test the performance of stocks bought and sold, we rely on the calendar-time portfolio returns.

FIGURE 1

Daily Cumulative Abnormal Returns for Common Stocks Bought and Sold by U.S. Senators

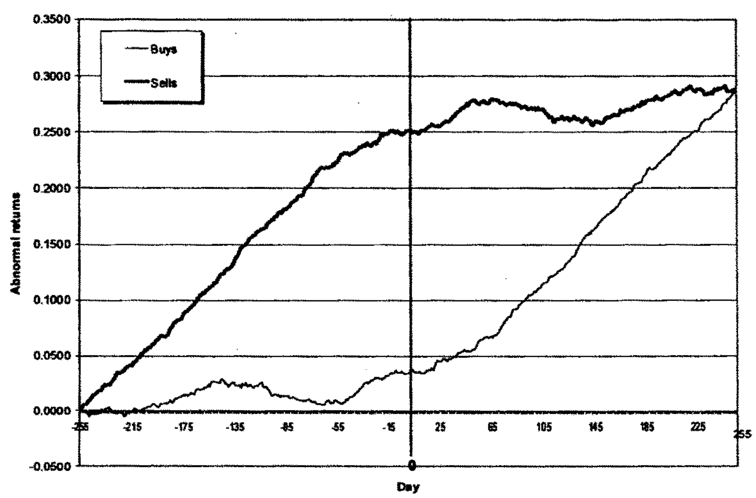

Figure 1 depicts the cumulative abnormal returns (CARs) of the buy and sell transactions of U.S. Senators during the period 255 days prior to and after the event date (day 0 on the horizontal axis). To calculate the CAR, we use the expression, $CAR_t = \sum_{T=-255}^{t} \overline{AR}_T$, where $\overline{AR}$ is the abnormal daily return on trading day t.

Table 2 shows the results of the calendar-time portfolio analysis for both the buy and the sell samples. Both the equal- and trade-weighted buy portfolios produce positive mean market-adjusted returns. The mean annualized return for the equal-weighted Senate buy portfolio is 25.8% vs. 21.3% for the market portfolio. The mean annualized return for the trade-weighted Senate buy portfolio is 34.1%, suggesting that the Senators invested more money in the stocks that ultimately performed best.

TABLE 2

Calendar-Time CAPM and Fama-French Three-Factor Portfolio Regressions of the Senate Buy Sample, Sell Sample, and a Hedged Portfolio for Years 1993–1998 (12-month holding period)

	Buys		Sells		Hedged Portfolio	
	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted
Mean return	1.932	2.476	1.594	1.504	1.961	2.595
Std. dev.	4.748	6.354	5.233	5.800	1.883	3.620
Market-adj. return	0.311	0.854	−0.028	−0.118	0.339	0.973
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.115	0.508	−0.316	−0.336	0.432**	0.844**
Fama-French Alpha	0.323**	0.849**	−0.012	−0.196	0.334	1.045***
$R_m - R_f$	1.008****	1.001****	0.987****	1.060****	0.021	−0.059
SMB	0.296****	0.342**	0.319****	0.135	−0.023	0.207
HML	−0.263****	−0.554****	−0.482****	−0.232	0.219***	−0.322**
Adj. R^2	0.920	0.666	0.908	0.592	0.084	0.086

Dependent variables are event portfolio returns, R_p, in excess of the one-month Treasury bill rate, R_f, observed at the beginning of the month. Each month, we form equal- and trade-weighted portfolios of all sample firms that have completed the event within the previous year. The event portfolio is rebalanced monthly to drop all companies that reach the end of their one-year period and add all companies that have just executed a transaction. For the CAPM regression, we use R_{pt}, to estimate the regression parameters α_i and β_i in the expression $R_{pt} - R_{ft} = \alpha_i + \beta_i(R_{mt} - R_{ft}) + \varepsilon_{it}$. The intercept, α, measures the average monthly abnormal return, given the model. For the Fama and French three-factor model we use R_{pt}, to estimate the regression parameters α_i, β_i, s_p, and h_p in the expression $R_{p,t} - R_{f,t} = \alpha_i + \beta_i(R_{m,t} - R_{f,t}) + s_p\text{SMB}_t + h_p\text{HML}_t + \varepsilon_{p,t}$. The three factors are zero-investment portfolios representing the excess return of the market, $R_m - R_f$; the difference between a portfolio of small stocks and big stocks, SMB; and the difference between a portfolio of high book-to-market stocks and low book-to market stocks, HML. See Fama and French (1993) for details on the construction of the factors. The intercept, α, again measures the average monthly abnormal return, given the model.

****, ***, **, and * indicates significance at the 0.5%, 2.5%, 5.0%, and 10% levels, respectively.

Regressing the two buy portfolios on the market risk premium alone (CAPM), the Jensen alpha is positive although not statistically significant in either case. However, when we regress the buy portfolios on the Fama-French three-factor model, the Fama-French alphas are both positive and statistically significant in each case, indicating a substantial informational advantage. The Fama-French alpha was much higher for the trade-weighted buy portfolio supporting our earlier contention that Senators tend to invest more funds in the better performing stocks. In looking at the other coefficients generated by the Fama-French regressions, we find that the beta coefficients for both buy portfolios are relatively close to one, suggesting that the Senators tilted toward stocks with average market risk. Coefficients associated with the size factor, SMB, are positive and statistically different from zero, suggesting that Senators favored smaller companies. Coefficients associated with the value/growth factor, HML, are negative and significantly different from zero indicating that Senators also favored growth stocks with low book-to-market value ratios.

The market-adjusted returns are negative for both the equal- and trade-weighted sell portfolios. Although the Jensen alphas and Fama-French alphas are negative for these portfolios, neither is significantly different from zero. As with the buy portfolios, the results suggest that Senators tended to sell stocks of smaller companies with average market risk and higher book-to-market value ratios.

To combine the effects of the buy transactions with the sell transactions, we analyze a hedged portfolio in which we hold the purchase transactions long and short the sell transactions. The results of this analysis are also presented in Table 2. The Jensen alphas are positive and statistically significant for both the equal- and trade-weighted portfolios. The Fama-French alphas are positive for both the equal- and trade-weighted portfolios but statistically significant only in the case of the trade-weighted portfolio. These results indicate substantial informational advantage. Again the trade-weighted alphas are much higher suggesting that Senators invested much more heavily in the most profitable transactions. As we would expect for a hedged portfolio, the beta coefficient is not significantly different from zero indicating little market risk. Coefficients associated with the size factor, SMB, are not significantly different from zero indicating that the Senators' buy transactions and sell transactions involve similarly sized firms. The coefficient associated with the value/growth factor, HML, is positive and statistically significant on an equal-weighted basis suggesting Senators' buys involve more growth firms than their sells. The negative and statistically significant HML coefficient in the trade-weighted regression indicates that on a value-weighted basis, Senators invest more money in value stocks than they sell.

Taken collectively, the results of these analyses are economically very significant. Barber and Odean (2000) measured common stock returns for 66,465 randomly selected households in the U.S. from 1991 to 1996 and found that the average household underperformed the market by approximately 12 basis points per month. Jeng, Metrick, and Zeckhauser (2001) examined the returns to corporate insiders when they traded shares of their respective company's common stock during the period 1975 to 1996 and found that insiders earned an economically significant positive abnormal return of 50 basis points per month. In comparison, we find that members of the U.S. Senate outperformed the market by almost 100 basis points per month. Although some of the abnormal returns measured for the Senate portfolios are not statistically significant, we are somewhat hampered by the short time-series of monthly returns, which invariably lowers the power of our statistical tests.[3] Nonetheless, the economic returns earned by the Senators are extraordinarily large.

Because a few Senators purchased a disproportionately large number of stocks, it is necessary to address concerns that a few high volume traders might seriously bias our results. To do this, we calculate a calendar-time portfolio for each Senator and then we average the returns across Senators on each calendar day. Analyzing the data in this fashion gives each Senator's calendar-time portfolio equal weight in the analysis. Assuming only a few high volume traders were responsible for the abnormal returns found in the full sample, the abnormal returns should disappear with this analysis. On the other hand, the persistence of positive statistically significant abnormal returns would suggest that trading with an informational advantage is reasonably widespread among Senators who trade.

Table 3 presents the results of this analysis. When we equally weight the returns of each Senator, the buy portfolio earns a compound annual rate of 28.6% on an equal-weighted basis and 31.1% on a trade-weighted basis compared to 21.3% for the market. Both Jensen alphas for the buy portfolio are positive, but only the trade-weighted Jensen alpha is statistically significant. The Fama-French alphas for the buy portfolio are positive and statistically significant on both an

[3]Financial Disclosure Forms of the Senators are only retained six years by law. After six years, they are destroyed.

equal- and trade-weighted basis. On the sell side, we see no evidence of abnormal returns with Jensen alphas being slightly negative and Fama-French alphas being slightly positive, none of which are statistically significant.

TABLE 3

Calendar-Time CAPM and Fama and French Three-Factor Portfolio Regressions of the Senate Buy Sample and Sell Sample for Years 1993–1998, Analyzed as Portfolios of Stocks Held by Individual Senators (12-month holding period)

	Buys		Sells		Hedged Portfolio	
	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted
Mean return	2.115	2.285	1.799	1.868	1.937	2.039
Std. dev.	4.981	4.905	5.209	5.119	2.391	2.445
Market-adj. return	0.494	0.664	0.178	0.247	0.315	0.417
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.232	0.444*	−0.132	−0.042	0.364	0.486*
Fama-French Alpha	0.489*	0.568***	0.118	0.181	0.271	0.387
$R_m - R_f$	1.107****	1.104****	1.043****	1.040****	0.064	0.064
SMB	0.267****	0.253****	0.238****	0.181***	0.029	0.071
HML	−0.163**	−0.095	−0.416****	−0.399***	0.253**	0.304***
Adj. R^2	0.882	0.848	0.900	0.891	0.033	0.058

Dependent variables are event portfolio returns, R_p, in excess of the one-month Treasury bill rate, R_f, observed at the beginning of the month. Each month, we form equal- and trade-weighted portfolios of all sample firms that have completed the event within the previous year. The event portfolio is rebalanced monthly to drop all companies that reach the end of their one-year period and add all companies that have just executed a transaction. For the CAPM regression, we use R_{pt}, to estimate the regression parameters α_i and β_i in the expression $R_{pt} - R_{ft} = \alpha_i + \beta_i(R_{mt} - R_{ft}) + \epsilon_{it}$. The intercept, α, measures the average monthly abnormal return, given the model. For the Fama and French three-factor model, we use R_{pt}, to estimate the regression parameters α_i, β_i, s_p, and h_p in the expression $R_{p,t} - R_{f,t} = \alpha_i + \beta_i(R_{m,t} - R_{f,t}) + s_p\text{SMB}_t + h_p\text{HML}_t + \epsilon_{p,t}$. The three factors are zero-investment portfolios representing the excess return of the market, $R_m - R_f$; the difference between a portfolio of small stocks and big stocks, SMB; and the difference between a portfolio of high book-to-market stocks and low book-to market stocks, HML. See Fama and French (1993) for details on the construction of the factors. The intercept, α, again measures the average monthly abnormal return, given the model.

****, ***, **, and * indicates significance at the 0.5%, 2.5%, 5.0%, and 10% levels, respectively.

Comparing Table 2 (whole sample) to Table 3 (weighing the Senators equally) we find that the results obtained from the buy portfolios are very similar. The sell portfolios also behave similarly in that neither case produces evidence of statistically significant returns. We therefore conclude that our results are not biased by the heavy trading volume of some Senators and that trading with an informational advantage is common among Senators.

Positions of power within the Senate (committee memberships and chairmanships) are generally determined on the basis of political party and seniority. To explore the impact of party affiliation and seniority on stock performance, Senate stock transactions are grouped by party (Table 4) and then by seniority (Table 5).

We find that our analyses of the calendar-time portfolios of Democratic Senators produced similar results to our analyses of the total sample. Both the equal- and trade-weighted buy portfolios of Democratic Senators produce significant market-adjusted mean returns with the trade-weighted market-adjusted returns being approximately twice as large as the equal-weighted adjusted returns, again suggesting larger investments in the best performing stocks. The equal- and trade-weighted Democratic buy portfolios produced higher annualized returns than the Senate sample as a whole, with returns of 28.6% and 36.1%, respectively. In each case, the Jensen alphas are positive but not statistically significant. Both Fama-

TABLE 4

Calendar-Time CAPM and Fama and French Three-Factor Portfolio Regressions of the Senate Buy Sample, Sell Sample, and a Hedged Portfolio for Years 1993–1998 (12-month holding period), Grouped by Political Party and a *t*-Test for Significance of Party

	Buys		Sells		Hedged Portfolio	
	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted
Panel A. Democratic Party						
Mean return	2.119	2.604	1.844	1.775	1.898	2.451
Std. dev.	5.131	6.916	6.529	6.616	3.424	3.790
Market-adj. mean return	0.498	0.982	0.222	0.153	0.276	0.829
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.242	0.625	−0.246	−0.153	0.488	0.777*
Fama-French Alpha	0.480**	0.976*	0.286	0.275	0.194	0.702
$R_m - R_f$	1.037****	1.003****	0.944****	0.895****	0.093	0.108
SMB	0.349****	0.363*	0.538****	0.414***	−0.190	−0.052
HML	−0.293***	−0.563***	−0.858****	−0.705****	0.565****	0.142
Adj. R^2	0.868	0.569	0.860	0.637	0.259	−0.022
Panel B. Republican Party						
Mean return	1.727	1.741	1.356	1.296	2.009	2.067
Std. dev.	4.923	5.106	4.564	4.826	3.049	4.426
Market-adj. mean return	0.105	0.120	−0.266	−0.325	0.387	0.445
Coefficient estimates on:						
Jensen Alpha (CAPM)	−0.116	0.014	−0.311	−0.261	0.161	0.275
Fama-French Alpha	0.120	0.232	−0.241	−0.303	0.328	0.535
$R_m - R_f$	0.973****	1.000****	1.091****	1.047****	−0.121	−0.047
SMB	0.180****	0.138	0.191***	−0.013	−0.028	0.151
HML	−0.430****	−0.380***	0.003	0.086	−0.405****	−0.466**
Adj. R^2	0.895	0.757	0.831	0.603	0.113	0.073
Panel C. t-Test for Significance of Difference in Party Affiliation Buys Sells						
Mean return : Democrats	2.119	2.604	1.844	1.775	1.898	2.451
Mean return : Republicans	1.727	1.741	1.356	1.296	1.822	2.067
Mean *D*−Mean *R*	0.392	0.862	0.488	0.479	0.076	0.383
Pooled std.	5.028	6.084	5.639	5.796	3.242	4.106
t-test stat.	0.506	0.916	0.559	0.534	−0.223	0.613
Significance (*p*-value)	0.614	0.361	0.577	0.594	0.824	0.540

Dependent variables are event portfolio returns, R_p, in excess of the one-month Treasury bill rate, R_f, observed at the beginning of the month. Each month, we form equal- and trade-weighted portfolios of all sample firms that have completed the event within the previous year. The event portfolio is rebalanced monthly to drop all companies that reach the end of their one-year period and add all companies that have just executed a transaction. For the CAPM regression, we use R_{pt}, to estimate the regression parameters α_i and β_i in the expression $R_{pt} - R_{ft} = \alpha_i + \beta_i(R_{mt} - R_{ft}) + \epsilon_{it}$. The intercept, α, measures the average monthly abnormal return, given the model. For the Fama and French three-factor model, we use R_{pt}, to estimate the regression parameters α_i, β_i, s_p, and h_p in the expression $R_{p,t} - R_{f,t} = \alpha_i + \beta_i(R_{m,t} - R_{f,t}) + s_p\text{SMB}_t + h_p\text{HML}_t\epsilon_{p,t}$. The three factors are zero-investment portfolios representing the excess return of the market, $R_m - R_f$; the difference between a portfolio of small stocks and big stocks, SMB; and the difference between a portfolio of high book-to-market stocks and low book-to market stocks, HML. See Fama and French (1993) for details on the construction of the factors. The intercept, α, again measures the average monthly abnormal return, given the model.

****, ***, **, and * indicates significance at the 0.5%, 2.5%, 5.0%, and 10% levels, respectively.

French alphas are positive and statistically significant. Consistent with the full sample, Democratic Senators leaned toward smaller growth firms with average market risk.

Stocks purchased by Republican Senators did not perform as well as those purchased by Democrats. Stocks purchased by Republicans have smaller positive market-adjusted returns with average annualized returns of 22.8% for the equal-weighted calendar-time portfolio and 23.0% for the trade-weighted portfolio. Furthermore, neither the Jensen alphas nor the Fama-French alphas are statistically different than zero. However, when analyzed for statistical differences between the buy portfolios of the two parties using a *t*-test, the returns from the buy portfolios of Democrats and Republicans are not statistically different.

Analyses of the Democratic sell portfolios indicate no abnormal returns after sale. The equal-weighted Democratic sell portfolio yields a raw mean average annual return of 24.5% with a small positive market-adjusted mean return. The trade-weighted Democratic sell portfolio yields a mean average annual return of 23.5%. For both Democratic sell portfolios, the regression analyses calculate a negative Jensen alpha and a positive Fama-French alpha with none of the alphas being significantly different from zero.

Common stocks sold by Republican Senators underperformed the market during the calendar year after sale. The mean annual return is 17.5% for the equal-weighted Republican sell portfolio and 16.7% for the trade-weighted Republican sell portfolio. The lower return for the trade-weighted portfolio suggests that Republican Senators sold off a higher volume of those stocks that would do worst

TABLE 5

Calendar-Time CAPM and Fama and French Three-Factor Portfolio Regressions of the Senate Buy Sample, Sell Sample, and Hedged Portfolio for Years 1993–1998 (12-month holding period), Grouped by Seniority, and a Nested Test for Significance of Seniority

	Buys		Sells		Hedged Portfolio	
	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted
Panel A. Seniority Less Than 7 Years						
Mean return	1.911	2.581	1.359	0.861	2.175	3.343
Std. dev.	5.066	6.034	5.640	5.660	3.132	5.793
Market-adj. mean return	0.290	0.960	−0.263	−0.761	0.553	1.721
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.071	0.712	−0.586*	−0.775	0.657*	1.487***
Fama-French Alpha	0.323	0.991***	−0.342	−0.818*	0.665*	1.808***
$R_m - R_f$	0.970****	0.968****	1.038****	1.004****	−0.068	−0.036
SMB	0.255***	0.262*	0.147	−0.229	0.108	0.491**
HML	−0.408****	−0.467***	−0.478****	−0.086	0.070	−0.381
Adj. R^2	0.870	0.624	0.772	0.450	−0.017	0.104
Panel B. Seniority between 7 and 16 Years						
Mean return	2.049	1.817	1.347	1.086	2.341	2.366
Std. dev.	4.806	5.641	4.996	5.108	2.703	3.394
Market-adj. mean return	0.427	0.196	−0.275	−0.535	0.719	0.744
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.197	0.041	−0.347	−0.506	0.559*	0.561
Fama-French Alpha	0.306	0.062	−0.112	−0.493	0.476	0.587
$R_m - R_f$	1.096****	1.038****	0.988****	1.003****	0.113	0.038
SMB	0.105	−0.286*	0.273***	−0.120	−0.136	−0.149
HML	−0.180***	−0.290*	−0.304***	−0.133	0.073	−0.186
Adj. R^2	0.885	0.580	0.769	0.575	0.008	−0.002
Panel C. Seniority More Than 16 Years						
Mean return	2.023	2.209	1.879	2.050	1.768	1.776
Std. dev.	4.860	6.734	5.372	7.620	2.526	4.194
Market-adj. mean return	0.402	0.587	0.258	0.428	0.146	0.154
Coefficient estimates on:						
Jensen Alpha (CAPM)	0.289	0.297	0.114	0.163	0.170	0.130
Fama-French Alpha	0.534**	0.644	0.447	0.649	0.128	0.059
$R_m - R_f$	0.922****	0.996****	1.012****	1.026****	−0.086	−0.024
SMB	0.383****	0.548****	0.476****	0.670	−0.071	−0.087
HML	−0.282****	−0.396*	−0.353****	−0.540****	0.036	0.088
Adj. R^2	0.815	0.570	0.795	0.507	0.005	−0.025

(continued on next page)

TABLE 5 (continued)

Calendar-Time CAPM and Fama and French Three-Factor Portfolio Regressions of the Senate Buy Sample, Sell Sample, and Hedged Portfolio for Years 1993–1998 (12-month holding period), Grouped by Seniority, and a Nested Test for Significance of Seniority

Panel D. t-Test for Significance of Difference in Seniority

	Buys		Sells		Hedged Portfolio	
	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted	Equal-Weighted	Trade-Weighted
Mean return—seniority < 7 years (G1)	1.911	2.581	1.359	0.861	2.175	3.343
Mean return—seniority 7–16 years (G2)	2.049	1.817	1.347	1.086	2.341	2.366
Mean return—seniority > 16 years (G3)	2.023	2.209	1.879	2.050	1.768	1.776
Mean return G1 – mean return G2	−0.138	0.764	0.012	−0.226	−0.166	0.976
Pooled std.	4.938	5.841	5.330	5.393	2.925	4.748
t-test stat.	−0.181	0.848	0.015	−0.270	−0.367	1.333
Significance (p-value)	0.857	0.398	0.988	0.787	0.714	0.184
Mean return G2 – mean return G3	0.026	−0.391	−0.533	−0.963	0.572	0.590
Pooled std.	4.833	6.211	5.188	6.487	2.616	3.815
t-test stat.	0.035	−0.408	−0.662	−0.957	1.368	0.952
Significance (p-value)	0.972	0.684	0.509	0.340	0.173	0.342
Mean return G1 – mean return G3	−0.112	0.372	−0.521	−1.189	0.407	1.567
Pooled std.	4.964	6.393	5.509	6.706	2.845	5.057
t-test stat.	−0.146	0.378	−0.611	−1.145	0.880	1.970
Significance (p-value)	0.884	0.706	0.542	0.254	0.380	0.051*

Dependent variables are event portfolio returns, R_p, in excess of the one-month Treasury bill rate, R_f, observed at the beginning of the month. Each month, we form equal- and trade-weighted portfolios of all sample firms that have completed the event within the previous year. The event portfolio is rebalanced monthly to drop all companies that reach the end of their one-year period and add all companies that have just executed a transaction. For the CAPM regression, we use R_{pt}, to estimate the regression parameters α_i and β_i in the expression $R_{pt} - R_{ft} = \alpha_i + \beta_i(R_{mt} - R_{ft}) + \varepsilon_{it}$. The intercept, α, measures the average monthly abnormal return, given the model. For the Fama and French three-factor model, we use R_{pt}, to estimate the regression parameters α_i, β_i, s_p, and h_p in the expression $R_{p,t} - R_{f,t} = \alpha_i + \beta_i(R_{m,t} - R_{f,t}) + s_p\mathrm{SMB}_t + h_p\mathrm{HML}_t + \varepsilon_{p,t}$. The three factors are zero-investment portfolios representing the excess return of the market, $R_m - R_f$; the difference between a portfolio of small stocks and big stocks, SMB; and the difference between a portfolio of high book-to-market stocks and low book-to market stocks, HML. See Fama and French (1993) for details on the construction of the factors. The intercept, α, again measures the average monthly abnormal return, given the model.

****, ***, **, and * indicates significance at the 0.5%, 2.5%, 5.0%, and 10% levels, respectively.

in the coming year. The Jensen alphas and Fama-French alphas are negative for both Republican sell portfolios although neither is statistically significant. The regression coefficients suggest that the stocks Republicans sold were firms with average market risk, average size, and average book-to-market value. As with the party buy portfolios, when comparing the mean returns for the respective party sell portfolios in a t-test, we find no statistically significant differences between the two political parties.

To examine the influence of seniority, we form three groups with approximately the same number of Senators in each group: those with less than seven years in the Senate, those with seven to 16 years in the Senate, and those with more than 16 years. Stocks purchased by all three groups yield positive market-adjusted mean returns. Stocks purchased by Senators with the least seniority earned an annualized mean return of 25.5% on an equal-weighted basis and 35.8% on a trade-weighted basis in comparison to those purchased by Senators with middle seniority that earned 27.6% (EW) and 24.1% (TW) and those purchased by Senators with the longest seniority with 27.2% (EW) and 30.0% (TW). The CAPM regression analysis of the buy portfolios produces positive equal- and trade-weighted Jensen alphas for all three groups although only the Jensen alpha of the equal-weighted buy portfolio of the group with most seniority is statistically significant. Using the three-factor model, all the buy portfolios also yield positive

Fama-French alphas. The Fama-French alpha is only statistically significant for the trade-weighted buy portfolio of Senators with the least seniority. Comparison of the mean returns from the buy portfolios of the three seniority groups with a t-test shows no statistical differences between the groups.

Regression analyses of the sell portfolios for Senators with the least seniority and Senators with middle seniority produce all negative Jensen and Fama-French alphas, although only the sell portfolios of Senators with the least seniority produce statistically significant alphas. The equal-weighted sell portfolio of Senators with the least seniority yields a statistically significant negative Jensen alpha and their trade-weighted sell portfolio yields a significant negative Fama-French alpha. Analyses of the sell portfolios of Senators with the most seniority produce positive market-adjusted mean returns and positive alphas, none of which are statistically significant. Again, a t-test reveals no significant differences among the mean returns of the sell portfolios for the three groups.

Combining the buy transactions with the sell transactions in hedged portfolios, we find that the hedged portfolios of Senators with the least seniority substantially outperform the other two seniority groups. For Senators with the least seniority, the Jensen alphas and Fama-French alphas are positive and statistically significant when transactions are both equal- and trade-weighted. The Jensen alphas and Fama-French alphas are also all positive for the middle seniority group, but only the Jensen alpha for the equal-weighted portfolio is statistically significant. The hedged portfolios of Senators with the most seniority exhibit small positive Jensen and Fama-French alphas, none of which are significant. We also find that the mean return of the hedged trade-weighted portfolio of Senators with the least seniority is statistically higher than the mean return of the hedged trade-weighted portfolio of Senators with the most seniority.

As a final analysis, we divide the sample by years and measure cumulative abnormal returns on an annual basis. We find that, during the years 1993 through 1996, the pattern of cumulative abnormal returns for both the buy and the sell samples looks remarkably similar to the sample as a whole. In these four years, the buy samples all show moderate to low positive CARs prior to purchase followed by a strong positive surge after the event date. In 1993, 1994, 1995, and 1996, the daily CARs for the buy samples rise 39.6%, 21.6%, 43.6%, and 42.4%, respectively, during the 12 calendar months after acquisition on a trade-weighted basis. Sale samples from this same time period also behave consistently with the combined sell sample. For 1993 though 1996, we find a consistent pattern of very strong positive daily CARs in the year preceding the sale that peak just prior to sale. There were no abnormal returns after stocks were sold during these four years.

However in 1997 and 1998, we see very different results. In both of these years, we find little evidence of abnormal returns for either the buy samples or the sell samples, suggesting that something dramatic occurred between 1996 and 1997 that curtailed the Senators' normal trading habits. We also observe that trading activity slowed considerably during these two years with Senatorial stock purchases falling 36% from 1996 to 1997 and sales falling 33% during the same period. The retirement of and failure to re-elect some Senators who were high volume traders (e.g., Senator Pell retired at the end of 1996) could have caused the sudden drop in trading activity in 1997. The sudden change in trading habits is more difficult to explain since we find no changes in the law that would likely cause such a reaction. Besides changes in the law, other explanations seem plausible. For example, Boller's (1995) work received considerable publicity in the print media and on television. Boller may have created some concern among Senators that researchers were actively investigating their trading activities.

IV. Conclusions

Members of the U.S. Senate have obvious access to valuable information by virtue of their government position and social contacts. Our goal in this research is to determine if the Senators' investments tend to outperform the overall market, which would support the notion that Senators use their informational advantage for personal gain as suggested by public choice theory. We test whether common stocks purchased and sold by U.S. Senators exhibit abnormal returns.

Cumulative abnormal returns for the portfolio of stocks bought by Senators are near zero for the calendar year prior to the date of purchase. After acquisition, the cumulative abnormal return rises over 25% within one calendar year after the purchase date. The cumulative abnormal returns for the portfolio of stocks sold by the Senators are near zero for the calendar year after the date of sale. However, these same stocks saw a cumulative abnormal positive return of 25% during the year immediately preceding the event date. These results suggest that Senators knew appropriate times to both buy and sell their common stocks.

Regressing the calendar-time portfolio returns of the entire sample on the Fama-French three-factor model, we find that stocks purchased by U.S. Senators earn statistically significant positive abnormal returns outperforming the market by 85 basis points per month on a trade-weighted basis as a further indication that Senators use their informational advantage. That Senators use an informational advantage is additionally evidenced by the fact that the trade-weighted portfolio of purchased stocks outperforms the equal-weighted portfolio suggesting that Senators made much heavier investments in those stocks that ultimately performed best. After being sold by Senators, stocks underperform the market by 12 basis points per month on a trade-weighted basis although the abnormal returns after sale are not statistically significant. Combining the buy transactions with the sell transactions in a hedged portfolio we find that Senators outperform the market by 97 basis points (nearly 1%) per month on a trade-weighted basis. Abnormal returns from the hedged portfolio are statistically significant when we use either the CAPM or the Fama-French three-factor model. Regression coefficients of the Fama-French three-factor model suggest that Senators favor the common stocks of smaller growth firms with average market risk.

We find no reliable differences between the returns earned by Democrats and Republicans but seniority appears to be important. Senators with the least seniority (in their first Senatorial term) earn statistically higher returns than those Senators with the longest seniority (over 16 years in the Senate).

When we examine the trades on an annual basis, the return patterns of common stocks bought and sold by Senators for years 1993 through 1996 appear very similar to the patterns observed for the entire sample. However, in 1997 and 1998, we find significantly reduced trading volume and no evidence of abnormal returns.

It should be noted that these results should not be used to infer illegal activity. Current law does not prohibit Senators from trading stock on the basis of information acquired in the course of performing their normal Senatorial functions. Nor can we speculate on the magnitude of profits earned on these transactions because of limitations in the data. However, it seems clear that Senators have demonstrated a definite informational advantage over other investors although the specific source(s) and nature of that information remain unknown.

Until now, the primary focus of ethical concern with respect to legislative activity has been on campaign finance reform. Some Senators, most notably John McCain of Arizona, have expressed a strong belief that the methods currently used to fund political campaigns inherently cause agency problems. However, our results suggest that the problems may extend beyond campaign financing. Political power confers many benefits. Among those benefits are privileged access to information, the power to influence legislation, and the power to influence the application of regulatory jurisdiction by administrative agencies. It makes sense that politicians would use such powers for personal gain and also that they compete for any rents that arise from such influence. Our results are consistent with the hypothesis that such rents exist.

The results of this study warrant further investigation. Senate committees can be studied for abnormal returns and examined to determine if Senators serving on committees disproportionately invest in companies under their committee's jurisdiction. Membership on certain key committees may provide Senators with better investment opportunities than other committees. Connections between campaign contributions and common stock transactions also seem like fertile ground for further study. We recommend that the financial transactions of members of the U.S. House of Representatives, high-ranking officials of the Federal executive branch, and Federal judges should all be examined and tested in future research.

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Statement for the Record by
The U.S. Securities and Exchange Commission
Before the
House of Representatives Committee on Financial Services
Subcommittee on Oversight and Investigations

July 13, 2009

The Securities and Exchange Commission is pleased to have the opportunity to provide the Subcommittee with comments for the record in connection with the Subcommittee's hearing entitled, "Preventing Unfair Trading by Government Officials."

In light of the Commission's critical investor protection mission, we believe it is vital that all agency staff conduct themselves in accordance with the highest standards of ethical conduct in all matters concerning their personal financial holdings. The Commission's Office of the Inspector General recently issued a report in Case No. OIG-481 that identified weaknesses in the agency's compliance program. Even before that report was issued, the Commission had begun to take action to strengthen its oversight of employee securities transactions. The findings and recommendations in the report have reinforced the need for prompt action, and the Commission has responded in several ways. The steps taken by the Commission, outlined below, address and in some respects go beyond the Inspector General's recommendations.

The employees at the SEC have a well-deserved reputation for integrity and professionalism. When fully implemented, these measures will further bolster our standing by helping to prevent not only an actual impropriety, but the appearance of one as well. And these measures will ensure that the Commission's compliance program is second to none.

Strengthened Rules: We have proposed new rules governing trading by SEC employees.[1] The proposed new rules, which amend and expand the Commission's existing Rule 5, will:

- Require the pre-clearance of all trades.
- Prohibit all trading in the securities of a company under SEC investigation, regardless of whether the employee is aware of the investigation.
- Require all employees to authorize their brokers to provide duplicate trade confirmation statements to the agency.

[1] In addition to the SEC's internal rules governing trading, SEC employees also have always been and will continue to be bound by generally applicable laws prohibiting the purchase or sale of securities based on material nonpublic information.

- o Prohibit the ownership of securities in publicly-traded exchanges and transfer agents, in addition to existing prohibitions against owning securities in other firms directly regulated by the Commission.
- o Require employees to certify that they do not have any non-public information about the company whose securities they are trading.
- o Require supervisors to conduct periodic reviews of employee securities transactions and compare any transactions to the employee's work projects.

These rules were submitted to the Office of Government Ethics ("OGE") on May 22, 2009, and we are in the process of working with OGE to finalize them.

Modernized Computer Compliance System: We recently contracted with an outside firm specializing in automated compliance systems to develop a new computer compliance system for the agency. This modernized system will automate and simplify the transaction reporting process and make it easier to verify and monitor employee trading. We expect the new system to be operational within three months. Six months after the computer system is in place, we will bring on board a compliance expert to review the system and ensure the program is operating effectively.

New Chief Compliance Officer Position: We have created a new Chief Compliance Officer position to oversee the agency's compliance program. The position was posted on May 18, 2009. We have already received applications from a number of candidates for the position and begun the interview process.

Organizational Changes: The Chairman recently consolidated responsibility for the oversight of employee securities transactions within the SEC's Ethics Office and directed that additional staff resources be devoted to monitoring, reviewing, and spot-checking these transactions.

In its March 3, 2009 report, the SEC's Office of the Inspector General made eleven recommendations concerning the agency's compliance program. As we have advised the Inspector General, the steps outlined above and other actions by the Commission address each of these recommendations:[2]

1. Consolidation of responsibility for ensuring compliance with Rule 5 in one office: As discussed above, the Commission has consolidated responsibility for securities transaction monitoring and review in the Ethics Office.

[2] In addition to these eleven recommendations concerning Commission policies and practices, the Inspector General also recommended disciplinary action against two employees identified in the report. As we have advised the Inspector General, we have deferred consideration of an appropriate response to this recommendation based on what we understand to be a pending criminal inquiry by the U.S. Attorney's Office. Such a deferral ensures that any disciplinary action is consistent with the results of the U.S. Attorney's Office's review and eliminates the risk that Commission action would interfere with any criminal inquiry or be viewed as prejudging whether any criminal violation occurred. At the appropriate time, we will consider what, if any, disciplinary action should be taken.

2. Integrated computer compliance system: We have already retained an outside firm to build this system.

3. Requiring duplicate brokerage confirmations: The proposed new securities trading rules will require employees to authorize their brokers to supply the Commission with duplicate trade confirmations.

4. Requiring certification that employee does not possess non-public information: When the new compliance system is in place, employees making a trade will certify as part of the pre-clearance process that they do not possess any nonpublic information about the company whose securities they are trading. In the interim, we have amended Form 681, the employee securities transaction reporting form, to require such a certification.

5. Review of transaction reporting forms to ensure that clearance was obtained and trade was timely made: The new computer compliance system will ensure that pre-clearance is obtained and will enable the monitoring of subsequent trading activity.

6. Supervisory review of employee securities holdings: The new rules will require periodic supervisory review of employee securities transactions and comparison to the employee's work projects for any conflicts, apparent or real.

7. Spot-checks for compliance with trading rules: Once the new system and rules are in place, we will monitor all employees' compliance with trading rules on a real-time basis. This response goes beyond the recommended action.

8. Expanded training: We will conduct a thorough training program on the new rules and computer compliance system once they are in place, and we expect that this training will be consonant with this recommendation. In addition, since the Inspector General issued its report, the Chairman and the Ethics Office have both issued guidance to agency staff concerning duties with respect to securities trading.

9. Comparison of securities holding and securities transaction reporting forms to ensure accuracy: Again, once the new system and rules are in place, all employee securities transactions will be monitored on a real-time basis. This response goes beyond the recommended action.

10. Expansion of duty to file Form 450 (financial disclosure form): The new rule, coupled with the computer compliance system, will address this concern about the scope of the obligation to file financial disclosure forms by ensuring that securities transactions by all employees are recorded and monitored.

11. <u>Written policy concerning confidentiality of SEC information</u>: Our Office of General Counsel will be working with the Division of Enforcement to review our policies concerning confidential information and ensure that such information is safeguarded appropriately. In addition, the new requirements that all securities trades be pre-cleared, that no employee may trade in the securities of any company under investigation, and that every employee making a trade must certify that he or she does not possess any nonpublic information about the company at issue will address the risk of employee trading based on non-public information.

Thank you for the opportunity to submit this statement for the record. We hope that our comments will be useful to the Subcommittee.

Common Cause • Democracy 21
League of Women Voters • Public Citizen • U.S. PIRG

March 4, 2009

The Hon. Brian Baird
The Hon. Louise McIntosh Slaughter
The Hon. Timothy Walz
U.S. House of Representatives
Washington, D.C. 20515

RE: Stop Trading on Congressional Knowledge Act

Dear Reps. Baird, Slaughter and Walz:

Our organizations – Common Cause, Democracy 21, League of Women Voters, Public Citizen and U.S. PIRG – strongly support passage of the "Stop Trading on Congressional Knowledge Act" (H.R. 682), which you have taken the lead in co-sponsoring.

The legislation would prohibit members of Congress, congressional staff and other federal employees from using non-public information obtained through their official duties for personal gain in the stocks and commodities markets. It would also prohibit private individuals and firms who attempt to mine such information from public officials to use it for insider trading. This legislation is critically important as the federal government increases its regulation and oversight – and invariably insider knowledge – of prospective business opportunities of banks and financial services companies.

The Securities and Exchange Commission (SEC) does not have the authority to hold employees of Congress or the Executive Branch liable for using non-public information gained from official proceedings for insider trading. Under current law, "insider trading" is defined as the buying or selling of securities or commodities based on non-public information in violation of confidentiality – either to the issuing company or the source of information. Most federal officials and employees do not owe a duty of confidentiality to the federal government and thus are not liable for insider trading.

With the federal government assuming a far greater role over the financial services industry, the opportunity and temptation for federal employees to cash in on their insider knowledge of legislation, rules and even business trends that can have a dramatic and immediate effect on the stock market will become all the more dangerous. Members of Congress and federal employees should be required to live by effective restrictions on insider trading.

H.R. 682 also enables the public and enforcement authorities to monitor more closely whether lobbyists and other political intelligence consultants are attempting to cash in on knowledge gained from federal officials or their staff. The legislation would require for the first time that individuals and firms that make it their business to extract non-public information from officials or employees of Congress or executive branch agencies for the purpose of analyzing securities markets or guiding investment decisions must register under the Lobbying Disclosure Act (LDA). They would have to disclose to the public their clients, income and expenditures and activity that affect government policy. Similarly, members of Congress and their staffers would be required to report stock transactions of $1,000 or more within 90 days after the transaction.

This measure provides a balanced application of the laws against insider trading to both the private and public sectors and offers the important tool of disclosure for ensuring compliance with the law. H.R. 682 should be adopted by Congress before new problems arise.

Sincerely,

Common Cause
Democracy 21
League of Women Voters
Public Citizen
U.S. PIRG

Public Citizen

Auto Safety Group • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group

July 13, 2009

Contact: Craig Holman (202) 454-5182
Angela Bradbery (202) 588-7741

Insider Trading Is Illegal for the Rest of Us; It Should Be Unlawful for Congress as Well

Statement of Craig Holman, Government Affairs Lobbyist, Public Citizen

Note: A hearing on this matter is scheduled for 2 p.m. today in 2128 Rayburn by the Subcommittee on Oversight and Investigations of the House Financial Services Committee.

It's well known that insider trading is illegal. So the American public likely would be shocked to learn that it's perfectly legal for members of Congress, their staffs and other federal employees to profit from insider information gained in the course of their jobs.

That's why Public Citizen strongly supports legislation sponsored by Reps. Brian Baird (D-Wash.), Louise McIntosh Slaughter (D-N.Y.) and Tim Walz (D-Minn.) that would apply to government officials the same restrictions against insider trading that apply to the rest of us. The "Stop Trading on Congressional Knowledge Act" (H.R. 682) would prohibit members of Congress, executive officials and their staffs from using privileged information obtained through their official duties for personal gain. This legislation is critically important as the federal government increases its regulation and oversight of banks and financial services companies.

Currently, members of Congress, their staffs and other federal employees may obtain non-public information in the course of their official duties that sheds light on confidential information on the stocks and commodities markets and legally make investments based on that insider information. Lobbyists and "political intelligence consultants" have the opportunity to cash in on knowledge gained from federal officials and their staffs about the stock markets.

There is reason to fear that abuses may already be occurring. A 2004 study found that investment returns for senators were 25 percent higher than for average investors. And the most recent financial disclosure statements for members of Congress show an alarming trend of members investing in businesses and industries directly affected by Congress. A study released last week by the Center for Responsive Politics found that nearly one in four members invested in health care companies in 2007 and 2008, such as Merck, Pfizer and United Health, whose business activities are the subject of intense congressional scrutiny and whose business futures depend on pending congressional actions.

Whether members of Congress are in fact cashing in on insider information, or coincidence just makes it appear so, the damage to the integrity of the federal government is the same. The reality or appearance of congressional insider trading demands passage of H.R. 682.

With the federal government now assuming a larger role in financial services under the watchful eye of Congress, it is imperative that Congress act quickly to assure the nation that the government's involvement is solely in the public's interest.

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Public Citizen is a national, nonprofit consumer advocacy organization based in Washington, D.C.

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July 13th, 2009

The Honorable Dennis Moore
Chairman, Subcommittee on Oversight and Investigations
Financial Services Committee
U.S. House of Representatives
Washington DC, 20515

Dear Chairman Moore:

We write to offer our perspective on the Financial Services Oversight and Investigation subcommittee's hearing, *Preventing Unfair Trading by Government Officials*, and to state our support of H.R. 682, the Stop Trading on Congressional Knowledge (STOCK) Act, a bill introduced by Reps. Brian Baird (D-WA) and Louise Slaughter (D-NY). We ask that this letter be included in the record of the hearing.

Currently, members of Congress, their staff and employees of the executive branch are not subject to many of the laws against "insider trading." As Congress and the executive branch take a more active role in oversight of Wall Street and the financial services sector, this fact takes on new significance.

Insider trading, the practice of trading a company's stock or securities for personal gain by individuals with access to non-public information about the company or financial markets, is illegal in almost every industrial country in the world. With advance knowledge of a pending business transaction, investors can use this information to reap profit at the expense of those without insider details.

Currently most federal officials and employees do not owe a duty of confidentiality to the federal government and thus are not liable for trading done with information garnered in their official capacity. This ambiguity means that members of Congress, their staff and other federal employees may obtain non-public information in the course of their official duties that sheds light on the stock and commodities markets and, if they choose, use it for personal trades without repercussions.

U.S.PIRG strongly supports H.R. 682. This bill would prohibit congressional and executive branch officials and employees from using non-public information for personal gain. The bill would also prohibit private individuals and firms that attempt to mine this information from sharing or using it for insider trading. The legislation would require members of Congress and their staff to disclose stock transactions of $1,000 or more within 90 days, and require "political intelligence consultants" to register under the Lobbying Disclosure Act and disclose their financial activities.

This type of regulation is consistent with laws already in place. It is an important step to rebuild public trust in our public officials. The bill levels the fiscal playing field between public officials and those they represent.

U.S.PIRG urges you and the committee members to support this measure and address a dangerous loophole that allows federal employees to game the financial markets.

It is especially important at this time when the federal government is in the process of reining in the excesses of the financial sector, that there is no possibility of unfair advantage for elected or other public officials.

Sincerely,
Lisa Gilbert
U.S.PIRG Democracy Advocate