Testimony on "H.R. 1148, the Stop Trading on Congressional Knowledge Act"

By

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

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

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

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

Enforcement's Insider Trading Program

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

The increased number of insider trading cases has been matched by an increase in the quality and significance of our recent cases. In fiscal year 2011 and the early part of fiscal year 2012, the SEC obtained judgments in 18 actions arising out of its investigation of Galleon hedge fund founder Raj Rajaratnam, including a record $92.8 million civil penalty against Rajaratnam personally. The SEC also discovered and developed information that ultimately led to criminal convictions of Rajaratnam and others, including corporate executives and hedge fund managers, for rampant insider trading. In addition, we recently filed an insider trading action against Rajat Gupta, a former director of both Goldman Sachs and Procter & Gamble, whom we allege provided confidential Board information about both companies' quarterly earnings and about an impending $5 billion Berkshire Hathaway investment in Goldman Sachs to Rajaratnam, who traded on that information.

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

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

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

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

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

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

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

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

Law of Insider Trading

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

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

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

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

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

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

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[4] 15 U.S.C. § 78j(b).

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

[6] *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

[7] *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

[8] *Id*. at 228–29 (citation omitted).

[9] *United States v. O'Hagan*, 521 U.S. 642, 653 (1997).

[10] *Id.* at 652.

[11] *Id.*

liable for "tipping" material, nonpublic information to others who trade, and a "tippee" can be held liable for trading on such information.[12]

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

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

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

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

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

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[12] *Dirks v. SEC*, 463 U.S. at 660-62.

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

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

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

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

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

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

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

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

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

[17] H.Con.Res. 175, 85th Cong., 2d Sess., 72 Stat., pt. 2, B12 (1958).

[18] *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

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

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

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

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

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

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

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

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

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

[21] *See Dirks v. SEC*, 463 U.S. 646, 662 (1983).

[22] *Id.* at 660.

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

<u>Conclusion</u>

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

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

[24] *Gravel v. United States*, 408 U.S. 606, 616 (1972).

[25] *Id*.

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

[27] *Id*. at 624 (citing *Tenney v. Brandhove*, 341 U.S. 367, 376 (1951)).