Hearing on H.R. 1148
The Stop Trading on Congressional Knowledge Act
Before the United States House of Representatives Committee on Financial Services

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Chairman Bachus, Ranking Member Frank, and Members of the Committee: Thank you for inviting me to submit written testimony as part of your hearing on H.R. 1148, the Stop Trading on Congressional Knowledge (STOCK) Act. My name is Donna M. Nagy and I am the C. Ben Dutton Professor of Law at Indiana University Maurer School of Law in Bloomington, Indiana. I began my academic career 17 years ago at the University of Cincinnati College of Law. Before that, I practiced securities litigation as an associate at Debevoise & Plimpton in Washington, D.C. I am the co-author of two books: a treatise on the law of insider trading (with Ralph C. Ferrara and Herbert Thomas) and a casebook on Securities Litigation and Enforcement (with Professors Richard W. Painter and Margaret V. Sachs). I have also published several law review articles on insider trading, including a 58 page article on the precise topic of today's hearing.[1]

The article sought to debunk what at the time was bordering on urban myth: that Congress had somehow exempted itself from a federal statute that outlaws insider trading by all those outside of the Capitol. Indeed, while the current catalyst is *60 Minutes*' recent claim that congressional insider trading is "perfectly legal," a similar hullabaloo occurred more than a year ago after the *Wall Street Journal* asserted that legislative staffers could legally profit from the use of congressional knowledge because Congress was purportedly "immune from insider-trading laws."

Congress in no way has sought to immunize or exempt itself. Beyond that, my article concluded then, and I continue to say with confidence now, that congressional insider trading in securities violates the broad anti-fraud provisions in federal securities law as well as the federal mail and wire fraud statutes. Thus, congressional insider trading is already illegal under existing law. I acknowledge, however, that many distinguished securities law scholars see shades of gray in existing law,[2] and at least one

[1] Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 BOSTON UNIV. L. REV. 1105 (2011).

[2] See, e.g., DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION § 3.09 (2011) (observing that the issue "raises difficult constitutional and political questions"); Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows*?, 26 YALE J. ON REG. 89, 107 (2009) (maintaining that although a plausible theory exists that

such scholar has concluded that "the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted."[3]

With my testimony, I hope to accomplish three things. The first is to provide a brief snapshot of existing insider trading law and where members of Congress stand in relation to that law. As I hope to show, sometimes applying that law to Representatives and Senators is reasonably straightforward, while other times it is less so. The second is to analyze the STOCK Act and to highlight some significant – but readily fixable – problems with its present formulation. The third is to show why fixing those problems, although crucial to do, does not go far enough. What we need, in my opinion, is legislation that offers a definition of insider trading that is applicable to everyone, or at a minimum ensures that the same anti-fraud prohibition will be applied to everyone. Congress has already done work on this issue that brings us almost to the finish line. I will show the feasibility of crossing the finish line and the vital importance of doing so.

A Brief Snapshot of Existing Insider Trading Law

The controversy surrounding the application of existing law to Members of Congress and their staff stems largely from the fact that Congress has never enacted a federal securities statute that explicitly prohibits *anyone* from insider trading. Rather, since the 1960s, when the Securities and Exchange Commission (SEC) first began to initiate enforcement actions for securities trading on the basis of material nonpublic information, the offense of insider trading has typically been prosecuted as a violation of Rule 10b-5, a general antifraud rule which the SEC promulgated nearly seventy years ago pursuant to the congressional grant of rulemaking authority in Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act). Rule 10b-5 broadly prohibits fraud "in connection with the purchase or sale of any security." The Department of Justice also prosecutes insider trading as a criminal violation of either Rule 10b-5 or the federal statutes prohibiting mail fraud and wire fraud, 18 U.S.C. §§ 1341 and 1343. Thus, in the vast majority of instances, insider trading is illegal only insofar as it can be deemed a fraudulent act or practice.[4] The explicit statutory ban on insider trading, which operates in nearly every other country with a developed securities market, is entirely absent in U.S. securities law.

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

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

[4] When insider trading involves material nonpublic information pertaining to a tender offer, a special insider trading rule applies. Once "a substantial step" toward a tender offer has been taken, Rule 14e-3(a) prohibits trading by any person in possession of material nonpublic information relating to that tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (2010). Accordingly, the government can establish liability for insider trading under Rule 14e-3(a), even if it cannot prove the breach of a fiduciary-like duty of disclosure.

Consequently, our federal courts, through their interpretation of Exchange Act Section 10(b) and Rule 10b-5, have largely shaped the contours of the federal prohibition of insider trading. To be sure, in 1984 and then again in 1988, Congress amended the Exchange Act to authorize stiff monetary penalties and long prison terms when a civil or criminal prosecution establishes a Rule 10b-5 violation by a person who has traded securities based on material nonpublic information. But Congress has left the formidable task of defining fraudulent insider trading to the SEC and federal courts, with the U.S. Supreme Court as the final arbiter, subject to a legislative override by Congress. The end result takes the form of two complementary theories of insider trading liability: a classical theory and a misappropriation theory. Although these theories can be set out and described in a few sentences, they have resulted in an insider trading jurisprudence that is extraordinarily complex and frequently criticized for its ambiguity and indeterminacy.[5]

The classical theory, which the Supreme Court established in 1980 and reaffirmed three years later, regards insider trading as a fraud on the parties to a securities transaction, when those parties trade with a person who remains silent about material nonpublic information in breach of a fiduciary-like disclosure duty. *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983). Pursuant to this theory, persons who owe fiduciary-like duties of trust and confidence to an issuer's shareholders must either disclose all material nonpublic information in their possession or abstain from trading in the issuer's shares. The failure to "disclose or abstain" in such transactions constitutes a violation of Rule 10b-5.

More than a decade later, in *United States v. O'Hagan*, 521 U.S. 642 (1997), the Court endorsed an alternative approach for determining whether insider trading constitutes a fraud in violation of Rule 10b-5. Under the "misappropriation theory," a fraud occurs when a person owing a fiduciary-like duty to the source of material nonpublic information misappropriates that information by secretly using it to reap personal profits. The misappropriation theory thus focuses on the relationship of trust and confidence that exists between the securities trader and the source of the material nonpublic information and regards the source as the person who is defrauded in connection with the securities transaction.

[5] See, e.g., Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883 (2010) (observing that there are "hundreds of decisions grappling with the issue" of whether an insider trading defendant engaged in fraud within the meaning of Rule 10b-5, and that "[m]any of these decisions are confusing and inconsistent with one another"); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1498 (1999) ("[T]he SEC's dysfunctional regulatory strategy brings to mind unpleasant images of Cinderella's stepsisters who each chopped off portions of a foot in order to stuff the foot into Cinderella's shoe."); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that "the legal restrictions on trading securities while in possession of material nonpublic information are confused and confusing," and emphasizing that the "case law contains logical as well as interpretive flaws").

The Supreme Court has also ruled unanimously on two occasions that insider trading can constitute a criminal violation of the federal mail fraud or wire fraud statutes. As the Court in *Carpenter v. United States*, 484 U.S. 19 (1987) explained, "[t]he concept of fraud includes the act of embezzlement, which is the fraudulent appropriation to one's own use of [property] entrusted to one's case by another." *Id*. at 27. *Carpenter* further clarified that the "intangible nature" of material nonpublic information "does not make it any less 'property' protected by the mail and wire fraud statutes." *Id.* at 24. The Court therefore affirmed the Second Circuit's judgment that the mail and wire fraud statutes had been violated by a reporter and those who received his tips in a trading scheme involving the pre-publication use of material nonpublic information belonging to the reporter's employer, the Wall Street Journal. Nearly a decade later, *Carpenter*'s fraud holding was reaffirmed in *O'Hagan*, when the Court concluded that an attorney's undisclosed self-serving use of material nonpublic information for securities trading purposes defrauded his law firm and its client of the exclusive use of their property within the meaning of the federal mail fraud statute.[6]

Few securities law scholars would dispute the broad and malleable nature of Rule 10b-5's misappropriation theory, which captures conduct by "outsiders" who lack any duty or connection to the issuer's shareholders.[7] Nor is there any serious question as to whether the misappropriation theory can be applied to persons who owe duties of trust and confidence to the source of misappropriated information, even if the requisite relationship fails to qualify as a "paradigmatic fiduciary relationship," such as those involving employers-employees, principals-agents, or clients-attorneys. Indeed, the Supreme Court has never implied – let alone stated – that a relationship has to be strictly a "fiduciary" one for a disclosure duty to attach under the misappropriation theory. Rather, in *Chiarella*, *Dirks*, and *O'Hagan*, the Court used the term "fiduciary duty" interchangeably with "a duty of trust and confidence."

Over the last decade, the SEC and Justice Department have cast a tremendously wide net in Rule 10b-5 investigations premised on the misappropriation theory. In such prosecutions, the government's ability to satisfy its burden was facilitated considerably after 2000, when the SEC promulgated Rule 10b5-2.[8] Rule 10b5-2(b) sets out a list of

[6] The Court found that its ruling under Rule 10b-5 required it to vacate the circuit court's judgment reversing O'Hagan's conviction on the mail fraud count as well, because both convictions were predicated on the attorney's fraudulent misappropriation of intangible property. See *O'Hagan*, 521 U.S. at 652 (emphasizing that misappropriators "deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal").

[7] That said, such scholars engage in rigorous debate as to whether such elastic interpretations of anti-fraud provisions should be heralded or scorned.

[8] SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2. The SEC promulgated this rule in partial response to *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), a decision that adopted what the SEC regarded as an unduly narrow interpretation of the "trust and confidence duty" in the context of a spousal relationship. See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,863 (Dec. 20, 1999) ("[T]he *Chestman* majority's

three *non-exclusive* situations in which a person shall be deemed to have a “duty of trust or confidence” for purposes of the misappropriation theory:

> (1) Whenever a person agrees to maintain [that] information in confidence;
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> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
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> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential.[9]

Thus, when a court is confronted with a relationship that is not quintessentially fiduciary-like, most courts will look to the “reasonable and legitimate” expectations of the source of the material nonpublic information.

Based on such *ad hoc* inquiries, Rule 10b-5 liability has been imposed in misappropriation cases involving:

- family members and other persons who traded on information misappropriated from their relatives and friends (including in family relationships more remote than spousal, parent-child, and siblings);
- participants in private placements who traded securities in the public markets based on the confidential information to which they were given access;
- an electrician who traded on information that he overheard while at a company repairing its wiring;
- a member of a business roundtable who traded on information conveyed by a fellow member;
- a businessman who traded on information entrusted to him by his business partner;
- a bank that traded corporate bonds based on nonpublic information obtained through service on six bankruptcy creditors’ committees;
- a juror who tipped confidential information obtained from his service on a grand jury; and
- a governmental affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department.[10]

In all of these instances, and in dozens of other prosecutions falling outside of ordinary fiduciary categories, the linchpin has been a securities trader (or tipper) who breached a

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approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.”).

[9] Id., § 240.10b5-2(b)(1)-(3).

[10] Specific cites to these examples can be found in Nagy, *supra* note 1, at 1120-21.

duty of entrustment by secretly profiting from the use of material nonpublic information that rightfully belongs to somebody else. And while that linchpin might not be readily apparent from the facts of all of these cases (as I have observed in my scholarship),[11] the SEC and Justice Department have proven themselves quite adept at convincing courts to find the type of "feigning fidelity" that, under *O'Hagan*, is "essential" to liability under the misappropriation theory.[12]

Application of Existing Law to Members of Congress

Based on the foregoing summary of existing law, I will focus my analysis on its application to Members of Congress. I note that even scholars who question whether existing law applies to Representatives and Senators are quick to conclude that legislative staffers and other congressional employees are liable for insider trading based on the well-established employer-employee misappropriation theory precedents. For Members of Congress, however, their employee status is far more complicated because case law conflicts as to whether Representatives and Senators actually constitute "employees" of the federal government. Therefore, a court presented with a prosecution of a Member of Congress could not simply use the employment heuristic to find the existence of a relationship of trust and confidence for purposes of insider trading liability.

Rather, as in all other insider trading cases falling outside of paradigmatic fiduciary relationships, a court would have to decide whether the defendant – in our case an individual Member– owed a duty of trust and confidence to either the investors with whom she traded or to the source of the material nonpublic congressional knowledge. As with all other insider trading cases falling outside traditional paradigms, the analysis would necessarily be *ad hoc*. It could depend on criteria that reflect the Member's status as a Representative or Senator, or the "reasonable and legitimate expectations" of the particular persons communicating the information to the individual Member.

In view of the substantial number of cases holding the insider trading prohibition applicable to relationships that are by no means ordinary fiduciary ones, I very much doubt that a federal court would have the temerity to conclude as a matter of law that a Member of Congress lacks a duty of "trust and confidence" for purposes of the

[11] See Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009) (discussing instances where federal courts have arguably stretched too far the relationship of trust and confidence parameters originally drawn by the Court in *Chiarella*, *Dirks*, and *O'Hagan*).

[12] That is not to imply that the government always emerges victorious in ligation. In addition to the Second Circuit's en banc decision in *Chestman*, *supra* note 8, see United States v. Cassese, 273 F. Supp. 2d 481 (S.D.N.Y. 2003) (emphasizing that the business competitors were "not inherent fiduciaries, but rather potential arms-length business partners . . . [who] did not have a long-standing relationship or . . . regularly shared confidences") and United States v. Kim, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (holding that a member of the Young Presidents Association, a national organization of company presidents under the age of fifty, did not owe a duty of trust and confidence to fellow club member). See also SEC v. Cuban, 634 F. Supp. 2d 713, 724 (N.D. Tex. 2009) (dismissing complaint and holding that Rule 10b5-2(b)(1) is invalid and unenforceable insofar as it predicates liability on a defendant's mere agreement to maintain information in confidence), vacated and remanded on other grounds, 620 F.3d 557 (5th Cir. 2010).

misappropriation theory. Given the Constitution's repeated reference to public offices being "of trust," and Members' oath of office to "faithfully discharge" their duties, I would predict that a court would be highly likely to find that Representatives and Senators owe fiduciary-like duties of trust and confidence to a host of parties who may be regarded as the source of material nonpublic congressional knowledge. Such duties of trust and confidence may be owed to, among others:

- the citizen-investors they serve;
- the United States;
- the general public;
- Congress, as well as the Senate or the House;
- other Members of Congress; and
- federal officials outside of Congress who rely on a Member's loyalty and integrity.

Moreover, precedent tells us that such duties of trust and confidence are both bona fide and enforceable through each Chamber's own constitutionally specified authority to punish its Members, as well as through prosecutions by the Executive Branch under criminal and civil statutes. For example, in connection with conduct involving kickbacks or bribes, the Justice Department has prosecuted congressional officials for mail or wire frauds that deprive the United States and the public of its right to honest services, and these prosecutions are premised on a Member's breach of a fiduciary duty of loyalty.[13] Thus, while Members of Congress may constitute a class that is *sui generis*, that class has been found to owe the public the same duties of trust and loyalty that the public expects from other government officials.

As with all insider trading cases, when the person prosecuted is a Member of Congress, one can envision both reasonably straightforward cases as well as cases that are more factually complex. In my view, a relatively straightforward case falling well within the misappropriation theory of Rule 10b-5 and the federal mail and wire fraud statutes involves a Representative who learns from a Committee Chair that an aircraft manufacturer will be receiving a multi-million dollar defense contract in an

[13] See HEARING ON RESTORING KEY TOOLS TO COMBAT FRAUD AND CORRUPTION AFTER THE SUPREME COURT'S *SKILLING* DECISION BEFORE THE SENATE JUDICIARY COMMITTEE, September 28, 2010 (written statement by Lanny A. Breuer, Assistant Attorney General, Criminal Division, Department of Justice) (stating that for decades, federal prosecutors have used the mail and wire fraud statutes to reach "schemes designed to *deprive citizens* of the honest services of public and private officials who owe them *a fiduciary duty of loyalty*" and observing that some of these prosecutions and convictions have involved members of Congress) (emphasis added). See also *United States v. Jefferson*, 562 F. Supp. 2d 719, 721 (2008) (denying motion to dismiss counts of indictment charging then-Congressman William Jefferson with "a scheme to defraud and deprive American citizens of their right to [his] honest services by taking bribes . . .in return for [his] performance of various official acts" and concluding that these "honest-services fraud" counts were not unconstitutionally vague). Although the Supreme Court recently held that the Due Process Clause requires 18 U.S.C. § 1346's prohibition of honest-services fraud to be read narrowly, the Court made clear that bribe and kickback cases continue to fall within the statute's constitutional scope. Skilling v. United States, 130 S. Ct. 2896 (2010).

Appropriations bill. If that Representative were to buy shares of stock in the aircraft manufacturer based on that material nonpublic information, that Representative would be misappropriating that information for his own personal benefit, and in the absence of disclosure about his intent to trade, he would be deceiving and defrauding multiple sources of that information, including: the United States and the public, Congress and the House of Representatives, and/or the fellow Member (the Chairman of the Committee) who conveyed that information with a reasonable and legitimate expectation of confidentiality.[14] Likewise, if the Representative had learned similar defense contract type information from a federal official outside of Congress, for example, the Secretary of Defense, the prosecution should also be relatively straightforward. Here, the Representative's stock purchases would still constitute a fraud and deceit on the United States and the public, and/or on Congress and the House of Representatives, but instead of a fellow Member, the Representative's undisclosed securities trading based on his nonpublic knowledge would likely deceive and defraud the Secretary of Defense who entrusted him with the information.

For a court to conclude otherwise and foreclose misappropriation theory liability, it essentially would have to view the nonpublic congressional knowledge pertaining to the defense contract award as a perk of office belonging to the individual Representative to do with as he wished. Such a view would be strikingly inconsistent with the tenets of a representative democracy. It would be at odds with the high ethical conduct Americans expect. It also would contradict a provision in the Code of Ethics for Government Service, which specifies that all Government employees, including officeholders, should "never use any information coming to him confidentially in the performance of government duties as a means for making personal profit."[15]

A more factually complex case could involve a Representative who realizes that with her own vote, sufficient support exists to pass legislation that would result in an aircraft manufacturer's receipt of a multi-million dollar defense contract. Here the congressional knowledge that motivates the purchase of an issuer's stock would have been gleaned from the Representative's own legislative activity. But even then, the material nonpublic information pertaining to how her vote is likely to affect a legislative outcome should not be viewed as "belonging" individually to her, just as a corporate board member's knowledge of her own vote in an upcoming board meeting would not allow that board member to trade securities based on the meeting's anticipated outcome. Both the Representative and the board member would be, in the words of the Supreme

[14] There is also a compelling argument that could be made for this Representative's liability under Rule 10b-5's classical theory: as a person who owes duties of trust and confidence to the general public (including at least some of the aircraft manufacturer's shareholders on the other side of his trades), the Representative would violate Rule 10b-5 were he to purchase stock while remaining silent about material nonpublic facts pertaining to the imminent award of a multi-million dollar defense contract.

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

Court, "tak[ing] advantage of information intended to be available only for an [institutional] purpose and not for the personal benefit of anyone." *Dirks*, 463 U.S. at 654.

Although a member of Congress has never been prosecuted for insider trading based on nonpublic congressional knowledge, the Justice Department has used the federal mail and wire fraud statutes to successfully prosecute congressional officials for deceiving and defrauding the United States and the public through the undisclosed misappropriation of congressional funds and tangible property. For example, in affirming former Congressman Charles Diggs's conviction under the mail fraud statute, the D.C. Circuit concluded that the Congressman's conduct "amounted to no less than a scheme to take illicit kick-backs" and that this scheme "defrauded the public of not only substantial sums of money but of his faithful and honest services." *United States v. Diggs*, 613 F.2d 988, 998 (1979). The Justice Department also used the federal mail and wire fraud statutes to prosecute former Congressman Daniel Rostenkowski for "a scheme to defraud the United States of its money, its property, and its right to [his] fair and honest services" in connection with alleged staff salary kickbacks, misappropriation of goods worth over $40,000, and misappropriation of funds by exchanging stamp vouchers for cash.[16]

Given that congressional funds and tangible property are deemed to "belong" to the United States and the public, and given the Supreme Court's clear dictate that that the "intangible nature" of material nonpublic information does not render it "any less property," it is difficult to see how a court could reject the SEC or Justice Department's claim that Rule 10b-5 is violated by a Member's undisclosed self-serving use of material nonpublic congressional knowledge.[17] To be sure, this analysis assumes that the government would be able to prove that the information was material, nonpublic, and, in fact, was used with scienter by the Member in deciding to trade securities -- and many practical and constitutional obstacles could stand in the way of prosecutors as they attempt to gather evidence to make this showing. But such practical and constitutional obstacles would be present in any criminal or civil prosecution involving a Member of Congress, even prosecutions brought pursuant to an express statutory insider trading prohibition such as the one proposed in H.R. 1148's STOCK Act, to which I shall now turn.

The Legislative Response

H.R 1148's proposed STOCK ACT seeks to explicitly proscribe insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and

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[16] See United States v. Rostenkowski, 59 F.3d 1291, 1294 (D.C. Cir. 1995) (rejecting arguments that the Speech or Debate Clause and the Rulemaking Clause stood as an absolute bar to the 17 count indictment).

[17] Moreover, if pressed to speculate, I would go so far as to predict the SEC or Justice Department's ultimate success at the Supreme Court. Although the Court can be expected to read Rule 10b-5 quite narrowly in the context of private securities litigation (particularly in fraud-on-the-market lawsuits), the Court has embraced a decidedly broader interpretation in circumstances where the government has urged it to preserve the SEC or Justice Department's Rule 10b-5 enforcement authority.

other federal employees. I applaud and endorse the motivation behind this proposed legislation. At the same time, I believe that there are a number of immediate changes to the text of the STOCK Act that would vastly improve its efficacy.

First and foremost, the language in the bills should clarify that the Act does not constitute the exclusive insider trading prohibition applying to Members of Congress and legislative staffers. Without such clarification, there is a very real risk that the STOCK Act could be read to displace the application of Rule 10b-5 and the mail and wire fraud statutes regarding instances of congressional insider trading. This risk is particularly troubling because, as I read H.R. 1148, the bill fails to reach a host of hypothetical situations involving congressional insider trading that would almost certainly fall within this existing law.

Much of the under-inclusiveness stems from H.R. 1148's language authorizing the SEC to proscribe congressional insider trading only when the material nonpublic information pertains to "pending or prospective legislative action" relating to "such issuer" – that is, the issuer of the particular securities which were traded. But Members of Congress and legislative staffers routinely possess all sorts of material nonpublic information that do not relate to any "pending or prospective legislative action," such as information conveyed in confidential briefings by federal officials outside of Congress, including those conducted by Cabinet and sub-cabinet officials and those conducted by independent regulatory agencies. Thus, while SEC rules promulgated under the STOCK Act would reach a Representative who buys stock in an aircraft manufacturer based on information pertaining to a not-yet publicly announced multi-million defense contract in an Appropriations bill, those rules would likely fail to reach that same Representative if he learned of a multi-million dollar defense contract through a confidential informational briefing by the Secretary of Defense.

Likewise, the STOCK Act would not seem to prohibit a Representative, in possession of information pertaining to a "pending or prospective legislative action" that related to one issuer, from using that information to purchase securities in an altogether different issuer whose business could be affected by a positive or negative legislative development. For example, the STOCK Act likely would not reach a Representative who learned that Boeing would be receiving a multi-million dollar defense appropriation, but then shorted Lockheed Martin stock based on that material nonpublic congressional knowledge.

A third example of under-inclusiveness concerns the bill's failure to explicitly prohibit Members of Congress and legislative staffers from tipping others about material nonpublic information. Under existing law, to establish Rule 10b-5 liability on the part of a congressional official for tipping material nonpublic information (as opposed to trading on that information herself), the government would have to show that the official breached a duty of loyalty for some "direct or indirect personal benefit . . . such as a pecuniary gain or a reputational benefit" or that the official intended to make "a gift of confidential information to a trading relative or a friend." *Dirks v. SEC*, 463 U.S. 646, 659 (1983). The STOCK Act, however, only authorizes the SEC to prohibit tippee trading. Thus, any liability on the part of a Member of Congress or legislative staffer for self-interested tipping would have to be inferred from the statutory ban on tippee trading (a ban that, as it is currently drafted, extends far beyond the tippee-trading prohibition under existing law).

In short, STOCK Act provisions such as these would actually create gaps that do not exist under current law. And if these express statutory provisions were interpreted to displace application of Rule 10b-5 and the federal mail and wire fraud statutes, then congressional enactment of the STOCK Act would constitute an unfortunate step backward. In the name of Congressional accountability, it would actually demand less of Members and legislative staffers than existing law requires.

But a mere fix to those drafting problems, although crucial to do, would not go far enough. H.R. 1148 strives to send the public an important message: that Senators, Representatives, and legislative staffers should not operate under a different set of rules, but should instead be treated the same as all other investors who trade securities in the capital markets. Unfortunately, the statutory prohibition in H.R. 1148 risks sending an alternative message that is antithetical to the principle of uniform application: Such an explicit statutory prohibition could imply that Rule 10b-5's fiduciary-focused anti-fraud prohibition is hopelessly vague and uncertain as it applies to Congress and federal employees, and hence must be corrected, but that such vagaries and uncertainties are acceptable for all others who trade in the capital markets.

There is, however, an alternative approach that would accomplish H.R. 1148's worthy goal – and more – without creating the anomalous and potentially harmful situation of an explicit statutory definition of insider trading for Congress and federal employees, but none for anyone else. On several past occasions, Congress has sought to bring greater coherence, legitimacy, and predictability to the law of insider trading through the enactment of an express statutory definition and prohibition that would apply to all securities traders. The most promising attempts at legislation were untaken in the period preceding the enactment of the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Congress, however, ultimately decided against any explicit statutory prohibition because, in its view, "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."[18]

Yet, these "court-drawn parameters of insider trading" have not proven to be particularly effective when applied to some *nontraditional* insider trading cases. Such

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

cases include those involving trading by non-fiduciary thieves (such as computer hackers who manage to gain access to confidential information), brazen fiduciaries (who make full disclosure before trading on information misappropriated from their principal and thereby obviate a finding of fraud), and persons who are not in any sense fiduciaries, but who nonetheless may fall within Rule 10b5-1(1)'s prohibition because they are alleged to have breached an arm's-length promise to maintain information in confidence (such as the case involving the governmental affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department, or the case against Mark Cuban, referenced *supra* at footnotes 10 and 12). Moreover, these "court-drawn parameters of insider trading" may not be applied uniformly in cases where there is reason to doubt the fiduciary-like bona fides in a particular relationship (such as in many misappropriation cases involving business associates, family members, and friends, or in the case involving the electrician, discussed *supra*). Indeed, as Professor Thomas Hazen reminds us, without explicit legislation, courts will have no choice but to continue muddling through "the tortuous path of Rule 10b-5 liability for insider trading."[19]

Thus, rather than addressing one manifestation of the problem through a legislative effort such as H.R. 1148, Congress could use this current controversy to diagnose and treat the entire malady through the enactment of an express statutory definition and prohibition of insider trading. For example, the proposed Insider Trading Proscription Act of 1987 would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a "person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."[20] Much could be gained from dusting off that proposal and reconsidering it in light of the insider trading jurisprudence that has developed over the last 25 years. Then, as part of this general statutory overhaul, Congress should consider addressing the particular issue of congressional insider trading by including a separate provision in the new statute that would expressly prohibit securities trading based on material nonpublic information learned in the course of congressional service.

Even if Congress is not prepared to take on the task of a general statutory overhaul, there are several legislative responses that would be vastly superior to the lengthy and complicated provisions in H.R. 1148. For example, just last week in hearing testimony on two STOCK Act proposals before the Senate Committee on Homeland

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[19] Hazen, *supra* note 5, at 889.

[20] The Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong. (1987), reprinted in *SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep (BNA) 1817 (Nov. 27, 1987). The statutory definition of "wrongful" extended to information that "has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship." *Id.*

Security and Governmental Affairs, Professor John Coffee suggested a single sentence statutory prohibition declaring in essence "that a Member of Congress is a fiduciary for purposes of insider trading liability, and that no personal benefit or deceptive act is required to establish liability." Professor Donald Langevoort proposed an alternative route to an effective congressional insider trading prohibition that would conform with the anti-fraud prohibition applied to the rest of the investing public. I then suggested a variation on that route: Congress could instruct the SEC to add a new fourth subsection to the three nonexclusive situations already set out in existing Rule 10b5-2(b) – a new fourth subsection specifying that for purposes of the misappropriation theory, a duty of trust and confidence exists whenever a person is a Member of Congress, federal official, or federal employee and that person has learned material nonpublic information in the course of his or her governmental service. All three of these alternatives would allow Congress to rely substantially on existing case law, but would make unmistakably clear that congressional insider trading constitutes a violation of federal law.

Conclusion

H.R. 1148 would explicitly ban some instances of insider trading in securities and security-based swaps by Members of Congress, legislative staffers, and other federal employees. But the proposed STOCK Act would not do anything to clarify the uncertainty for the millions of other investors who must continue to look to the vicissitudes of a fiduciary-focused anti-fraud prohibition to determine the legality – or illegality – of securities trading based on material nonpublic information.

The record must be made clear that Rule 10b-5 and the federal mail and wire fraud statutes do indeed apply to insider trading by Members of Congress and legislative staffers. The current controversy can then serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. Although H.R. 1148 should receive thoughtful consideration in the weeks and months ahead, congressional attention to insider trading in securities should not end there. Instead, these hearings should initiate a serious conversation that could result in a statutory overhaul of the federal law of insider trading. A generally applicable statutory prohibition of insider trading would clarify and simplify the law for all those who trade securities in our capital markets -- from Members of Congress right on down to electricians, business associates, and friends.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Donna M. Nagy	**2. Organization or organizations you are representing:** N/A
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** ☐ Yes N/A ☐ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Donna M. Nagy	

Please attach a copy of this form to your written testimony.