COMMENT

CASHING IN ON CAPITOL HILL: INSIDER TRADING AND THE USE OF POLITICAL INTELLIGENCE FOR PROFIT

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Government officials have recently been scrutinized for using information acquired in the performance of their official duties to gain market-trading advantages. Lobbyists have similarly been criticized for collecting material nonpublic political information from Capitol Hill contacts and selling it to their clients—notably hedge funds—who presumably use the information in their market transactions. Is this insider trading? Most likely not. Should it be? A few members of Congress have responded by introducing legislation in the past three Congresses that would bring trading on this "political intelligence," by government insiders and outsiders, under the umbrella of the federal securities laws. Unsurprisingly, the legislation has failed to garner significant political support. But a renewed fervor for "cleaning up" Washington ushered in by the Obama Administration, coupled with the current economic crisis, has reinvigorated the campaign. The legislation was reintroduced and received a hearing in 2009. In addition, recent academic scholarship is now calling for the passage of this legislation in order to bring trading on political intelligence under the federal insider trading regime.

This Comment takes issue with the insider trading approach. It argues that the federal securities laws are an inappropriate and ineffective legal mechanism for remedying issues of political ethics. First, as it pertains to govern-

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ment insiders, this Comment recommends an ethics approach, such as mandatory blind trusts, to deal with financial conflicts of interest. Second, with gard to outside actors, such as lobbyists and hedge funds, it argues for public disclosure of political-intelligence gathering activities. This Comment argues against prohibiting trading on political intelligence by outside actors because these actors are merely the Washington equivalents of market analysts, whose information gathering functions are perfectly legitimate, if not desirable. Lastly, this Comment warns that insider trading regulation of political intelligence would have two distinct chilling effects: one on democratic process, by hampering dialogue between lawmakers and constituents, and another on market efficiency, by discouraging valuable information gathering.

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INTRODUCTION

On Tuesday, November 15, 2005, day traders grew perplexed by irregular price fluctuations in USG Corporation's stock.[1] USG stock was trading at double its normal volume and gained $2.12 to close at $61.55.[2] USG was not alone. W.R. Grace and Crown Holdings—companies like USG that had used asbestos materials in manufacturing and that had been mired in litigation for years—experienced simi-

[1] *See* Eamon Javers, *Washington Whispers to Wall Street*, BUSINESSWEEK, Dec. 26, 2005, at 42 (discussing the confusion among day traders regarding increased trading of USG Corporation stock despite a lack of public news that would typically spur such activity).

[2] *Id.*; *see also* Press Release, Congressman Brian Baird, Reps. Baird and Slaughter Introduce Legislation to Prohibit Insider Trading on Capitol Hill (May 16, 2007), *available at* http://www.house.gov/list/press/wa03_baird/stockact.html ("On November 15, 2005, the stock of a building materials company in Chicago (USG Corp) suddenly doubled, despite the fact that there was no publicly available news about the company, or industry, which explained the increase in volume.").

lar irregular gains.[3] At the same time, stock prices of peer companies in the same sector remained flat, as did the market as a whole.[4]

The following day, Senate Majority Leader Bill Frist delivered news promising a full Senate vote on a bill that would create a $140 billion government-backed trust fund for liability claims against asbestos-using manufacturers.[5] The announcement marked a great advance for the legislation, which had been on Congress's agenda for four years and had previously made little progress.[6] A full Senate vote was welcomed by shareholders of affected companies, as asbestos-related litigation had plagued hundreds of companies that had once used asbestos in their manufactured goods.[7] The legislation therefore had broad market implications for affected companies. One Washington lobbyist noted that "[e]very advancement or setback and every hint of activity on the bill had a direct impact on this small but well-defined group of companies."[8] To demonstrate the market effects of an asbestos-liability trust fund, when the Senate Judiciary Committee gave its approval to a similar bill in 2003, USG's share price immediately rose by 8.3%, W.R. Grace's by 7.9%, and Georgia-Pacific's by 9.2%.[9]

Senator Frist's announcement, coupled with the irregular trading that had preceded it, drew suspicion.[10] Senator Frist, who as Majority

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[3] Brody Mullins & Kara Scannell, *Hedge Funds Hire Lobbyists to Gather Tips in Washington*, WALL ST. J., Dec. 8, 2006, at A1.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *See id.* ("For 30 years, manufacturers, trial lawyers, insurers and labor unions have been fighting over how to deal with more than 700,000 Americans who contended they got cancer from exposure to asbestos. The lawsuits clogged U.S. courts and cast uncertainty over hundreds of U.S. companies that once used asbestos in their products. Dozens of companies filed for bankruptcy due to their asbestos liabilities.").

[8] *See id.* (quoting Elliott Portnoy, an attorney with Sonnenschein Nath & Rosenthal LLP, who was hired to lobby against the asbestos legislation "on behalf of investors in a manufacturer that declared bankruptcy because of asbestos liabilities").

[9] Jim Snyder, *K Street Phones Wall Street: Political Inside Info for Hedge Funds Moves Stock Prices*, HILL, Feb. 15, 2005, at 1, *available at* LEXIS.

[10] *See* Mullins & Scannell, *supra* note 3 ("SEC officials asked preliminary questions about how the information could have leaked. But the agency hasn't yet followed up with Mr. Frist's office or with the Senate lawyer . . . ."); John Byrne, *Democrats Want Ethics Committee to Probe 'Day Trading' Allegations*, RAW STORY, Jan. 19, 2006, http://www.rawstory.com/news/2005/Democrats_want_ethics_committee_to_probe_0119.html ("House Democrats are pushing the ethics committee to investigate allegations of congressional offices providing privleged [sic] information to Wall Street investors."); Interview by Air Am. Radio, The Majority Report, with Representative Louise Slaughter (Jan. 18, 2006) ("'I'm going to track this down, I know it's true,' Slaughter told us, 'that Frist, DeLay and probably others had some day traders working out of

Leader had discretion to schedule full Senate votes, had been careful to keep his intentions quiet.[11] Nevertheless, in the two days prior to the public announcement, share prices of USG increased 5.4%, W.R. Grace jumped 4.2%, and Crown Holdings grew by 3.2%.[12] The positive market reaction to the trust-fund approval by the Senate Judiciary Committee in 2003 indicated that the market would react positively again this time.[13] But this time the bounce occurred prior to the public announcement.

The legislation eventually died the following February when it failed to receive the sixty-member vote needed "to waive a budget objection raised about the legislation."[14] The episode, however, left many questions surrounding the irregular trading that occurred prior to the official announcement of the full Senate vote: How did material nonpublic political information find its way to the market? Through whose lips did the information pass? And for whose benefit?

The asbestos-announcement leak has been credited to the discreet and virtually unknown Washington practice of "political intelligence" gathering.[15] Fueled primarily by hedge funds, K Street lobbyists (in-

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their offices.'"), *as quoted in* Posting of Josh Orton to Daily Kos, Insider Trading in Frist and Delay's [sic] Office: Story Growing, http://www.dailykos.com/story/2006/1/19/17445/7449 (Jan. 19, 2006).

[11] Mullins & Scannell, *supra* note 3. Senator Frist's staff reported that they were careful not to tell many people of the Senator's plans "because they wanted their boss to make a splash." *Id.* An advance copy of the announcement was given to the Reuters news service on the evening prior to the speech, but Reuters was told that the announcement could not be published until the morning of the speech. *Id.* Additionally, Senator Frist conveyed the information to the bill's sponsor, Senator Arlen Specter. *Id.*

[12] *Id.* These increases were "more than competitors in their respective sectors." *Id.* Additionally, during this time the Dow Jones Industrial Average remained "essentially flat." *Id.*

[13] The market, however, did not respond with the expected optimism. On the Wednesday of Senator Frist's speech, USG prices remained flat, W.R. Grace decreased by 0.6%, and Crown Holdings rose 2.3%. *Id.* One possible explanation is that, by the time of the Wednesday announcement, the market had already adjusted to reflect the leaked information.

[14] Stephen Labaton, *Asbestos Bill Is Sidelined by the Senate*, N.Y. TIMES, Feb. 15, 2006, at C1.

[15] *See* Javers, *supra* note 1, at 42 ("But the news got to key Wall Street players a day early via a little-known pipeline: a small group of firms specializing in 'political intelligence' that mine the capital for information and translate Washington wonkspeak into trading tips."); Press Release, Congressman Brian Baird, Rep. Baird Takes on Capitol Hill Insider Trading (Dec. 16, 2005), *available at* http://www.house.gov/list/press/wa03_baird/BizWeek121605.html ("Congressman Baird tipped a reporter at Business Week to the 'political intelligence' business. A Business Week article published today confirms the existence of the practice and notes that, just last month, investors profited in advance of a major asbestos liability speech and policy push by Se-

cluding lawyer-lobbyists at several prominent law firms) have cultivated the lucrative niche of ferreting out little-known political information and funneling it to Wall Street. They translate political knowledge into economic profit.[16] As just demonstrated, when political intelligence signaled that companies bogged down by asbestos litigation might be salvaged through a trust fund, their market value instantly rose.[17]

U.S. federal securities laws police abusive insider trading practices that threaten the integrity of the financial markets. Corporate insiders who possess material nonpublic information about their firms are precluded from trading in their companies' securities based on that information.[18] In many instances, outsiders who receive inside "tips" are similarly precluded.

In recent years, the investment behavior of elected public officials has received scrutiny.[19] Additionally, the practice of political outsiders acquiring material nonpublic political information from Capitol Hill insiders has received a great deal of publicity.[20] Hedge funds employ Washington lobbyists to gather political intelligence that is then presumably relied upon in making investment decisions.

Are government insiders who trade on material nonpublic political information violating insider trading laws? And are outsiders who trade on advance political knowledge gathered by highly paid lobbyists similarly in violation of U.S. securities laws? If not, should they be?

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nate Majority Leader Bill Frist."); Press Release, Baird, *supra* note 2 ("What the public didn't know yet, but what some investors discovered through back channels and political intelligence companies, was that then–Senate Majority Leader Bill Frist had quietly decided to move forward with legislation to relieve companies, such as USG Corp, of their liabilities in asbestos related lawsuits."). One Washington firm has gone so far as to claim credit for providing political intelligence in the area of asbestos reform. *See* Pub. Law & Policy Strategies, Sonnenschein Nath & Rosenthal LLP, Information Capital & Political Intelligence, http://www.sonnenschein.com/docs/docs_plps/Information_Capital.pdf (last visited Mar. 15, 2010).

[16] *See infra* Section I.B.

[17] For example, hedge funds would not likely invest in the bonds of a bankrupt asbestos-products manufacturer because there is no guarantee that the bonds would ever pay out. Kristin Jensen, Mike Forsythe & J.D. Salant, *Hedge Funds Hire Lobbyists for Inside Tips on U.S. Legislation*, BLOOMBERG, Mar. 16, 2005, http://www.bloomberg.com/apps/news?pid=10000103&sid=aYbb6sQ4HmGc&refer=us. However, "[a] hedge fund might take the gamble, for example, of buying an Owens Corning [a bankrupted asbestos-using manufacturer] note, due in 2009, that Friday was selling for 63 cents on the dollar on a bet that a settlement will allow companies to recover and pay their debts." *Id.*

[18] *See infra* Section II.A.

[19] *See infra* Section I.A.

[20] *See infra* Section I.B.

This Comment explores the relevance and application of the federal securities laws to the trading practices of actors who are privy to material nonpublic political information—i.e., political intelligence. These actors include (1) "government insiders,"[21] such as politicians and their staff members who have direct access to inside political information,[22] and (2) outside actors, such as lobbyists and investment funds who receive political intelligence indirectly.

The contemporary literature dealing with government insider trading is relatively sparse. Several scholars—at different times and on different theories—have argued that insider trading doctrine supports liability for government officials who trade on inside political information.[23] Others disagree and advocate a legislative solution.[24] While di-

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[21] The term "government insider" is borrowed from Herbert Krimmel. *See* Herbert T. Krimmel, Note, *The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine*, 47 S. CAL. L. REV. 1491 (1974) (arguing that then-current doctrine supported extending insider trading liability to government insiders).

[22] The scope of consideration of government insiders here is limited to the legislative branch. Further analysis should also examine officials and employees of the executive and judicial branches. There is overlap among these various government insiders across all branches of government, but full treatment is beyond the scope of this Comment.

[23] In 1974, Herbert Krimmel argued that insider trading doctrine at that time sufficiently supported holding government insiders accountable under federal securities laws. *See* Krimmel, *supra* note 21, at 1492 ("It is the thesis of this Note that government insiders who use undisclosed government information for their personal benefit in the sale or purchase of a security have violated rule 10b-5."). In 1982, Professor Donald Langevoort agreed with Krimmel despite the Supreme Court's substantial restriction of insider trading since Krimmel's assertion a decade earlier. *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CAL. L. REV. 1, 3-4, 34-35 (1982) (arguing that "although the majority opinion [in Chiarella v. United States, 445 U.S. 222 (1980),] clearly limits the applicability of rule 10b-5 with respect to trading by a person with an informational advantage over others in the marketplace, the Court's emphasis on fiduciary duty leaves substantial flexibility for applying that rule in future cases," which include the case of a government official who "has an advantageous position as compared to the persons whom he is charged with serving"). Andrew George picked up where Krimmel and Langevoort left off and in 2008 argued that current doctrine still supports insider trading liability for government insiders, albeit under the modern misappropriation theory. *See* Andrew George, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL'Y REV. 161, 163 (2008).

[24] Professor Stephen M. Bainbridge as well as a group of law students that includes Matthew Barbabella, Daniel Cohen, Alex Kardon, and Peter Molk separately argue that current federal securities doctrine cannot clearly sustain holding government insiders liable. *See* Stephen M. Bainbridge, *The Stop Trading on Congressional Knowledge Act* (UCLA Sch. of Law, Law-Economics Research Paper No. 09-16, 2009), *available at* http://ssrn.com/abstract=1449744 (arguing that insider trading liability under the federal securities laws should be extended to members of Congress and that the Constitution does not hinder such an extension); Matthew Barbabella, Daniel Cohen, Alex Kardon & Peter Molk, *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. &

vided on approach, this literature shares a common desire to bring trading on political information by government insiders under the umbrella of the federal securities laws.

This Comment takes issue with regulating political intelligence through federal securities law. First, it challenges the literature's assumption that insider trading law *should* regulate government insiders' use of political intelligence. Second, it extends the debate beyond government insiders and considers the application of insider trading liability to outside actors who trade on political information, a topic that has not yet been addressed and that has far-reaching ramifications.

Part I introduces these actors and analyzes the prevalence of their trading practices as well as existing laws and congressional ethics rules that purport to curtail trading on political information. Doing so reveals a deficiency in current law that allows members of Congress not only to trade on information acquired on the job, but also to vote on legislation that may materially affect their already-held investments. Part II provides an overview of current federal securities law and doctrine. It applies this doctrine to political-intelligence trading and finds that current law can sustain liability only by drastically manipulating current doctrine. Part III considers legislative proposals recently introduced in the U.S. Congress and insider trading laws in the United Kingdom. Specifically, it analyzes the legislation introduced in recent Congresses by Representatives Brian Baird and Louise Slaughter, which seeks to categorically ban trading on political information, as well as the U.K. law that achieves this same prohibition. Part IV asks whether the theory and justifications underlying U.S. insider trading law support its expansion to encompass trading on political intelligence and concludes that only a few of the many policy concerns animating insider trading prohibitions are relevant to political-intelligence trading.

Part V concludes with recommendations. First, it advocates a legislative solution that would prohibit trading on political information by government insiders but not under the rubric of federal securities law. It argues that insider trading law should not be stretched to its breaking point simply to remedy what is really a problem of political ethics. Nor are the federal securities laws the most effective way to combat congressional ethical lapses generally. Rather, Part V proposes a requirement that government insiders place their assets in blind trusts, thereby meet-

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SEC. L. 199, 237 (2008) ("[T]he legality of Congressional insider trading constitutes an unfortunate gap in securities law—one that should be filled by an amended version of the STOCK Act, or some other similar regulation.").

ing all the concerns underlying the insider trading proposals without disrupting federal securities law. This rule would require members of Congress to place their assets under the management of a trustee, who would divest the trust of the original assets known to the member and then make new investments. The rule would also limit communications between members of Congress and the trustee so as to prevent the member from learning of the trust's newly acquired assets.[25] As a result, Part V argues, a blind-trust requirement is *more* effective than the insider trading approach. Whereas insider trading regulation would only preclude government insiders from *buying or selling* assets after acquiring political intelligence but before public disclosure, the blind-trust approach would also prevent government insiders from *voting* in a way that materially affects their existing market positions.

Second, Part V proposes broad disclosure requirements on lobbyists who are hired to ferret out political intelligence. It does not advocate prohibiting outside actors from trading on political intelligence, primarily because political-intelligence gatherers are the Washington equivalent of market analysts and researchers whose conduct is perfectly legitimate, if not desirable.

Lastly, Part V warns that extending the federal securities laws to outside actors would make trading on legislative information potentially incriminating and, accordingly, produce two distinct chilling effects. First, democratic processes would be harmed by chilling critical dialogue between lawmakers and constituent groups. Second, market efficiency would be jeopardized by discouraging information gathering that functions to efficiently deliver knowledge to the marketplace.

This Comment explores relationships between some of the most vilified actors in the public sphere today. Recent political scandals and controversies have brought to light flagrant instances of illegal and unethical conduct of some elected officials,[26] conduct that was aided in

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[25] *See infra* notes 302-09 and accompanying text.

[26] Several members of Congress have given up or lost their seats in recent years because of involvement in corruption scandals. Members include Senator Ted Stevens (R-AK) in 2008, Representative Bob Ney (R-OH) in 2007, Representative Tom DeLay (R-TX) in 2006, and Representative Duke Cunningham (R-CA) in 2005. Senator Stevens was found guilty by a jury in 2008 for failing to reveal tens of thousands of dollars in gifts he received from an oil-services executive, but his conviction was later voided because of "prosecutorial missteps." *See* Editorial, *The Ted Stevens Scandal*, WALL ST. J., Apr. 2, 2009, at A18 (denouncing the misconduct of the prosecutors who pursued Senator Stevens's case); Posting of Susan Davis & Brent Kendall to Washington Wire, Jury Finds Sen. Stevens Guilty of Failing to Report Gifts, http://blogs.wsj.com/washwire/2008/10/27/jury-finds-sen-stevens-guilty-of-failing-to-report-gifts (Oct. 27, 2008) (describing the conviction of Stevens for concealing gifts in violation of federal law). Bob Ney pled guilty and was

many instances by K Street lobbyists.[27] In addition, many have quickly attributed the current economic crisis, in part, to obscure and unregulated hedge funds.[28] Even prior to and independent of the financial crisis, hedge funds were the source of numerous securities fraud investigations and accusations.[29] Legislative action has been swift in the face of these political controversies[30] and the economic crisis.[31] Simulta-

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sentenced to thirty months in jail for his involvement with lobbyist Jack Abramoff's corrupt activities. *See* Susan Schmidt & James V. Grimaldi, *Ney Sentenced to 30 Months in Prison for Abramoff Deals*, WASH. POST, Jan. 20, 2007, at A3. Then–House Majority Leader Tom DeLay resigned from his leadership position and declined to run for reelection in 2006 after a grand jury indicted him for violating campaign finance laws and his former staffer pled guilty to conspiracy and corruption charges related to the Abramoff scandal. *See* Jonathan Weisman & Chris Cillizza, *DeLay to Resign from Congress*, WASH. POST, Apr. 4, 2006, at A1. Duke Cunningham pled guilty to taking $2.4 million in bribes, was sentenced to eight years and four months in jail, and was ordered to pay $1.8 million in restitution. *See* Tony Perry, *The Penalty Is Severe for Cunningham*, L.A. TIMES, Mar. 4, 2006, at 1, *available at* 2006 WLNR 6956166.

[27] Former lobbyist Jack Abramoff is currently serving jail time for his involvement in a major political scandal. *See* Richard B. Schmitt, *Ex–GOP Lobbyist Abramoff Sentenced to 4 Years in Prison*, L.A. TIMES, Sept. 5, 2008, at 23, *available at* 2008 WLNR 16823739. Abramoff pled guilty to defrauding American Indian tribes and corrupting public officials. *See* Susan Schmidt & James V. Grimaldi, *Abramoff Pleads Guilty to 3 Counts*, WASH. POST, Jan. 4, 2006, at A1 (summarizing the charges against Abramoff of "fraud, tax evasion, and conspiracy to bribe public officials"). His testimony implicated members of Congress, Capitol Hill staff, and White House officials. *See id.* (reporting the extent of the scandal, which involved Tom DeLay and Bob Ney). Former Representative DeLay's staffer and lobbyist Tony Rudy also pled guilty to conspiracy charges related to the Abramoff scandal. *See* Philip Shenon, *Ex–DeLay Aide Pleads Guilty in Lobby Case*, N.Y. TIMES, Apr. 1, 2006, at A1.

[28] *See, e.g.*, *Hedge Funds and the Financial Market: Hearing Before the Subcomm. on Oversight and Government Reform of the H. Comm. on Financial Services*, 110th Cong. (2008) (statement of Rep. Henry A. Waxman), *available at* http://oversight.house.gov/images/stories/documents/20081113100820.pdf (examining the danger that hedge funds might pose to economic stability); *see also* Tom Hamburger, *Financial System in Crisis*, L.A. TIMES, Oct. 6, 2008, at 1, *available at* 2008 WLNR 18977026 (reporting that Congress will certainly place blame for the financial crisis, in part, on hedge funds).

[29] *See, e.g.*, *Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 1-3 (2006) (statement of Sen. Arlen Specter) (expressing concern over the frequency of insider trading in hedge funds); Greg N. Gregoriou & William Kelting, *Hedge Fund Fraud* (asserting that the lack of regulation of hedge funds coupled with hedge funds' "performance-based remuneration structures" have led to increased speculation that hedge funds are participating in insider trading or other forms of securities fraud), *in* INSIDER TRADING 167, 168 (Paul U. Ali & Greg N. Gregoriou eds., 2009).

[30] *See, e.g.*, Honest Leadership and Open Government Act of 2007, Pub. L. No. 110-81, 121 Stat. 735 (codified as amended in scattered sections of 2 & 18 U.S.C.) (requiring heightened and more frequent disclosure of lobbying activities, lobbyists' political contributions, and member-supported earmarks in appropriations legislation).

neously, the Obama Administration stated an intention to "chang[e] the culture of Washington" by placing strict limits on lobbyists serving in government positions.[32] As we move forward to consider the issues presented here, we must be careful to make informed decisions that are consistent with underlying law and public policy objectives and not to resort to demagoguery for the sake of political expediency.

I. TRADING ON POLITICAL INTELLIGENCE

This Part considers the prevalence of trading on political information by government insiders and outside actors to demonstrate that political intelligence can be very lucrative. It then analyzes and reveals several deficiencies in current laws and ethics rules that attempt to curtail these activities. First, there are no legal barriers preventing government insiders or outside actors from trading on political information. Second, government insiders are not only able to trade on information acquired while on the job; they are also able to make legislative decisions that will positively impact their existing portfolios. This fact reveals that political-intelligence trading by government insiders is part of a larger problem of political corruption, not merely insider trading. Third, unlike lobbyists who seek to influence legislative policy, lobbyists hired to ferret out political intelligence are not required to publicly disclose those activities.

A. *Government Insiders: Elected Officials and Capitol Hill Staffers*

There is nothing new about politicians profiting on advance political knowledge. In fact, it is something of a tradition dating back to the Founding Fathers. Following the ratification of the Constitution, Treasury Secretary Alexander Hamilton persuaded Congress to redeem securities issued earlier by the federal government and the states.[33] The securities were redeemed at face value, despite the fact that the market value of many securities had fallen to as low as ten

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[31] *See, e.g.*, Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 & 26 U.S.C.) (authorizing the Department of the Treasury to spend up to $700 billion to purchase distressed assets).

[32] Dan Eggen, *Lobbying Rules Keep Some Activists Out of Government*, WASH. POST, Mar. 22, 2009, at A1 (quoting President Obama).

[33] *See* Sallie Gaines, *Founding Fathers First Inside Traders*, CHI. TRIB., May 17, 1987, at 1, *available at* 1987 WLNR 1405587; *see also* Jeffry M. Netter, Annette B. Poulsen & Philip L. Hersch, *Insider Trading: The Law, the Theory, the Evidence*, CONTEMP. POL'Y ISSUES, July 1988, at 1 (introducing the Founding Fathers' "massive insider trading scheme" as background to the insider trading scandals of the 1980s).

percent of their initial worth.[34] Aware of the redemption plan, many members of Congress bought up these securities in the market before news of the redemption plan became public.[35]

> Those who got wind of Hamilton's plans made a killing in some cases. . . . Thomas Jefferson, James Madison and other leaders of the new government were said to be unhappy about their cohorts' activities. But there was nothing the critics could do. There was no Securities and Exchange Commission and no legal concept of insider trading.[36]

Today, we have the Securities and Exchange Commission (SEC) as well as an accepted—albeit confusing and ad hoc—concept of insider trading. Would the current regime have satisfied Jefferson and Madison by prosecuting profiteering politicians? That question is addressed in the next Section. This Section looks first to the prevalence of this American pastime. It then analyzes current ethics laws to see if they police today's government insiders any better than they would have policed our Founding Fathers.

1. Prevalence of Trading by Government Insiders

Elected officials and their staff—government insiders—often have advance notice of key legislative, regulatory, or political decisions. "While investors spend time worrying how their stocks will do, members of Congress often already know."[37] Government insiders are not simply aware of key decisions in advance but also are often directly involved in making those decisions. As one commentator has observed,

> Members of Congress are privy to information that affects the market. Few investors are better positioned to know when a new regulation is about to derail a booming business; when a young firm is set to win its first lucrative government contract; or whether a much-debated tax bill will actually become law.[38]

The academic literature dealing with members' market activities is relatively sparse. Two studies are instructive.

In the first study, Professor Gregory Boller from the University of Memphis analyzed financial disclosure reports (FDRs) of members of

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[34] *See* Gaines, *supra* note 33.
[35] *Id.*
[36] *Id.*
[37] Joy Ward, *Taking Stock in Congress*, MOTHER JONES, Sept.–Oct. 1995, at 16.
[38] Sheila Kaplan, *Congress's Insider Traders*, NATION, July 6, 1998, at 5.

both houses of Congress.[39] He found that twenty-five percent of members were investing in companies that faced ongoing legislative action.[40] Although his research has been criticized because it only *suggests* a conflict,[41] it provides strong anecdotal evidence indicating an informational advantage for government insiders. Boller provides several examples, one of which is that of former Senator Al D'Amato of New York:

> On Oct. 22, 1992, D'Amato purchased between $8,000 and $120,000 worth of stock in eight different public utilities. Two days later, President Bush signed the National Energy Policy Act. A part of the bill, which wasn't publicized, deregulated energy transmissions, offering growth opportunities for many utilities.[42]

Boller also provides the example of former Senator Lloyd Bentsen of Texas:

> On Feb. 22, 1991, then-Sen. Bentsen purchased stock (reported as between $1,000 and $15,000 in value) in food and dairy company Morningstar Foods. Four days later, an amendment to the National School Lunch Act was introduced in the Senate to diversify milk choices for lunch programs. On Dec. 23, 1991, Bentsen sold his stock. Eight days later, Morningstar came under a Justice Department probe into bid-rigging to sell milk in public schools.[43]

This anecdote suggests that former Senator Bentsen knew not only when to purchase stock in a company that would benefit from legislation but also when to sell stock that would be detrimentally affected by a governmental investigation. Consider one final example involving former Representative Newt Gingrich of Georgia:

> In January 1992, Gingrich bought between $1,000 and $15,000 worth of Boeing stock. Three weeks later, when the House introduced the NASA Authorization Act, Gingrich helped kill amendments to cut funding for the space station program. Later, Boeing became the prime contractor for the station.[44]

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[39] *See* Alan J. Ziobrowski, Ping Cheng, James W. Boyd & Brigitte J. Ziobrowski, *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661, 662 (2004) (summarizing Professor Boller's findings); Ward, *supra* note 37, at 16 (publishing Professor Boller's results).

[40] Ward, *supra* note 37, at 16.

[41] *See* Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 662 ("However, this result merely suggests a potential conflict of interest. His research did not demonstrate that these investments yielded unusually large returns.").

[42] Ward, *supra* note 37, at 16.

[43] *Id.*

[44] *Id.*

Former Representative Gingrich's behavior suggests that not only do members trade on political information in advance of the information's public release but that members may also cast votes that directly benefit their financial portfolios. This distinction is critical because, as this Comment points out, regulating politicians' behavior under insider trading will only, at most, curtail the former while leaving members free to make decisions perfectly aware of how those decisions will benefit them financially.

A separate review of financial disclosure reports in 1997 demonstrated that many lawmakers make no attempt to stay away from industries over which they would naturally appear to be conflicted because of their political authority or committee assignments.[45] This demonstrates that public officials are not only well situated to access market-sensitive information, they are also in a position to *make* market-sensitive decisions.

The second study—by Alan Ziobrowski, Ping Cheng, James Boyd, and Brigitte Ziobrowski (Ziobrowski study)—takes Professor Boller's insights one step further by demonstrating that congressional informational advantages translate into material economic benefits. The Ziobrowski study looked for abnormal returns on the common stock portfolios held by U.S. Senators from 1993 to 1998.[46] The objective of the research was to determine whether Senators' investments outperformed the market, because such a showing would "support the notion that Senators use their informational advantage for personal gain" and are "thereby using their unique position to increase their personal wealth."[47] Similar to the Boller study, the Ziobrowski study analyzed annual FDRs.[48] Federal law requires that members of Con-

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[45] *See* Kaplan, *supra* note 38, at 5 ("An analysis by *The Nation* of Congressional disclosure reports for 1997, released in mid-June, shows that while some lawmakers avoid buying stock in industries that coincide with their key areas of legislative responsibility—or put their assets into blind trusts—many do not.").

[46] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 661. The Ziobrowksi et al. study has received a good deal of attention. *See, e.g.*, Jonathan Macey, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 25 YALE J. ON REG. 305, 309 (2008) (stating that the results "show that U.S. Senators are able to use their inside information about forthcoming government action to obtain significant positive abnormal returns on their equity investments"); Bainbridge, *supra* note 24, at 1-2 (summarizing the study's results); Press Release, Baird, *supra* note 2 (citing the study).

[47] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 662.

[48] *Id.* Though the published Ziobrowski study only considered the U.S. Senate, *id.*, an unpublished study concerning the U.S. House of Representatives also found abnormal returns. *See Preventing Unfair Trading by Government Officials: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 111th Cong. (2009) (proposed statement of Alan J. Ziobrowski, Ph.D., Robinson College of Business, Georgia State University), *available at* http://www.house.gov/apps/list/

gress publicly disclose all common stock transactions in FDRs each year.[49] The study scrutinized the sales and purchases of common stock—"trigger events"—during a six-year period from 1993 to 1998.[50] The results are staggering. Portfolios that mirror the *purchases* of U.S. Senators outperformed the market[51] by eighty-five basis points—nearly one percent—each month.[52] Portfolios mimicking the *sales* of Senators underperformed the market[53] by twelve basis points per month over the twelve months following the sale, meaning that the Senators in the study sold stocks that then went on to perform poorly relative to the market.[54] Consequently, Senators beat the market by nearly twelve percent per year.[55]

Further, the study also looked for cumulative abnormal returns (CARs), which are the difference between the expected return of a

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hearing/financialsvcs_dem/ziobrowski_testimony.pdf [hereinafter *Hearing on Preventing Unfair Trading by Government Officials*] (noting that the House study showing that returns on common stock investments by House members "beat the market" was never published because it "contain[ed] nothing new").

[49] *See infra* notes 85-86 and accompanying text.

[50] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 662. It is also significant to note that the reporting of trigger events by the FDRs does not occur until five to seventeen months after the purchase or sale. This is important because any "subsequent returns of these stocks could not have been market reactions to the actual transactions themselves." *Id.* The authors conclude that "[a]ny statistically significant abnormal returns therefore would likely be the result of reactions to events *anticipated by Senators and motivated [by] their transactions*." *Id.* (emphasis added). The study was limited to six years because FDRs are, by law, only retained for six years before being destroyed. *Id.* at 669 n.3.

[51] "Outperforming" the market means that the stock or portfolio did better than the stock market overall.

[52] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 663. This is using a calendar-time approach with the Fama-French three-factor model and the Capital Asset Pricing Model. For a thorough explanation of the data and research design, see *id.* at 663-66. Portfolios mirroring common stock investments by members of the House of Representatives outperformed the market by approximately one-half of one percent per month, or six percent annually, from 1985 to 2001. *Hearing on Preventing Unfair Trading by Government Officials*, *supra* note 48, at 3 (proposed statement of Alan J. Ziobrowski).

[53] "Underperforming" the market means that the stock or portfolio did worse than the stock market overall.

[54] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 663.

[55] *See Hearing on Preventing Unfair Trading by Government Officials*, *supra* note 48, at 3 (proposed statement of Alan J. Ziobrowski) ("Common stock investments made by Senators beat the market by approximately 1% per month or 12% per year from 1993 to 1998."); Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 675 (finding that, when combining buy and sell transactions in a hedged portfolio, "Senators outperform the market by 97 basis points (nearly 1%) per month on a trade-weighted basis").

particular stock and the actual return of that stock.[56] The CARs of stocks purchased by U.S. Senators were "near zero" over the calendar year prior to being purchased.[57] CARs increased to more than twenty-five percent over the twelve months following the purchase of the stock by a U.S. Senator, meaning that these stocks exceeded expectations.[58] Abnormal returns on common stocks sold by U.S. Senators were "near zero" over the twelve months after being sold but had been twenty-five percent positive over the twelve months prior to being sold.[59] The point of sale usually represented a peak in abnormal return value.[60] "These results suggest that Senators knew appropriate times to both buy and sell their common stocks."[61]

Senators' exceptional returns are economically significant. By way of example, common stock returns for randomly selected households over a similar period—1991 to 1996—found that the average household underperformed the market by nearly twelve basis points.[62] One could easily argue that U.S. Senators are not average U.S. households. At the very least, they are savvy enough to get themselves elected to high public office. Politicians are often well educated and have access to social networks that may provide informational advantages apart from those that they encounter while performing official duties.

Another study found, however, that corporate insiders who traded in their respective companies earned abnormal returns ranging from approximately fifty to approximately seventy basis points each month,[63] or six percent on an annual basis.[64] While still significant,

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[56] *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 360 (9th ed. 2008) (providing a formula to show that abnormal return is the difference between the actual return on a security and the expected return on the security). Accordingly, a "cumulative daily abnormal return" is simply the total daily abnormal return over a defined period of time for a specific security.

[57] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 675.

[58] *Id.*

[59] *Id.*

[60] *Id.* at 663.

[61] *Id.* at 675.

[62] *Id.* at 669 (citing Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773 (2000)).

[63] *See* Leslie A. Jeng, Andrew Metrick & Richard Zeckhauser, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. ECON. & STATS. 453, 467 (2003) (looking at trading in company common stock during the period of 1975 to 1996 and concluding that "abnormal returns to a value-weighted portfolio of all insider purchases—holding positions for 6 months—are between 52 and 68 basis points per month, an economically and statistically significant magnitude").

[64] *See id.* at 456 ("Purchases . . . are followed by a positive CAR of about 6% over the subsequent 100 days.").

the average abnormal returns of corporate insiders are only a fraction (approximately one-fourth) of U.S. Senators' abnormal returns.[65] Corporate insiders should be the most savvy, educated, and networked investors, especially when investing in their own companies. Nevertheless, policymakers outperform corporate insiders, suggesting an informational advantage above and beyond mere talent and skill.

These studies provide compelling evidence that government insiders possess a material informational advantage when investing in the market. The Ziobrowski study concludes that, although the exact source and nature of market information are not known, "Senators have demonstrated a definite informational advantage over other investors."[66]

2. Current Laws and Ethics Rules Affecting Government Insiders' Trading Practices

The Code of Ethics for Government Service (Code of Ethics) provides broad ethical guidelines for "all Government employees, including officeholders."[67] It was passed as a concurrent resolution by Congress in 1958 and provides, in relevant part, that government employees should "[n]ever use any information coming to [them] confidentially in the performance of governmental duties as a means for making private profit."[68] Though the concurrent resolution is not a legally binding statute, the House of Representatives has incorporated it into the *House Ethics Manual*.[69] Consequently, covered individuals who violate the Code of Ethics can face formal charges.[70] The *Senate Ethics Manual*,

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[65] The CARs for U.S. Senators were twenty-five percent. *See supra* note 58 and accompanying text.

[66] Ziobrowski, Cheng, Boyd & Ziobrowski, *supra* note 39, at 676. Ziobrowski, Cheng, Boyd, and Ziobrowski conclude by recommending further investigation. *Id.* They suggest examining the "financial transactions of members of the U.S. House of Representatives, high-ranking officials of the Federal executive branch, and Federal judges." *Id.*

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

[68] *Id.*

[69] H. COMM. ON STANDARDS OF OFFICIAL CONDUCT, 110TH CONG., HOUSE ETHICS MANUAL 20, 249 (2008) [hereinafter HOUSE ETHICS MANUAL], *available at* http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf; *see also* Javers, *supra* note 1, at 42 ("But ethics experts say no one's breaking the rules. Hill staffers and government employees are forbidden from personally profiting from confidential data and can't share information that's classified or deemed secret by their employers.").

[70] HOUSE ETHICS MANUAL, *supra* note 69, at 20. In at least one instance the House "reprimanded" a member who took official action that increased his personal finances. *Id.* at 20-21 (citing H.R. REP. NO. 94-1364, at 3 (1976)).

however, does not explicitly incorporate the Code of Ethics but rather lists it as a source of jurisdiction for the Senate Ethics Committee.[71]

In addition to incorporating the Code of Ethics, the *House Ethics Manual* prohibits "all Members, officers, and employees"—known as "covered" individuals—from "improperly using their official positions for personal gain."[72] Nonetheless, it does not require covered individuals to "divest themselves of assets" upon taking up a covered position.[73] Furthermore, members are not required to "disqualify themselves from voting on issues that generally affect their personal financial interests."[74] Rather, the House of Representatives sets forth broad financial disclosure requirements as "a means of monitoring and deterring conflicts."[75]

Unlike the House ethics rules, neither the *Senate Ethics Manual* nor the Senate Code of Conduct provide language prohibiting Senators from using information acquired while performing official duties for personal profit.[76] Like the House version, the *Senate Ethics Manual* provides that "[a] Member or employee should never use the prestige or influence of a position in the Senate for personal gain."[77] However, like the House rules, the Senate rules provide sweeping language that enables Senators to maintain market positions that potentially conflict with official duties; members are not required to divest themselves of assets, even where there are conflicts of interest. The *Senate Ethics Manual* explains that

> [u]nlike many officials in the executive branch, who are concerned with administration and regulation in a narrow area, a Senator exercises judgment concerning legislation across the entire spectrum of business and economic endeavors. The wisdom of complete (unlike selective) di-

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[71] *Cf.* S. SELECT COMM. ON ETHICS, 108TH CONG., SENATE ETHICS MANUAL 7-8 (2003) [hereinafter SENATE ETHICS MANUAL], *available at* http://ethics.senate.gov/downloads/pdffiles/manual.pdf.

[72] HOUSE ETHICS MANUAL, *supra* note 69, at 247.

[73] *Id.*; *see also* Kathleen Clark, *Do We Have Enough Ethics in Government Yet?: An Answer from Fiduciary Theory*, 1996 U. ILL. L. REV. 57, 89 ("Members of Congress are not required to divest their financial holdings or put them in a blind trust. As a result, members of Congress sometimes play key roles in passing or blocking legislation that has a direct impact on their investments.").

[74] HOUSE ETHICS MANUAL, *supra* note 69, at 247.

[75] *Id.*

[76] *See* S. SELECT COMM. ON ETHICS, 110TH CONG., AN OVERVIEW OF THE SENATE CODE OF CONDUCT AND RELATED LAWS (2007), *available at* http://ethics.senate.gov/downloads/pdffiles/overview.pdf; SENATE ETHICS MANUAL, *supra* note 71. A search of both documents reveals no prohibitive language.

[77] SENATE ETHICS MANUAL, *supra* note 71, at 65.

> vestiture may also be questioned as likely to insulate a legislator from the personal and economic interests that his or her constituency, or society in general, has in governmental decisions and policy.[78]

The *House Ethics Manual* provides similar reasoning.[79]

In contrast, Senate committee staff who earn over $25,000 per year are required to "divest themselves of any substantial holdings which may be directly affected by the actions of the employing committee."[80] Apart from the committee-staff exception, Senators and employees of individual Senators are not required to divest themselves of assets upon assuming their positions.[81] Additionally, as in the House, Senators are not required to "disqualify themselves from voting on issues that generally affect their personal financial interests."[82]

Rather, the Senate and the House view financial disclosure as superior to divestiture.[83] Public disclosure is seen as the best way to monitor political conflicts of interest and enable constituencies to judge the financial activity of their elected officials.[84] To that end, House and Senate disclosure rules require that all members, officers, and certain em-

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[78] *Id.* at 124. The same language is provided in the HOUSE ETHICS MANUAL, *supra* note 69, at 250.

[79] As the *House Ethics Manual* states,

> Proposals for divestiture of potentially conflicting assets and mandatory disqualification of Members from voting were rejected as impractical or unreasonable. Such disqualification could result in the disenfranchisement of a Member's entire constituency on particular issues. A Member may often have a community of interests with the Member's constituency, and may arguably have been elected because of and to serve these common interests, and thus would be ineffective in representing the real interests of the constituents if the Member was disqualified from voting on issues touching those matters of mutual concern.

HOUSE ETHICS MANUAL, *supra* note 69, at 249-50 (footnotes omitted).

[80] SENATE ETHICS MANUAL, *supra* note 71, at 70. Oddly, this divestiture requirement does not apply to the Senate committee members themselves.

[81] *Id.* at 124.

[82] *Id.*

[83] *See id.* ("The drafters of the original Senate Code of Official Conduct, in the 95th Congress, considered 'full and complete public financial disclosure' to be 'the heart of the code of conduct.'" (quoting S. REP. NO. 95-49, at 3 (1977))); *see also* HOUSE ETHICS MANUAL, *supra* note 69, at 249 ("Financial disclosure provisions were enacted to monitor and to deter possible conflicts of interest due to outside financial holdings."); H.R. DOC. NO. 95-73, at 9-10 (1977) ("In the case of investment income, then, the Commission's belief is that potential conflicts of interest are best deterred through disclosure and the discipline of the electoral process. Other approaches are flawed both in terms of their reasonableness and practicality, and threaten to impair, rather than to protect, the relationship between the representative and the represented.").

[84] *See* HOUSE ETHICS MANUAL, *supra* note 69, at 251; SENATE ETHICS MANUAL, *supra* note 71, at 124-25.

ployees make available "financial information concerning themselves, their spouses, and dependent children."[85] Congress condensed and consolidated the financial disclosure requirements for federal government officials into the Ethics in Government Act of 1978.[86] FDRs are required to contain information on "outside compensation, holdings, transactions, liabilities, positions held and gifts received."[87] The idea is that once FDRs are made available, the public will police investment behavior where it conflicts with legislative responsibilities.

Congress has decisively chosen disclosure over abstention or divestiture. The Code of Ethics is merely a concurrent resolution without force of law. Though the House has incorporated the Code of Ethics and the Senate cites it as authority, critics note that it is blatantly unenforced.[88] At most, only a handful of members have been reprimanded, and neither the House nor the Senate requires members to divest themselves of assets over which they have legislative jurisdiction or to recuse themselves from voting at any time in ways that affect their financial portfolios. This fact demonstrates that political-intelligence trading is merely part of a larger problem of financial conflicts of interest and political corruption, not just insider trading.

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[85] HOUSE ETHICS MANUAL, *supra* note 69, at 247; *accord* SENATE ETHICS MANUAL, *supra* note 71, at 124-25, 127. "Certain employees" refers to senior employees who meet certain salary thresholds. SENATE ETHICS MANUAL, *supra* note 71, at 125-26.

[86] Pub. L. No. 95-521, 92 Stat. 1824 (codified as amended in scattered sections of 2, 5 & 28 U.S.C.). The Ethics Reform Act of 1989 then codified legislative branch disclosure requirements. Pub. L. No. 101-194, 103 Stat. 1716 (codified as amended in scattered sections of 2, 5, 10, 18, 26 & 31 U.S.C.). Recourse for failure to comply with the FDR requirement is limited to committee action and civil penalties. In addition to official Senate or House committee action for failure to comply with the FDR requirement, the Attorney General can seek civil penalties from those who knowingly and willfully falsify or fail to file required information. 5 U.S.C. app. 4 § 104(a) (2006); *see also* HOUSE ETHICS MANUAL, *supra* note 69, at 265; SENATE ETHICS MANUAL, *supra* note 71, at 127.

[87] SENATE ETHICS MANUAL, *supra* note 71, at 125; *accord* HOUSE ETHICS MANUAL, *supra* note 69, at 252.

[88] *See* Posting of Rep. Louise Slaughter to Daily Kos, Follow-Up on Our Bill to Stop Insider Trading in DeLay's House (Congress), http://www.dailykos.com/story/2006/4/5/164552/0893 (Apr. 5, 2006) [hereinafter Slaughter Follow-Up] ("[The Code of Ethics clause] has never really been enforced, and it has not been adopted by the Senate. Furthermore, it is part of the House Ethics Rules—it is not law, so the practice is not illegal. In addition, the House ethics rule has absolutely no impact on the sharing of this information with outside political intelligence firms for trading decisions." (emphasis omitted)).

B. *Outside Actors: K Street Lobbyists and Wall Street Funds*

While government insiders directly encounter or create market-sensitive information during the performance of official duties, outside actors actively engage in mining such information. In Washington, the practice has become quite lucrative.[89] And for the investing clientele, purchasing political intelligence is paying off. As one Washington firm advertised,

> While Congress negotiated significant pension reform legislation *behind closed doors*, our clients relied on our *political intelligence* gathering to inform them of the resolution of *key outstanding issues that could affect their investments*.[90]

1. The Rise of Political-Intelligence Gathering

The practice of gathering and selling political information prior to its public release is nothing new. Investors realize that "[t]he invisible hand of the market sometimes takes cues from the long arm of Washington."[91] The industry started with a few firms in the 1970s and has taken off in recent years due to the "explosion of hedge funds," a new clientele with deeper pockets.[92] One Washington insider predicts that lobbying shops collectively generate $30 to $40 million in fees from their political-intelligence practices annually.[93] A Capitol Hill staffer reported that her legislator's office receives almost as many phone calls asking about the status of legislation as they do seeking to influence legislation.[94]

Who are these firms? And who are their high-paying clients? Little is known about who exactly the players are. This is because lobbying firms are not required to publicly disclose their political-

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[89] *See* Mullins & Scannell, *supra* note 3 (interviewing Elliott Portnoy and attributing his being named chairman of Sonnenschein Nath & Rosenthal LLP in part to his success at cultivating a successful political-intelligence unit).

[90] Pub. Law & Policy Strategies Group, Sonnenschein Nath & Rosenthal LLP, Information Capital & Political Intelligence (emphasis added) (on file with author). This sentence captures perfectly what "material nonpublic information" means in the insider trading context. "Behind closed doors" essentially means nonpublic, and "affect their investments" signifies information that is material.

[91] Snyder, *supra* note 9.

[92] Javers, *supra* note 1, at 42.

[93] *Id.*; *see also* Snyder, *supra* note 9 (interviewing Elliott Portnoy of Sonnenschein Nath & Rosenthal LLP, who hinted that the firm's annual revenue from political-intelligence gathering was between $1 million and $5 million).

[94] *See* Mullins & Scannell, *supra* note 3 (interviewing a congressional staffer, who stated that "[t]he amount of insider trading going on in these halls is incredible").

intelligence clients.[95] Traditional clients hire lobbyists to peddle influence on their behalf and accordingly are made public through the disclosure requirements of the Lobbying Disclosure Act (LDA).[96] Political-intelligence clients, on the other hand, do not actively influence legislation. They do not send information or opinions to Capitol Hill with the objective of affecting outcomes. Rather, political-intelligence clients receive information. They do not speak but listen. As defined by the LDA, these activities do not constitute "lobbying."[97]

What is known about this practice comes from media reports and lobbying firms' promotional materials. It is generally believed that the primary clients of political-intelligence groups are hedge funds.[98] Hedge funds "pursue high-risk, high-yield investments for wealthy clients."[99] Political intelligence is seen as more valuable to these funds since they tend to hold assets over a shorter amount of time; mutual funds, on the other hand, hold diversified portfolios over longer periods of time and do not have a similar potential to gain from placing bets on the political winds of Washington.[100] "What sets hedge funds apart is their ability to act instantly on news and to employ trading options that allow them to make money whether stocks rise or fall."[101] This includes short selling, in which hedge funds borrow securities and then sell the borrowed securities into the market with the expectation that they will buy them back when the price drops.[102] Mutual funds, on the other hand, are usually entrusted with retirement funds

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[95] *See infra* subsection I.B.2.

[96] Lobbying Disclosure Act of 1995, 2 U.S.C. § 1604(a) (2006 & Supp. I 2009).

[97] *See infra* notes 126-29 and accompanying text.

[98] *See* Jeffrey Young, *K Street Grows, Maybe Even Beyond Disclosure*, HILL, Feb. 25, 2008, http://thehill.com/business-a-lobbying/3475-k-street-grows-maybe-even-beyond-disclosure (interviewing Rich Gold, head of the lobbying group at Holland & Knight, who said that political intelligence has grown rapidly in the past five years because of the "uptick in hedge fund issues").

[99] Jensen, Forsythe & Salant, *supra* note 17.

[100] *See* Jim Snyder, *Transparency Sought on 'Political Intel,'* HILL, Apr. 4, 2006, at 6, *available at* LEXIS. The logic that short-term investors, such as hedge funds, benefit most from political intelligence is consistent with arguments that these investors are likewise the greatest beneficiaries of other informational advantages apart from political intelligence. *See* JONATHAN R. MACEY, INSIDER TRADING 13 (1991) (arguing that informational advantages benefit sizable investors who "trade frequently enough to reap the trading profits generated by that advice," as opposed to small investors who, if rational, follow long-term "buy-and-hold strategies").

[101] Jensen, Forsythe & Salant, *supra* note 17.

[102] *Id.*

and do not, or cannot, employ such practices because of substantive SEC regulations that prohibit mutual funds from doing so.[103]

A number of Washington firms have advertised their political-intelligence practices directly or have spoken with the media. Many firms involved in the practice can be identified through these communications, including Patton Boggs LLP,[104] Sonnenschein Nath & Rosenthal LLP,[105] Washington Analysis,[106] PodestaMattoon,[107] Cormac Group,[108] Mehlman Vogel Castagnetti Inc.,[109] Bryan Cave Strategies LLC,[110] DLA Piper,[111] Williams & Jensen,[112] and Akin Gump Strauss Hauer & Feld LLP.[113] Hedge funds, by contrast, generally do not want to discuss their political-intelligence activities.[114] From various inter-

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[103] *See id.*; Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. (forthcoming 2010) (manuscript at 22-24, on file with author) ("The ICA also imposes substantive regulation on mutual funds. Funds are restricted in their use of leverage. This limitation extends to short selling, which the SEC views as borrowing. Funds are limited to holding a maximum of fifteen percent of their portfolios in illiquid assets and are also regulated in their use of options and other derivative products." (footnotes omitted)).

[104] *See* Jensen, Forsythe & Salant, *supra* note 17 (interviewing former U.S. Senator John Breaux, who represents the hedge fund Clinton Group Inc. on behalf of Patton Boggs LLP).

[105] *See* Snyder, *supra* note 9 (interviewing Elliott Portnoy of Sonnenschein Nath & Rosenthal LLP, who reports having numerous political-intelligence clients).

[106] *See* Javers, *supra* note 1, at 42 (interviewing Leslie Alperstein, a founder of Washington Analysis, and reporting that the firm was sold in July 2005 "to China's Xinhua Finance, which is 6.5%-owned by the government-controlled Xinhua News Agency"); *see also* Snyder, *supra* note 9 (interviewing Tim VandenBerg, a senior policy analyst at Washington Analysis).

[107] *See* Jensen, Forsythe & Salant, *supra* note 17 (interviewing Tony Podesta—brother of John Podesta, former chief of staff to President Clinton—whose firm, PodestaMattoon, was retained by an unnamed hedge fund).

[108] *See id.* (interviewing Jonathan Slade, lobbyist for Cormac Group, who reported representing hedge fund GoldenTree Asset Management LP).

[109] *See id.* (interviewing Alex Vogel, cofounder of Mehlman Vogel Castagnetti Inc.).

[110] *See id.* (interviewing Steve Elmendorf, whose firm, Bryan Cave Strategies LLC, represents a hedge fund).

[111] *See* Mullins & Scannell, *supra* note 3 (interviewing Matthew Bernstein of DLA Piper, who estimated that its "political-intelligence business has quadrupled in size" in the three years between 2003 and 2006).

[112] *See* Young, *supra* note 98 (interviewing Williams & Jensen Chairman and CEO J. Steven Hart, who stated that the firm's decline in reported lobbying revenue reflects an increase in unreported political-intelligence work).

[113] *See* Snyder, *supra* note 9 (interviewing Joel Jankowsky of Akin Gump Strauss Hauer & Feld LLP, who reported that the firm "does some political-intelligence work").

[114] *See* Jensen, Forsythe & Salant, *supra* note 17 ("[H]edge funds aren't interested in talking about [their political intelligence activities]: Companies among the 25 biggest funds . . . declined to comment for this story.").

views, however, one can discern that hedge fund players include Clinton Group, Inc.,[115] GoldenTree Asset Management LP,[116] and Carlson Capital, L.P.[117]

Lobbying firms are not shy about their ability to mine little-known political information—this skill is precisely the product that they hawk.[118] Firms claim the capability to farm numerous substantive areas for political intelligence, including climate control legislation, asbestos reform, tariff decisions, energy policy, the federal budget (including funding for health care, defense, and research), tax policy and credits, and patent legislation.[119] What is critical is not merely receiving information but receiving it before it is widely known. As one lobbyist bragged, "We provide customized political intelligence and deliver the information ahead of the news cycle."[120] K Street is able to access much of this information through political connections and networks. Many of the lobbyists who have spoken with the press had previously worked on Capitol Hill or in various administrations. Again, firms are not shy about this fact.[121]

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[115] *See id.*

[116] *See id.*

[117] *See* Mullins & Scannell, *supra* note 3 (interviewing Clint Carlson, who runs a $3 billion hedge fund, Carlson Capital, L.P., that hires Washington lawyers to provide political intelligence).

[118] For example, one firm advertises that

> [t]hrough our pioneering Information Capital & Political Intelligence Practice, our team provides insight, analysis, and evaluation that separates rhetoric from reality . . . for [those] involved in the public and private equity markets.
>
> By knowing the legislative and political "pulse" in the nation's capital and in statehouses throughout the country, we present clients with valuable, insightful information so they can make prudent decisions in advance of the traditional news cycle.

Pub. Law & Policy Strategies, Sonnenschein Nath & Rosenthal LLP, Core Competencies: Information Capital & Political Intelligence, http://www.sonnenschein.com/practice_areas/plps/corecomps/cc3/index.aspx (last visited Mar. 15, 2010).

[119] *See* Pub. Law & Policy Strategies, Sonnenschein Nath & Rosenthal LLP, *supra* note 15.

[120] Snyder, *supra* note 9 (quoting Elliott Portnoy of Sonnenschein Nath & Rosenthal LLP).

[121] *See, e.g.*, Pub. Law & Policy Strategies, Sonnenschein Nath & Rosenthal LLP, *supra* note 15 ("[O]ur considerable network of federal and state political experts and relationships with key elected officials[] afford us a unique ability to decipher reality from rhetoric.").

2. Current Laws Affecting Political-Intelligence Gathering

The LDA requires individuals to publicly disclose the clients on whose behalf they lobby in quarterly reports filed with the Secretary of the Senate and Clerk of the House of Representatives.[122] Reports must include, in addition to other information, the name of the client, lobbying firm, and lobbyist; lists of activities, employees, and interests of foreign entities for each general substantive issue lobbied; and the approximate income received from the client (rounded to the nearest $10,000 if in excess of $5000).[123]

An individual is required to register and report within forty-five days after she has made a lobbying contact or has been hired to make a lobbying contact.[124] A "lobbying contact" is defined as an oral or written communication to a covered executive or legislative branch official that concerns (1) "the formulation, modification, or adoption" of federal legislation, rules, regulations, executive orders, programs, policies, or positions; (2) "the administration or execution" of federal policies or programs; or (3) "the nomination or confirmation" of an individual subject to Senate confirmation.[125]

Although an inquiry made on behalf of political-intelligence clients pertains to the "formulation, modification, or adoption" of legislation, it is exempt as an "administrative request."[126] Since political-intelligence gatherers are not actively seeking to "influence" legislation, the LDA does not apply.[127] No other laws appear to specifically regulate political-intelligence activities.

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[122] 2 U.S.C. § 1604(a) (2006 & Supp. I 2009).

[123] *Id.* § 1604(b)–(c).

[124] *Id.* § 1603(a)(1). The definition of "lobbyist" exempts individuals "whose lobbying activities constitute less than 20 percent of the time engaged in the services provided by such individual to that client over a 3-month period." *Id.* § 1602(10).

[125] *Id.* § 1602(8)(A).

[126] *See id.* § 1602(8)(B)(v) (exempting "a request for a meeting, a request for the status of an action, or any other similar administrative request, if the request does not include an attempt to influence a covered executive branch official or a covered legislative branch official"); SENATE OFFICE OF PUB. RECORDS & LEGISLATIVE RES. CTR., LOBBYING DISCLOSURE ACT GUIDANCE 7 (2009) [hereinafter LDA GUIDANCE], *available at* http://www.senate.gov/legislative/resources/pdf/S1guidance.pdf ("If a communication is limited to routine information-gathering questions and there is not an attempt to influence a covered official, the exception of Section 3(8)(B)(v) for 'any other similar administrative request' would normally apply."); *see also* Snyder, *supra* note 9 ("Because they aren't, in fact, lobbying for these clients, firms don't have to register with the Senate or the House.").

[127] *See* LDA GUIDANCE, *supra* note 126, at 7.

II. ANALYSIS UNDER THE CURRENT FEDERAL SECURITIES LAWS

The previous Part concluded that ethics laws do not adequately prohibit government insiders or outside actors from trading on material nonpublic political information. This Part considers whether the current federal securities laws cover these trading activities. This question is important because inside traders face criminal punishment and significant civil sanctions.[128] For government insiders, this prospect is certainly much more severe than breaching Congressional ethics rules, which in the Senate do not cover trading on inside information and in the House are unenforced.[129] Even still, breaches of ethics laws typically provide only for remedial action (reprimand or, at most, removal) and nominal civil fines.[130] For outside actors—who are not precluded from trading on political intelligence under any other laws and are not even required to disclose these activities—insider trading liability would certainly be a deal breaker.

A. *Current Law and Doctrine*

Insider trading is commonly defined as "the purchase or sale of securities on the basis of material non-public information."[131] Modern

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[128] Those convicted of insider trading face fines of up to $5 million and prison sentences of up to twenty years, but "no person shall be subject to imprisonment . . . for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation." Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (2006). The Sarbanes-Oxley Act of 2002 increased maximum fines from $1 million and maximum prison sentences from ten years. Pub. L. No. 107-204, sec. 1106, § 32(a), 116 Stat. 745, 810.

[129] *See supra* subsection I.A.2.

[130] *See* HOUSE ETHICS MANUAL, *supra* note 69, at 3 (describing penalties for violations of House ethics rules as including "censure, reprimand, condemnation, reduction of seniority, fine, or other sanction determined to be appropriate," and noting that in some situations, where the ethics rules "derive from criminal law," such violations "may lead to a fine or imprisonment, or both"); SENATE ETHICS MANUAL, *supra* note 71, at 4 ("Upon completion of its investigative process, the Committee may recommend . . . an appropriate sanction for a violation or improper conduct, including, for Senators, censure, expulsion, or party discipline and, for staff members, termination of employment."). In practice, expulsion and censure have been the most serious punishments imposed upon members violating ethical responsibilities. *See* CONGRESSIONAL RESEARCH SERV., ENFORCEMENT OF CONGRESSIONAL RULES OF CONDUCT 6 (2008) (reviewing various expulsion and censure cases and describing expulsion as the "most serious punishment").

[131] C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 3 (1991) (internal quotation marks omitted); *see also* NASSER ARSHADI & THOMAS H. EYSSELL, THE LAW AND FINANCE OF CORPORATE INSIDER TRADING 1 (1993) ("We define insider trading as transactions in the shares of publicly held corporations using material nonpublic information."); Stephen M. Bainbridge, The Law and Economics of Insider

federal insider trading law is statutorily rooted in section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act).[132] Yet, nothing in section 10(b) of the Exchange Act explicitly mentions insider trading. Rather, section 10(b) was considered "a catchall intended to capture various types of securities fraud not expressly covered by more specific provisions of the Exchange Act."[133] Congress intended for section 16 of the Exchange Act[134] to be the statutory basis for preventing insider trading, whereas "section 10 . . . was not thought by Congress in 1934 to be an anti-insider trading section."[135]

The SEC promulgated Rule 10b-5 in 1942 pursuant to section 10(b) of the Exchange Act.[136] Like the Exchange Act, the Rule does

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Trading: A Comprehensive Primer 3 (2001) (unpublished manuscript), *available at* http://ssrn.com/abstract=261277 ("Generally speaking, insider trading is trading in securities while in possession of material nonpublic information.").

[132] 15 U.S.C. § 78j. The relevant portion of section 10 provides that

> [i]t 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—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . 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.

Id.

[133] Bainbridge, *supra* note 131, at 10.

[134] Section 16 of the Exchange Act is a categorical prohibition on short-swing trading by corporate insiders. 15 U.S.C. § 78p(b). It provides that each officer, director, or ten-percent beneficial owner of a corporate security covered by the Exchange Act must file certain disclosures with the SEC and is precluded from realizing profit, which "inures" to the issuer, on the sale of any corporate security within six months of its purchase. *Id.* § 78p(a)–(b); *see also* Bainbridge, *supra* note 131, at 10-11.

[135] FLETCHER, *supra* note 131, at 45.

[136] *See* Bainbridge, *supra* note 131, at 11. The Rule provides as follows:

> 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.

17 C.F.R. § 240.10b-5 (2009).

not mention insider trading. It was not until 1961 that the SEC found insider trading on an impersonal stock exchange to violate Rule 10b-5,[137] and "[o]nly then did the modern federal insider trading prohibition at last begin to take shape."[138] Despite section 10(b)'s inauspicious statutory roots, judicial interpretation and SEC application have expanded section 10(b) into the broad antifraud provision that it is today, notwithstanding some judicial and administrative decisions that have narrowed its application.[139]

Several insider trading theories have been recognized under section 10(b). These include (1) classic insider trading liability, under which an insider breaches a fiduciary duty that she directly owes to the corporation and its shareholders; (2) tipper/tippee liability, under which a tippee trades on information gained from a fiduciary tipper and inherits the tipper's fiduciary duty; and (3) misappropriation liability, under which an individual trades on information in violation of a fiduciary duty or a duty of trust or confidence owed to the source of the information.

The SEC has provided its interpretation of these three theories in Rule 10b5-1, which provides that

> [t]he "manipulative and deceptive devices" prohibited by Section 10(b) of the Act [and Rule 10b-5] . . . include, among other things, the purchase or sale of a security of any issuer, on the *basis of material nonpublic information* about that security or issuer, in *breach of a duty of trust or confidence* that is *owed directly, indirectly, or derivatively, to the issuer of that security* or the shareholders of that issuer, or *to any other person who is the source of the material nonpublic information.*[140]

The rest of this Section briefly discusses each basis of liability and then applies each in the context of trading on political intelligence.

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[137] *See* Cady, Roberts & Co., 40 S.E.C. 907, 908-09, 911 (1961) (holding that a broker who obtained nonpublic information about a company's dividend action and who entered sale orders before the information became public had violated Rule 10b-5).

[138] Bainbridge, *supra* note 131, at 12.

[139] *See* FLETCHER, *supra* note 131, at 99 (describing the evolution of Rule 10b-5 jurisprudence). Supreme Court Chief Justice William Rehnquist opined that Rule 10b-5 is "a judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[140] 17 C.F.R. § 240.10b5-1(a) (emphasis added). The regulation, however, specifically notes that "[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect." *Id.* preliminary note.

1. Classic Insider Trading: The Disclose-or-Abstain Rule

The classic case of insider trading occurs when a corporate insider buys or sells shares of her company while possessing material nonpublic information acquired through her corporate insider position. Originally, the concept was applied broadly and required anyone with "access, directly or indirectly,"[141] to material nonpublic information to "disclose or abstain" from trading using the information.[142] It was not long, however, before the Supreme Court cabined the disclose-or-abstain rule by limiting it to corporate fiduciaries who possess material nonpublic information. A duty to disclose or abstain from trading arises only where there is a fiduciary relationship between the parties involved, namely, the individual trader and the issuer of the security.[143] Rule 10b-5 does

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[141] *Cady, Roberts*, 40 S.E.C. at 912.

[142] The SEC established the disclose-or-abstain rule in *Cady, Roberts*:

> We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

Id. at 911 (footnote omitted).

The first "truly seminal insider trading case[]" was *SEC v. Texas Gulf Sulphur Co.*, decided by the Second Circuit in 1968. *See* Bainbridge, *supra* note 131, at 13 (commenting on SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc)). *Texas Gulf Sulphur* involved corporate insiders who bought stock or call options in the Texas Gulf Sulphur Company (TGS) from the fall of 1963 through the spring of 1964. 401 F.2d at 839. During this time, TGS exploration teams discovered substantial zinc and copper deposits under a parcel of land, the rights to which TGS eventually purchased. *Id.* at 843-44. TGS denied rumors of the discovery until eventually announcing the find in April 1964, *id.* at 844-45, and by May, TGS stock was trading at prices 222% above its share price several months earlier, Bainbridge, *supra* note 131, at 13. The Second Circuit upheld the convictions of certain TGS insiders under Rule 10b-5, 401 F.2d at 852, reasoning that insiders who possess material nonpublic information must disclose the information or abstain from trading altogether, *id.* at 848.

[143] *See* Chiarella v. United States, 445 U.S. 222, 232 (1980) (holding that "the element required to make silence fraudulent—a duty to disclose—[was] absent in this case" because the petitioner "was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence"). In *Chiarella*, Vincent Chiarella, an employee of a financial printer, learned of an upcoming tender offer while preparing the tender offer materials. *Id.* at 224. Chiarella purchased shares in the target company and later sold them for a substantial profit. *Id.* He was convicted of violating Rule 10b-5. *Id.* at 222. The Second Circuit applied *Texas Gulf Sulphur* to uphold his conviction, United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), but the Supreme Court reversed, 445 U.S. at 231-35, 237. *See also* ARSHADI & EYSSELL, *supra* note 131, at 52 ("This ruling required that to impose the disclose or abstain rule, the trader must be a fiduciary to the firm and consequently to its shareholders.").

not create liability for nondisclosure "absent a duty to speak."[144] Accordingly, a cognizable insider trading claim under the classic theory can be sustained only if the defendant trades on material nonpublic information in breach of a fiduciary duty owed to the security's issuer.

2. Tipper/Tippee Liability

Courts have extended Rule 10b-5 to provide liability for an individual who is not a fiduciary but who trades on a tip from an individual who is a fiduciary. In this situation, the "tippee" inherits the fiduciary duty of the "tipper" when the tipper has received a personal benefit from passing on the tip.[145] This is because a tippee assumes the liability of the tipper by participating in the "insider's breach of a fiduciary duty."[146] The tippee's liability is "derivative."[147] Accordingly, a tippee is "liable only when the tipper breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty."[148] Further, the duty is inheritable only when the tipper received a gift, pecuniary gain, or reputational enhancement.[149] The term "reputational enhancement" is broad and can include merely a "warm glow" from helping a friend.[150]

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[144] *Chiarella*, 445 U.S. at 235.

[145] *See* Dirks v. SEC, 463 U.S. 646, 661-62 (1983) ("In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty. . . . [T]he test is whether the insider personally will benefit . . . from his disclosure."). Raymond Dirks was an investment analyst who, on the tip of a former officer of Equity Funding of America, uncovered substantial fraud at the company. *Id.* at 648-49. Dirks shared his discovery with the *Wall Street Journal* and his clients. *Id.* at 649-50. Some of Dirks's clients sold their holdings in Equity Funding and avoided substantial losses that would have occurred if they had held their securities until the news became public. *Id.* at 649. The Court held that Dirks did not violate Rule 10b-5 because the corporate insiders did not share information with Dirks for the purpose of gaining a personal advantage. *Id.* at 662, 665, 667. Consequently, the Court overturned Dirks's conviction. *Id.* at 667.

[146] *Id.* at 659 (quoting *Chiarella*, 445 U.S. at 230 n.12).

[147] *Id.*

[148] Bainbridge, *supra* note 131, at 19; *see also Dirks*, 463 U.S. at 660 ("Thus, 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.").

[149] *See Dirks*, 463 U.S. at 663-64 (noting that the determination of whether "there has been a breach of duty by the insider . . . requires courts to focus on objective criteria, *i. e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings. . . . The elements of fiduciary duty and exploitation of nonpublic information also

3. Misappropriation Theory

The misappropriation theory was developed to fill a void created by the fiduciary requirement imputed to the classic insider trading theory, and it has been used to reach outsider trading.[151] The Supreme Court adopted the misappropriation theory in 1997.[152] The theory creates insider trading liability for outsiders who trade on material nonpublic information in breach of a "duty of trust or confidence" owed to the inside source of the information.[153] In essence, even if a trader does not owe a duty to the issuer of the security in which he trades, he may still be liable if he is in a position of confidence with the information's source.

The SEC's interpretation of the misappropriation theory is provided in Rule 10b5-2.[154] The Rule applies to any violation under the Act or Rule 10b-5 "that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information *misappropriated in breach of a duty of trust or confidence*."[155] Rule 10b5-2 provides that a "duty of trust or confidence" will be inferred

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exist when an insider makes a gift of confidential information to a trading relative or friend." (citation omitted)); Bainbridge, *supra* note 131, at 19 (explaining that "nonpecuniary gain," such as a boost to one's reputation, could create a personal benefit).

[150] *See* ARSHADI & EYSSELL, *supra* note 131, at 53.

[151] The SEC pushed the misappropriation theory following setbacks in *Chiarella* and *Dirks*, decisions that were seen as having too greatly limited SEC authority to effectively curb insider trading. Bainbridge, *supra* note 131, at 22.

[152] United States v. O'Hagan, 521 U.S. 642, 653-54 (1997). James O'Hagan was a partner at the law firm of Dorsey & Whitney, which had been hired by Grand Metropolitan PLC with respect to a planned tender offer for shares of the Pillsbury Company. *Id.* at 647. O'Hagan, who was not working on the deal but knew of its details, purchased stock and call options in the target company, Pillsbury. *Id.* Following the announcement of the tender offer, O'Hagan sold his shares and options, reaping a "profit of more than $4.3 million." *Id.* at 648. O'Hagan was not subject to liability under the classic insider trading theory because his firm was employed by the bidder, and O'Hagan took positions in the target. *Id.* at 653 n.5. The Court recognized that O'Hagan owed no duty to the target company in which he traded, yet "it grounded liability under the misappropriation theory on deception of the source of the information." Bainbridge, *supra* note 131, at 30. O'Hagan, a fiduciary of his law firm, failed to disclose his use of information that belonged to the firm. *Cf. O'Hagan*, 521 U.S. at 655 n.6. O'Hagan's conduct, as a result, was sufficient to constitute a violation of Rule 10b-5. *Id.* at 666.

[153] *O'Hagan*, 521 U.S. at 653; *see also id.* at 652 ("[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.").

[154] The SEC is careful to note that the Rule does not displace judicially created doctrine. 17 C.F.R. § 240.10b5-2 preliminary note (2009).

[155] *Id.* § 240.10b5-2(a) (emphasis added).

when (1) there is an agreement to "maintain information in confidence"; (2) where the parties communicating such information have a "history, pattern, or practice of sharing confidences" so as to create a reasonable inference "that the recipient will maintain confidentiality"; or (3) information is received from a "spouse, parent, child, or sibling," although this presumption can be rebutted.[156]

Nevertheless, in a recent high-profile case, a U.S. District Court rejected such an understanding of Rule 10b5-2.[157] While the Court affirmed that the misappropriation theory does not require a fiduciary duty,[158] as is the case under the classic insider trading theory, it held that a duty of confidentiality does not imply a duty not to trade in a security. Rather, when confidential communications are made, there must not merely be an agreement to keep the information confidential but also an explicit agreement not to trade on the information.[159]

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[156] *Id.* § 240.10b5-2(b). In full, subsection (b) reads as follows:

> (b) *Enumerated "duties of trust or confidence."* For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:
>
> (1) Whenever a person agrees to maintain information in confidence;
>
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a *history, pattern, or practice of sharing confidences*, 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
>
> (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 that 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, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id. (emphasis added).

[157] *See* SEC v. Cuban, 634 F. Supp. 2d 713, 730-31 (N.D. Tex. 2009) ("To permit liability based on Rule 10b5-2(b)(1) would exceed the SEC's § 10(b) authority to proscribe conduct that is deceptive.").

[158] *See id.* at 726 ("[T]he court disagrees with his contention that, for a person to be held liable under the misappropriation theory, he must enter into an agreement that creates a relationship bearing all the hallmarks of a traditional fiduciary relationship.").

[159] *See id.* at 725 ("The agreement, however, must consist of more than an express or implied promise merely to keep information confidential. . . . He must agree to maintain the confidentiality of the information *and* not to trade on or otherwise use it. Absent a duty not to use the information for personal benefit, there is no deception in doing so.").

B. *Application to Political Intelligence*

Having briefly summarized the bases of insider trading liability, the remainder of this Part considers whether any are relevant to trading on political intelligence. This Section concludes that current law does not support holding government insiders or outside actors liable for insider trading without substantially manipulating current doctrine. First, government insiders, even if deemed "fiduciaries," are not fiduciaries of the issuer of the securities in which they trade and cannot be liable under the classic theory. The misappropriation theory is tenuous absent an explicitly recognized duty of confidentiality among members of Congress. Second, outside actors are not liable under the tipper/tippee theory because government insiders—the "tippers"—are not fiduciaries of a security issuer. Neither are outside actors liable under the misappropriation theory absent an explicit agreement of confidentiality because the very nature of lobbying implies that political information will be passed along to clients.

1. Government Insiders

Several scholars, commentators, and politicians have argued that the insider trading doctrine outlined above does not capture trading on political information by government insiders.[160] Yet, others believe it is covered by the current doctrine, either under the theory of classic insider trading[161] or the misappropriation theory.[162]

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[160] *See, e.g.*, Barbabella, Cohen, Kardon & Molk, *supra* note 24, at 200 (arguing that although trading on political intelligence "presents some obvious analogues to corporate insider trading," nevertheless "under current law, none of these described actions is illegal"); Brody Mullins, *Bill Seeks to Ban Insider Trading by Lawmakers and Their Aides*, WALL ST. J., Mar. 28, 2006, at A1 (quoting Thomas Newkirk, a former official in the Division of Enforcement at the SEC, as saying that "[i]f a congressman learns that his committee is about to do something that would affect a company, he can go trade on that because he is not obligated to keep that information confidential . . . . He is not breaching a duty of confidentiality to anybody and therefore he would not be liable for insider trading." (internal quotation marks omitted)); Press Release, Baird, *supra* note 2 ("Under current law, Members of Congress and their staff do not owe a duty of confidentiality to Congress, and therefore are not liable for insider trading."); Stephen Bainbridge, *Insiders on the Hill*, TCSDAILY, Mar. 30, 2006, http://www.tcsdaily.com/article.aspx?id=033006D ("Effective regulation of problematic Congressional trading thus requires a broader prohibition than the securities law definition of insider trading.").

[161] *See* Langevoort, *supra* note 23, at 34-35 (positing that government officials trading on political insider information breach a fiduciary duty owed to citizen investors).

[162] *See* George, *supra* note 23, at 166 (arguing that Senate and House ethical codes create a reasonable expectation of confidentiality).

First, Professor Langevoort argues that the classic theory of insider trading sufficiently covers government insiders.[163] Professor Langevoort contends that when a politician possesses "information that will substantially affect the price of an issuer's securities" and then trades on such information, he is breaching a "duty of fair dealing" to the "country's citizens" in contravention of Rule 10b-5.[164] Professor Langevoort and others acknowledge that government insiders do not owe a fiduciary duty to the issuing corporation of the stock in which they trade but that an equivalent duty owed to the public suffices under the *Chiarella* fiduciary duty requirement. Professor Langevoort explains that,

> [l]ike the corporate insider, the government official has an advantageous position as compared to the persons whom he is charged with serving. Thus, the principle of preventing unjust enrichment applies as well in the case of a government official. It follows that he should give up any trading profit coming to him because of his fiduciary position when other investors are harmed by the unavailability of information.[165]

A number of courts have similarly found that elected officials owe duties akin to fiduciary obligations to their constituents.[166] These courts have not held that the duties owed by public officials are the same as fiduciary duties in the traditional corporate context, but they simply make the argument by analogy.[167] Yet, to the extent that Congress con-

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[163] A decade prior to Professor Langevoort's article, a law student argued that government insiders are liable for trading on political information. *See* Krimmel, *supra* note 21, at 1492 (proposing that government insiders violate Rule 10b-5 when they use confidential information to purchase securities for their own benefit).

[164] Langevoort, *supra* note 23, at 34; *see also* Krimmel, *supra* note 21, at 1503 ("While a government employee bears no traditional or special fiduciary obligation as such to the shareholders of any specific corporation, he certainly owes a duty to the government, and eventually therefore to the public at large, for the proper performance of his responsibilities.").

[165] Langevoort, *supra* note 23, at 34-35.

[166] *See, e.g.*, United States v. Woodard, 459 F.3d 1078, 1086 (11th Cir. 2006) ("[A] public official . . . owe[s] a fiduciary duty to the public to make governmental decisions in the public's best interest . . . ." (footnote omitted)); United States v. Keane, 522 F.2d 534, 545 (7th Cir. 1975) ("[I]t was clearly improper and therefore actionable under the mail fraud statute for the defendant to make use of inside advance information obtained by virtue of his official position for his own personal gain."); United States v. Peltz, 433 F.2d 48, 52 (2d Cir. 1970) ("Public confidence essential to the effective functioning of government would be seriously impaired by any arrangement that would enable a few individuals to profit from advance knowledge of governmental action.").

[167] *See* Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities*, 49 BUS. LAW. 187, 245 (1993) ("Several courts and commentators analogized the government employee's relationship with taxpayers as akin to that of fiduciary to beneficiary.").

templated insider trading prior to the enactment of the Exchange Act, it did so only with regard to corporate fiduciaries in a limited sense.[168]

Nonetheless, Professor Langevoort's application seems to miss the major limitation imposed by *Chiarella*, namely that trading on material nonpublic information only violates Rule 10b-5 where the trader owes a fiduciary duty to the corporate issuer of the security. In this regard, it is irrelevant whether government insiders are fiduciaries of the public at large. Without a fiduciary duty owed to the issuer, a government insider would not be liable under the classic theory of insider trading.

A second argument advanced is that government insiders are liable under the misappropriation theory.[169] This argument maintains that members of Congress and Capitol Hill staffers are bound by a duty of confidentiality laid out in the Code of Ethics, discussed earlier.[170] For example, Senate Rule 29(5) provides expulsion or punishment for any "Senator, officer, or employee of the Senate who shall disclose the secret or confidential business or proceedings of the Senate."[171] Accordingly, it is argued that these contractual provisions are sufficient to create a duty of "trust or confidence" under Rule 10b5-2 that is breached when members misappropriate information for trading purposes.[172] Likewise, Professor Bainbridge agrees that congressional ethics limitations "should suffice" to establish the requisite trust and confidence under the misappropriation theory.[173]

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[168] *See* S. REP. NO. 73-1455, at 55 (1934) ("Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities.").

[169] *See* George, *supra* note 23, at 163 (arguing that the misappropriation theory is viable because legislators and their staffers possess a duty of confidentiality and because congressional information is not always public). In addition, George argues that staffers breach fiduciary duties owed to their legislator-employers arising out of the principal/agent relationship. *See id.* at 165-66 (asserting that staffers who relay political intelligence "breach traditional fiduciary duties arising out of principal/agent relationships with the legislators or with higher ranking staffers who are their employers" and "almost certainly break duties arising out of ethical rules as well as duties arising from history, pattern, or practice").

[170] *See id.* at 166 (concluding that Paragraph Eight of the Code of Ethics for Government Service creates a "duty-by-agreement . . . because it is binding upon all members of the Federal Government as a condition of employment.").

[171] STANDING RULES OF THE SENATE, R. XXIX(5), *as reprinted in* S. DOC. NO. 110-9, at 42 (2007).

[172] George, *supra* note 23, at 166.

[173] Bainbridge, *supra* note 24, at 9.

Other scholars dismiss both theories.[174] Although they acknowledge a consensus that "congressional representatives ought to place public interests first," a lack of a "concrete duty" has prevented enforcement actions under current law.[175] Accordingly, "[i]f congressional representatives and others are to be barred from engaging in such activities, regulation appears necessary insofar as it overcomes legislators' lack of a well-defined duty."[176]

These arguments are correct in stating that, at a minimum, there is a lack of consensus and understanding among members of Congress about the duties of trust and confidence owed. This is evidenced by the fact that members themselves have introduced legislation to clarify the extent of their duties with regard to insider trading rather than calling upon the SEC to enforce under the current regime.[177] When the Supreme Court endorsed the misappropriation theory, it was in the context of a clearly understood and well-defined duty owed by an employee to his employer.[178] If the misappropriation theory is enforced absent a concrete duty, there will be virtually no limit to swallowing up unwary confidants.[179] This certainly should not be the goal of the misappropriation theory.

Perhaps the best argument that government insiders are liable under the misappropriation theory stems not from a duty of trust or confidence based upon House or Senate ethics rules, but instead upon fiduciary duties stemming from the government insiders' employment relationship. Professor Bainbridge makes this argument with regard to Capitol Hill staff (employees) who he claims have fiduciary duties to the members of Congress for whom they work (employers).[180] Under the misappropriation theory, a congressional employee has a duty not to trade on information acquired from her

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[174] *See* Barbabella, Cohen, Kardon & Molk, *supra* note 24, at 215-17 (arguing that no theory of insider trading applies to trading on nonpublic material information obtained by members of Congress by virtue of their office).

[175] *Id.* at 217.

[176] *Id.*

[177] *See infra* Section III.A.

[178] *See* United States v. O'Hagan, 521 U.S. 642, 653 (1997) (finding misappropriation where "O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock").

[179] *SEC v. Cuban* prevents this by requiring not merely an agreement of confidentiality but also an agreement not to trade. 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009).

[180] *See* Bainbridge, *supra* note 24, at 9 ("These employment relationships should suffice for Congressional staffers to be deemed to have an agency or other relationship of trust and confidence with their employing agency.").

employer, a member of Congress.[181] Professor Bainbridge argues that this employment relationship is sufficient to sustain liability for employee staff members but not for members of Congress—the employers.[182] This approach fails to appreciate the potential reach of the argument, however, because members of Congress, like their staff, could also be deemed employees of the federal government. Accordingly, a better approach would not distinguish between congressional staff and elected members of Congress but would instead classify both groups as "employees" of the federal government, each owing fiduciary duties to its "employer," the federal government.[183] Under this characterization, it is difficult to distinguish misappropriation of political information by government insiders (politicians and staff alike) from misappropriation of information from one's employer in the traditional misappropriation cases.

Against this approach, however, is an intuition in favor of treating a member of Congress as her own boss—and hence, as an "employer"—and against treating members of Congress as "employees" of the federal government. This is true not only of Professor Bainbridge's argument, but it is apparent in other contexts as well.[184] On the one hand, members of Congress receive a paycheck from the federal government. On the other hand, there is a sense that members of Congress are not like employees because their public election gives them autonomy to make decisions as they see fit without being accountable to anyone but their constituency (and to that extent, only in subsequent elections). Furthermore, unlike employees, members of Congress are not in a clear principal/agent relationship with the federal government and, accordingly, are not accountable to the federal government as are typical "employees." These observations suggest that members of Congress are only "employees" because they formally receive a paycheck from the federal government while they functionally behave more like employers.

There is no consensus as to whether politicians are "employees" or "employers." Similar to the disagreement over the question whether

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[181] *See id.* at 10 ("Put into *O'Hagan*'s terminology, 'a [staffer's] undisclosed, self serving use of [Congressional] information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the [Congress].'" (alterations in original) (quoting *O'Hagan*, 521 U.S. at 652)).

[182] *See id.* at 12 ("As an employer, a member of Congress is free to trade; as an employee, the staffer is not.").

[183] I credit Professor Tyson for developing this argument.

[184] *See, e.g.*, *infra* note 237 and accompanying text (suggesting that members of Parliament in the United Kingdom are not fiduciaries of the British Government).

members of Congress and their staff are bound by a duty of trust or confidence sufficient to give rise to liability under the misappropriation theory, there is also disagreement over whether members of Congress are "employees" who could satisfy the misappropriation theory. This confusion suggests that regardless of one's view of the status of government insiders, it would be controversial to apply insider trading doctrine in this situation, to say the least. It would be unwise to extend insider trading liability where its application is tenuous, as would be the case under either misappropriation approach.

2. Outside Actors

Outside actors—lobbyists and hedge funds—present a different set of issues that makes them even less likely to be considered inside traders under current doctrine. First, classic insider trading theory is inapplicable unless the outside actor owes a fiduciary duty to the issuer of the security in which he trades.[185] For example, the classic theory would apply if corporate executives hired a lobbyist and then traded in their own companies' securities based on the political information acquired. However, this situation is unlikely because the political-intelligence practice is dominated by hedge fund clients who do not have fiduciary relationships with the issuers of the stock in which they trade.

Second, tipper/tippee liability will depend entirely on whether the government insider—the tipper—is a fiduciary not merely to the public at large, but specifically to the issuer of the security. Assuming arguendo that government insiders are fiduciaries, outside actors would inherit the fiduciary duty of the insider only if the insider were to breach her duty.[186] An insider breaches her duty only if she receives some sort of personal benefit in exchange for the inside information,[187] and courts have interpreted what constitutes a personal benefit

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[185] *See supra* note 143 and accompanying text.

[186] The Supreme Court stated in *Dirks* that

> some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly* . . . 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.

Dirks v. SEC, 463 U.S. 646, 660 (1983).

[187] *See id.* at 662 ("Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.").

very broadly.[188] The best argument for finding liability here is that government insiders pass along information to their K Street chums for a political contribution, reputational advantage, "warm glow" effect, or expectation of future employment. There certainly is a "revolving door" between K Street and Capitol Hill.[189] A "personal benefit" analysis would require a fact-intensive, case-by-case inquiry into the relationships between government insiders and lobbyists and would somehow have to measure fuzzy reputational advantages or determine future employment opportunities. All this is, however, moot, since the tipper/tippee theory will not apply even if a benefit can be construed. The government insider must have a fiduciary relationship with the issuer of the security in which the tippee trades, not merely with the general public.[190]

Third, the misappropriation theory presents a more viable application to outside actors. Since the misappropriation theory severs the fiduciary requirement between trader and issuer, we can simply look at whether the outside actor has breached a duty of confidentiality with the government insider. As we saw, Rule 10b5-2 provides a nonexclusive definition of the duty of trust and confidence. Such a duty may arise explicitly through an agreement or through a "history, pattern, or practice of sharing confidences."[191] For instance, in the asbestos example, there was an indication that the information was to be kept confidential: when the information was relayed to the press, its release was conditioned upon the information not being published until the morning of the official announcement.[192] If the same condition were placed upon the communication to the lobbyist, then there arguably would be an agreement "to maintain information in confidence."[193]

One could also argue that there is a pattern of sharing confidences between lobbyists and government insiders that establishes a general

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[188] *See supra* note 150 and accompanying text.

[189] *See* Gail Russell Chaddock, *Republicans Take over K Street*, CHRISTIAN SCI. MONITOR, Aug. 29, 2003, at 1, *available at* 2003 WLNR 2280355 (quoting Frank Clemente, director of Public Citizen's Congress Project, as saying that "[t]he revolving door is becoming more comfortably established and institutionalized").

[190] I have other concerns with pursuing this approach under tipper/tippee liability. Specifically, imposing the vague contours of tipper/tippee liability would limit constructive exchanges between Capitol Hill and constituent groups, often represented by lobbyists, because it may be impossible to determine ex ante whether liability would arise. I consider this further in Part V.

[191] 17 C.F.R. § 240.10b5-2(b)(2) (2009).

[192] *See supra* note 11 and accompanying text.

[193] 17 C.F.R. § 240.10b5-2(b)(1).

duty of confidentiality. Lobbying, however, by its very nature contradicts this argument. Government insiders know that lobbyists always represent someone—that lobbyists are mere liaisons between Capitol Hill and the constituent group—and they presume that the discussions will be relayed back. It would be unlikely that the lobbyist would not share the information absent an explicit agreement not to do so.

Application of the misappropriation theory could be further complicated by the holding in *SEC v. Cuban* that there must also be an explicit agreement not to trade using the confidential information.[194] The court acknowledged that "nondisclosure and non-use are logically distinct."[195] This requirement seems to suggest that the lobbyist himself could trade on acquired information unless he agreed not to do so. The lobbyist, however, would breach confidentiality by sharing information with a client regardless of whether the lobbyist agreed not to trade. This is unlikely to be an issue since lobbyists, in practice, pass political intelligence along to their clients. If, however, a constituent receives political intelligence directly from Capitol Hill, and she is able to maintain confidentiality while trading,[196] an explicit agreement not to trade would be required under the court's test.[197]

3. Conclusion

Though insider trading liability could arguably exist for government insiders and outside actors, such an expansive reading would have profound consequences for current insider trading doctrine. First, as it pertains to government insiders, the classic theory is inapplicable because it requires a fiduciary relationship between the party trading and the issuer of the security being traded. Accordingly, even assuming that government insiders have a fiduciary relationship with the public at large, that fiduciary relationship would be insufficient because it is not with the issuer of the security being traded. This assumption is heroic because, at most, courts have analogized public figures to fiduciaries but have not explicitly named them as such. Second, the misappropriation theory is more tenable, but holding public officials and employees liable would require either inferring a duty of trust or confidence arising from their public service or classify-

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[194] *See supra* notes 157-61 and accompanying text.

[195] SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) (footnote omitted).

[196] *See id.* ("A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain.").

[197] *See supra* note 159.

ing public officials as "employees" of the federal government. It is clear that there is no consensus regarding such a duty or employment status, as demonstrated by the fact that members of Congress themselves are sponsoring legislation that would clarify the issue rather than relying on current law. Pursuing government insiders under any of these theories would require stretching current doctrine beyond what it can legitimately sustain.

With regard to outside actors, insider trading liability is even more attenuated. First, tipper/tippee liability suffers the same fate as the classic theory for government insiders, since a tippee's liability depends on the tipper having a fiduciary relationship with the issuer. Second, the misappropriation theory may apply if there is an explicit understanding of confidentiality. In practice, however, this will seldom be the case, since it is the lobbyist's job to share political information with her clients.

Lastly, one should be concerned that such convoluted and indeterminate application of the federal securities laws to democratic processes may severely hamper political dialogue as well as market efficiency. Part V explores these ramifications further, but for now it will suffice to make a few preliminary comments. First, fear of criminal liability for insider trading will make government insiders think twice before meeting and sharing information with constituents. These exchanges of ideas and information between Capitol Hill and the American public are invaluable to building consensus, writing informed legislation, and preventing congressional insularity. Second, market efficiency depends on delivering accurate information to the marketplace, information that is then impounded into asset prices. Information gatherers—such as market analysts or, here, lobbyists hired by hedge funds—perform the valuable service of ferreting out information that will eventually be reflected in accurate and efficient market prices.[198] One should not lose sight of the unintended consequences resulting from applying insider trading doctrine to political-intelligence trading.

III. LEGISLATIVE PROPOSALS IN THE U.S. CONGRESS AND COMPARATIVE ANALYSIS OF U.K. INSIDER TRADING LAW

Part II concluded that current insider trading doctrine does not sufficiently support liability for trading on political information. This Part considers recent legislation introduced in the U.S. Congress

[198] I am grateful to Professor Fisch for calling this argument to my attention.

aimed at remedying this "loophole." It then turns to a comparative analysis of the insider trading law of the United Kingdom, which does prohibit government officials and outsiders from trading on political information. This Part concludes that the U.K. law is not instructive because of significant differences between U.K. and U.S. insider trading law and policy objectives.

A. *Recent Legislative Proposals Considered by the U.S. Congress*

The 2005 media attention surrounding the growing practice of political-intelligence gathering caught the attention of two Democratic members of the House of Representatives.[199] Representative Louise Slaughter of New York, chairwoman of the House Rules Committee, and Representative Brian Baird of Washington have introduced legislation in recent Congresses that would bring trading based on political intelligence—by government insiders and outside actors—under the umbrella of the federal securities laws. The legislation would also require lobbyists to disclose their political intelligence clients. But the legislation has proven politically unpalatable. As outlined below, after introducing broad legislation in 2006 and 2007, separate legislation was introduced in 2008 that only sought to require disclosure of political-intelligence activities. In 2009, Representatives Baird and Slaughter reintroduced the more comprehensive legislative proposal. The current economic and political climate has evidenced an appetite for financial regulation, and, in 2009, the legislation received its first congressional hearing.

1. Stop Trading on Congressional Knowledge Act

Representatives Baird and Slaughter introduced variations of the Stop Trading on Congressional Knowledge Act (STOCK Act) in the 109th,[200] 110th,[201] and 111th[202] Congresses. The STOCK Acts of the 110th

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[199] *See* Press Release, Baird, *supra* note 15; *see also* Macey, *supra* note 46, at 309 ("In response to the 'shocking' news of public officials using their official positions for personal gain, Louise Slaughter, the chair of the House Rules Committee (D-NY) and Brian Baird (D-WA) proposed the Stop Trading on Congressional Knowledge Act.").

[200] Stop Trading on Congressional Knowledge Act, H.R. 5015, 109th Cong. (2006); *see also* Press Release, Congressman Brian Baird, Baird, Slaughter Seek Capitol Hill Insider Trading Ban (Mar. 28, 2006), *available at* http://www.house.gov/list/press/wa03_baird/STOCKAct032806.html (announcing the introduction of legislation by Representatives Baird and Slaughter to "stop insider trading on Capitol Hill").

[201] Stop Trading on Congressional Knowledge Act, H.R. 2341, 110th Cong. (2007); *see also* Press Release, Baird, *supra* note 2 (announcing the reintroduction of

and 111th Congress were identical. A few changes were made between the 109th and the 110th versions that likely signify political compromise.

First, the STOCK Act seeks "[t]o prohibit securities trading based on nonpublic information relating to Congress."[203] The legislation would accomplish this by amending the Exchange Act to require the SEC to promulgate a rule prohibiting trading on material nonpublic information relating to legislation if the information was (1) "obtained by reason of such person being a Member or employee of Congress" or (2) "obtained from a Member or employee of Congress, and such person knows that the information was so obtained."[204] In addition, the STOCK Act would amend congressional rules to prohibit members and staff from sharing material nonpublic information with individuals believed to be using the information for trading purposes.[205]

Second, the bill seeks timely disclosure of the securities transactions of members of Congress, officers, and employees.[206] Specifically, it would amend the Ethics in Government Act of 1978 to require members of Congress to disclose, within ninety days, any "purchase, sale, or exchange of any stocks, bonds, commodities futures, or other forms of securities" involving at least $1000.[207]

Third, the legislation amends the LDA to bring political-intelligence activity in line with general lobbying. Specifically, it would require public reporting of "political intelligence activities" by

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Representatives Baird and Slaughter's legislation to prohibit insider trading, and reporting that the new bill was "strengthened to apply to all employees of the executive branch, in addition to Congressional staffers and Members of Congress").

[202] Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Cong. (2009); *see also* Press Release, Baird, *supra* note 2 (announcing the reintroduction of the STOCK Act).

[203] H.R. 5015; *accord* H.R. 682; H.R. 2341. The original 2006 bill only applied to the legislative branch, but the 2007 and 2009 legislation extended to all federal employees who derive material nonpublic information from their employment and to information obtained from those employees. H.R. 682 sec. 2, § 10; H.R. 2341 sec. 2, § 10.

[204] H.R. 682 sec. 2(a), § 10(c); H.R. 2341 sec. 2(a), § 10(c); H.R. 5015 sec. 2(a), § 10(c). Parallel prohibitions apply to other federal employees. H.R. 682 sec. 2(a), § 10(d); H.R. 2341 sec. 2(a), § 10(d).

[205] H.R. 682 § 3; H.R. 2341 § 3. Originally, this was to be accomplished through an SEC rule prohibiting members or staff from disclosing legislative information if the member or staff "has reason to believe" that the information will be used for trading purposes. H.R. 5015 sec. 2(a), § 10(c)(2). Certainly, the ethics approach in the current legislation is less potent than a corresponding amendment to the Exchange Act and likely represents an accommodation.

[206] H.R. 682 § 4; H.R. 2341 § 4; H.R. 5015 § 3.

[207] H.R. 682 sec. 4(a), § 103(*l*); H.R. 2341 sec. 4(a), § 103(*l*); H.R. 5015 sec. 3(a), § 103(*l*). Originally, the legislation introduced in the 109th Congress had a thirty-day filing requirement. H.R. 5015 sec. 3(a), § 103(*l*).

"political intelligence consultant[s]."[208] Political-intelligence activities are "political intelligence contacts" and efforts in support of such contacts.[209] A political-intelligence contact is defined as any communication to or from the legislative or executive branch that results in information "intended for use in analyzing securities or commodities markets, or in informing investment decisions, and which is made on behalf of a client" regarding "the formulation, modification, or adoption of Federal legislation."[210]

The legislation received fourteen cosponsors in the 109th Congress, including Representative Slaughter and excluding the bill's primary sponsor, Representative Baird.[211] It was referred to several committees but failed to receive any action.[212] The legislation introduced in the 110th Congress received ten cosponsors, including Representative Slaughter and excluding the primary sponsor, Representative Baird.[213] Again, the legislation was referred to committee but did not move.[214] In the 111th Congress, there are currently seven cosponsors, excluding the primary sponsor, Representative Baird.[215] In 2009, the legislation received its first hearing, conducted by the Subcommittee on Oversight and Investigations of the House Committee on Financial Services, which took testimony from Representatives Slaughter and Baird, the SEC Inspector General, and three academics.[216]

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[208] H.R. 682 sec. 5(a)(1), § 3(2); H.R. 2341 sec. 5(a)(1), § 3(2); H.R. 5015 sec. 4(a)(1), § 3(2).

[209] H.R. 682 sec. 5(a)(2), § 3(17); H.R. 2341 sec. 5(a)(2), § 3(17). The 2006 legislation only covered contacts to the legislative branch. H.R. 5015 sec. 4(a)(2), § 3(18).

[210] H.R. 682 sec. 5(a)(2), § 3(18); H.R. 2341 sec. 5(a)(2), § 3(18); *cf.* H.R. 5015 sec. 4(a)(2), § 3(18) (applying the same rule but only to the legislative branch).

[211] *See* 152 CONG. REC. H1195 (daily ed. Mar. 28, 2006); 152 CONG. REC. H1563 (daily ed. Apr. 5, 2006); 152 CONG. REC. H1853 (daily ed. Apr. 26, 2006); 152 CONG. REC. H1917 (daily ed. Apr. 27, 2006); 152 CONG. REC. H2586 (daily ed. May 11, 2006).

[212] House Bill 5015 was referred to the House Committees on Financial Services, Administration, Agriculture, and the Judiciary. H.R. 5015.

[213] *See* 153 CONG. REC. H5290 (daily ed. May 16, 2007); 153 CONG. REC. H6236 (daily ed. June 11, 2007); 153 CONG. REC. H7340 (daily ed. June 27, 2007); 153 CONG. REC. H8121 (daily ed. July 18, 2007); 153 CONG. REC. H11,028 (daily ed. Sept. 27, 2007); 154 CONG. REC. H5408 (daily ed. June 12, 2008); 154 CONG. REC. H10,642 (daily ed. Sept. 29, 2008).

[214] House Bill 2341 was referred to the same committees as the 2006 bill as well as to the House Committee on Standards of Official Conduct. H.R. 2341.

[215] *See* 155 CONG. REC. H525 (daily ed. Jan. 28, 2009); 155 CONG. REC. H3706 (daily ed. Mar. 19, 2009); 155 CONG. REC. H8009 (daily ed. July 10, 2009); 155 CONG. REC. H8302 (daily ed. July 16, 2009); 155 CONG. REC. H8356 (daily ed. July 17, 2009); 155 CONG. REC. H13,386 (daily ed. Dec. 1, 2009).

[216] *See Hearing on Preventing Unfair Trading by Government Officials*, *supra* note 48.

2. Political Intelligence Disclosure Act

Representatives Baird and Slaughter introduced the Political Intelligence Disclosure Act in the 110th Congress,[217] but they have not yet reintroduced it in the 111th Congress. The legislation sought to amend the LDA to require public reporting of political-intelligence activities in precisely the same way as the STOCK Act.[218] Representatives Slaughter and Baird noted that the Bill "was inspired by legislation [they] introduced in the 109th and 110th Congresses that prohibits Members of Congress and federal employees from profiting from nonpublic information they obtained from their official positions."[219] In the 110th Congress, the Political Intelligence Disclosure Act received only one cosponsor in addition to Representatives Baird and Slaughter.[220] It was referred to the House Committee on the Judiciary and did not receive any action.[221]

The fact that Representatives Baird and Slaughter chose to introduce the political-intelligence disclosure portion of the STOCK Act as a stand-alone bill suggests political maneuvering. It will certainly be easier to get Congress to accept the Political Intelligence Disclosure Act by itself than the STOCK Act by itself, which would regulate the members themselves and expose them to insider trading liability.[222] While Representatives Baird and Slaughter continue to push for the much broader insider trading regulation prescribed by the STOCK Act, the Political Intelligence Disclosure Act remains much more palatable to members of Congress.

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[217] Political Intelligence Disclosure Act, H.R. 5617, 110th Cong. (2008); *see also* Press Release, Congressman Brian Baird, Reps. Slaughter and Baird Introduce Bill to Regulate Political Intelligence Gathering (Mar. 13, 2008), *available at* http://www.house.gov/list/press/wa03_baird/politicalintelbill.html (announcing the introduction of the Political Intelligence Disclosure Act, and characterizing the legislation as "a bill that requires political intelligence firms to disclose their clients, profits, and activities, in the same way that lobbyists are required to do under the Lobbying Disclosure Act of 1995").

[218] *See* H.R. 5617 (stating its purpose as being "to amend the Lobbying Disclosure Act of 1995 to require the disclosure of political intelligence activities").

[219] Press Release, Baird, *supra* note 217.

[220] *See* 154 CONG. REC. H1701 (daily ed. Mar. 13, 2008); 154 CONG. REC. H3109 (daily ed. May 6, 2008).

[221] *See* H.R. 5617.

[222] *See, e.g.*, Macey, *supra* note 46, at 309 ("The proposed legislation was killed in congressional committee. Clearly, the SEC did not want to offend the politicians that both oversee the agency and determine its funding.").

B. *Insider Trading Law in the United Kingdom*

Unlike the United States, the United Kingdom regulates insider trading through a comprehensive statutory regime. Insider trading was not a crime in the United Kingdom until Parliament implemented the Companies Act 1980 (Companies Act).[223] The Companies Act was consolidated five years later in the Company Securities (Insider Dealing) Act 1985 (Insider Dealing Act).[224] The Insider Dealing Act prohibited insiders from trading "(1) on the basis of unpublished price-sensitive information, (2) in the securities of the company of which he is an insider, (3) on a recognized stock exchange."[225] The Insider Dealing Act defined insider as any individual who is, or had been within the previous six months, an employee, officer, or director of the corporation, or was professionally related to the company.[226]

The Insider Dealing Act explicitly included government employees in its definition of "insider," prohibiting "insider trading by crown servants and those who knowingly obtain inside information from crown servants."[227] The Financial Services Act 1986 extended the scope of the prohibition to all public servants.[228] The United Kingdom thus prohibited trading on political or governmental information by all royal and civil servants and by all outside individuals receiving information from these servants.[229]

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[223] Companies Act, 1980, c. 22, §§ 68–73 (U.K.); *see also* Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 AM. J. COMP. L. 123, 138 (2006) ("It was only in 1980 that insider trading became a crime under U.K. law, through Companies Act 1980 Part V.").

[224] Company Securities (Insider Dealing) Act, 1985, c. 8, §§ 1–19 (U.K.).

[225] Ronald E. Bornstein & N. Elaine Dugger, *International Regulation of Insider Trading*, 1987 COLUM. BUS. L. REV. 375, 389 (footnotes omitted); *see also* Company Securities (Insider Dealing) Act § 1.

[226] Company Securities (Insider Dealing) Act §§ 1, 9.

[227] Bornstein & Dugger, *supra* note 225, at 390; *see also* Company Securities (Insider Dealing) Act § 2 (prohibiting trading on information "held by a Crown servant or former Crown servant" or obtained from a current or former Crown servant that the servant should reasonably expect not to disclose or that involves "unpublished price sensitive information in relation to securities of a particular company").

[228] *See* Financial Services Act, 1986, c. 60, § 173 (U.K.) (substituting the word "public" for the word "Crown" wherever it occurs).

[229] *See generally* FLETCHER, *supra* note 131, at 226 ("In the United Kingdom, government employees are deemed insiders for purposes of the U.K.'s insider trading prohibitions. The Insider Dealing Act specifically prohibits insider trading by Crown servants and those who knowingly obtain insider information from Crown Servants. Other countries that have statutory definitions of 'insider' similarly include government employees."); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 242 n.266 (1991) (summarizing the U.K. prohibition); Mark A.

In 1989, the Council of the European Communities (the predecessor to the European Union) promulgated the European Economic Community Directive Coordinating Insider Trading (1989 Directive).[230] The 1989 Directive set a minimum floor for European Community member states' insider trading laws.[231] Specifically, member states, including the United Kingdom, are required to prohibit trading based on inside information that is obtained (1) because of "membership [in] the administrative, management or supervisory bodies of the issuer," (2) as a stockholder in the corporation, or (3) because of access to information "by virtue of the exercise of his employment, profession or duties."[232] In 2003, the 1989 Directive was replaced with a more comprehensive directive (2003 Directive), which covers options trading as well as market manipulation.[233] The 2003 Directive retains the same definitions of insider trading as the 1989 Directive and should be viewed as complementary to the earlier Directive.[234]

The E.U. definition of "insider" does not draw the same fiduciary line that U.S. law does,[235] although there could be significant overlap.

Spitz, Note, *Recent Developments in Insider Trading Laws and Problems of Enforcement in Great Britain*, 12 B.C. INT'L & COMP. L. REV. 265, 275-83 (1989) (providing an overview of the United Kingdom's statutory prohibitions against insider trading).

[230] Council Directive 89/592/EEC, Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30.

[231] *Id.* art. V; *see also* Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 662 n.142 (2001) ("The Directive, for example, sets forth minimum standards for defining the concepts of 'inside information' and 'insider' with respect to which Member States of the European Union must comply.").

[232] Council Directive 89/592/EEC, art. II; *see also* Council Directive 2003/6/EC, art. 2(1), 2003 O.J. (L 96) 16, 21 (listing the same three types of forbidden inside information and also including information obtained "by virtue of . . . criminal activities").

[233] *See* Council Directive 2003/6/EC, art. 1; *see also* Eric Engle, Insider Trading in U.S. and E.U. Law: A Comparison 26 (Sept. 22, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1271868 (surveying the efforts of the European Community to create a Community standard on prohibitions against insider trading).

[234] *See* Engle, *supra* note 233, at 27 ("The basic premises of the 1989 Directive are retained within the 2003 Directive and the 1989 Directive may be persuasive evidence of the meaning of the 2003 Directive."); *id.* at 30 ("In all events, the judicial interpretations of the meaning of the earlier Directive very likely apply to the successor Directive.").

[235] *See* Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9, 23 (1999) ("[U]nlike the U.S. insider trading laws, determination of illegal trading is based not on breach of a fiduciary duty, but rather, on possession of non-public information."); Carolyn Silane, *Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIRCUIT REV. 333, 352 (2009) ("Unlike the United States, the E.U. has soundly rejected any requirement of a fiduciary duty in favor of a straightforward rule against an imbalance of information in securities transactions.").

As a result, "[s]ome of the professionals [covered by the 1989 Directive] may have a contractual relationship with the issuer which is not of a fiduciary character."[236] Others who do not have a contractual or fiduciary relationship with the security issuer are still covered, including "members of the central bank, the press, *the parliament*, the ministry of economics and of other institutions, committees and bodies who may possess inside information because of their profession or their duties."[237] The Directive's broad definition suggests that the Council was promulgating a definition of insider trading that would prohibit trading based on political intelligence in the entire European Union.

In compliance with the 1989 Directive, the United Kingdom enacted Part V of the Criminal Justice Act 1993 (Criminal Justice Act).[238] Part V of the Act "completely replaced the existing law on insider trading" in the United Kingdom.[239] The Criminal Justice Act defines "insider" along the same lines as the Directives, including the expansive definition of inside information as information obtained "by virtue of [one's] employment, office or profession."[240] The Criminal Justice Act does not specifically classify "public servants" as insiders. Nonetheless, this prong is considered broad enough to encompass "public servants," consistent with the insider trading regime that the Criminal Justice Act replaced.[241] The United Kingdom, despite amendments to its insider trading statutes over the past thirty years, remains committed to the categorical prohibition of trading based on inside political intelligence.

U.K. and E.U. law suggest an approach that may serve as an example for the United States. Representatives Baird and Slaughter attempt to import a component of the U.K./E.U. prohibition into American doctrine, but doing so is flawed because U.K./E.U. insider trading doctrine departs markedly from that of the United States.

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[236] Klaus J. Hopt, *The European Insider Dealing Directive*, 27 COMMON MKT. L. REV. 51, 64 (1990).

[237] *Id.* (emphasis added).

[238] Criminal Justice Act, 1993, c. 36, §§ 52–64 (U.K.).

[239] Richard G. Small, *Towards a Theory of Contextual Transplants*, 19 EMORY INT'L L. REV. 1431, 1453 (2005); *see also* Keith Wotherspoon, *Insider Dealing—The New Law: Part V of the Criminal Justice Act 1993*, 57 MOD. L. REV. 419, 420 (1994) ("[P]rovisions in Part V of the 1993 Act wholly supersede the Company Securities (Insider Dealing) Act 1985 . . . .").

[240] Criminal Justice Act 1993 § 57(2).

[241] *See* Wotherspoon, *supra* note 239, at 426 ("The provision in section 57(2)(a)(ii) is also wide enough to cover public servants whose official duties give them access to price-sensitive information." (footnote omitted)). This would include, for example, "officials in the Bank of England or the Monopolies and Mergers Commission." *Id.* at 426 n.57.

First, unlike the United Kingdom and the European Union, the United States does not provide a statutory definition of insider trading. As demonstrated in Part II, insider trading has come to be defined by judicial interpretation. Though this does not preclude legislative definition, it suggests that the Baird-Slaughter legislation would only add to an already ad hoc insider trading regime.

Second, U.K. law does not provide a good point of reference because the United Kingdom (and the European Union) wholly embraces an access-to-information theory of insider trading regulation.[242] Part IV shows how an access-to-information theory can help to make sense of the policy motivations underlying insider trading law, but these have been rejected by U.S. courts.[243] Rather, Part II demonstrated that the U.S. approach is inextricably linked with fiduciary duties. The U.K. prohibition and the E.U. Directives sever any fiduciary requirement.[244] The Baird-Slaughter legislation attempts to regulate outside actors who have access to political information, which may make sense under a regime predicated upon an access-to-information theory, but not under a regime rooted in fiduciary duty concepts, as is the case in the United States.

Third, consideration of U.S. insider trading doctrine's objectives militates against adopting an approach similar to those of the United Kingdom and the European Union. Part IV considers whether insider trading law should include trading upon political intelligence and concludes that many policy objectives animating U.S. insider trading law generally are inapplicable to the political-intelligence context and that, in at least one context, insider trading regulation would not sufficiently address these political corruption issues. Accordingly, an ethics approach that makes use of such tools as a blind trust—whereby members of Congress are completely unaware of current and prospective investments—is the best mechanism for preventing trading on political intelligence.

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[242] *See* Loke, *supra* note 223, at 126-37 (arguing that the United States still takes a fiduciary approach while other countries, such as the United Kingdom, have moved toward a theory that defines insider trading by access to information); Silane, *supra* note 235, at 352 ("Unlike the United States, the E.U. has soundly rejected any requirement of fiduciary duty in favor of a straightforward rule against an imbalance of information in securities transactions.").

[243] *See infra* note 255 and accompanying text.

[244] *See supra* note 235 and accompanying text.

IV. SHOULD THE UNITED STATES ADOPT A DEFINITION OF INSIDER TRADING THAT INCLUDES TRADING ON POLITICAL INTELLIGENCE?

One of the great debates about insider trading has been whether to regulate it at all. Numerous scholars have rejected insider trading prohibitions as contrary to the fundamental aim of efficient markets.[245] That debate is outside the scope of this Comment. Accordingly, this Part puts aside the deregulation discussion and assumes the current regulatory regime. As became clear in Part II, current insider trading doctrine does not adequately accommodate regulating trading on political intelligence. A few theories of insider trading may arguably encompass certain political-intelligence trading activities. As a response, legislation introduced in Congress is seeking to clarify the situation and to follow the United Kingdom in bringing political-intelligence trading within securities law. This Part asks whether this is a result to be desired. Specifically, what normative justifications animate the U.S. prohibition on insider trading? Do these underlying public policy considerations support a ban on political-intelligence trading?[246]

To begin, the Exchange Act was enacted to protect the integrity of the financial markets.[247] Congress has adhered to this sweeping justification, noting that trading on material nonpublic information threat-

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[245] *See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (arguing that insider trading is beneficial because it causes market prices of securities to more accurately reflect the price of stocks had the inside information been public, thus helping all investors and the company).

[246] Another approach has been to consider political-intelligence trading against the arguments for deregulating insider trading. *See* Barbabella, Cohen, Kardon & Molk, *supra* note 24, at 223-34. This approach, which asks whether the general arguments in favor of deregulating insider trading also support not regulating political-intelligence trading, is flawed for two reasons. First, the arguments for deregulation have been rejected. They have failed to prevail in the traditional corporate context, so why are they relevant to political intelligence? Second, the deregulation approach assumes the wrong baseline for evaluating whether to include trading on political intelligence in the insider trading framework. The starting point for considering political-intelligence trading is the status quo of no regulation. The question, then, is whether we should regulate. In asking this question, we look to the normative reasons for regulating insider trading generally and ask whether they are salient in the context of political intelligence. If the arguments for regulating corporate insider trading are persuasive in the context of political intelligence, they will militate in favor of insider trading regulation.

[247] *See* H.R. REP. NO. 73-1383, at 2-5, 13 (1934) (identifying the purpose of the bill as regulating the stock exchange in order to curb harmful speculation); S. REP. NO. 73-792, at 3, 9 (1934) (same); 1944 SEC ANN. REP. 50 (noting the "inequitable character" of insider trading and various provisions in the 1934 Act designed to curtail this abuse).

ens "the fair and honest operation of our securities markets."[248] The ABA Task Force on Regulation of Insider Trading concluded that

> commonsense observations suggest that two of the traditional bases for prohibitions against insider trading are still sound: the "fair play" and "integrity of the markets" arguments. The first relies on the basic policy that cheating is wrong and on the traditional sympathy for the victim of the cheat. The second rests on the oft-repeated argument that people will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed.[249]

Securities laws achieve "fair play" and "integrity" through intensive disclosure requirements that compel covered entities, particularly corporations, to make certain corporate information public.

Such broad objectives of fairness and market integrity, however, provide very little guidance on their faces. Any disparity of information could certainly be deemed "unfair" and thus a threat to public confidence in the market. Digging deeper, we find public policy arguments divided into economic and noneconomic terms, namely, fairness.[250] This Part briefly analyzes each justification and applies each to political intelligence.

A. *Fairness*

The essence of the fairness argument is that something is inherently wrong when one trader possesses information unknown by another trader—the informational advantage is unfair.[251] Insider trading law, however, has never presupposed a parity-of-information standard.[252] In fact, true equality of information among all investors would undermine one investor's ability to profit in the marketplace and arguably destroy profit motive altogether.[253] Others have proposed, in

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[248] H.R. REP. NO. 100-910, at 8 (1988); *see also* ELIZABETH SZOCKYJ, THE LAW AND INSIDER TRADING 2 (1993) (arguing that people will not trust their resources to a system that they do not think is fair).

[249] Comm. on Fed. Regulation of Sec., Am. Bar Ass'n, *Report of the Task Force on Regulation of Insider Trading* (pt. 1), 41 BUS. LAW. 223, 227 (1985).

[250] This categorization follows Bainbridge, *supra* note 131, at 70-82.

[251] *See* Fisch, *supra* note 229, at 220-21 ("Whether other traders are harmed directly, such as by inducement to trade at an incorrect price, or indirectly, through the presence in the market of other traders who possess an overwhelming informational advantage, inequality of information is at the heart of the fairness rationale.").

[252] *See, e.g.*, Netter, Poulsen & Hersch, *supra* note 33, at 2 (arguing that possessing asymmetric information does not and should not violate insider trading law).

[253] *See* MACEY, *supra* note 100, at 21.

lieu of an equal-information standard, an equal-access-to-information approach. In this regard, insider trading is perceived as unfair because the insider possesses a "lawful monopoly on access to the information involved . . . which cannot be competed away."[254] The Supreme Court has expressly rejected, as legal theories, parity of infor-information and equal access to information.[255] But the access-to-information justification is helpful in constructing a public policy basis for insider trading prohibitions.

If insider trading is animated by unfair access to information, where should we draw the line between fair and unfair informational advantages? One can imagine the equal-access-to-information theory ranking potential investors on a continuum with regard to the information they possess.[256] At one end of the continuum are the corporate insiders who hold secret, firm-specific information, while at the other extreme are the "proverbial grandparents who have little access to even publicly available information."[257] An insider trading law rooted in the access theory picks a point on the continuum at which investor access is considered too great and deems the investors insiders for purposes of the prohibition.[258] The dividing line separates legal informational advantages from illegal informational advantages.

Where do government insiders and outside actors reside on the continuum of access to political intelligence? Government insiders represent the equivalent of corporate insiders. Politicians and their staff possess intimate knowledge of legislative initiatives and have direct access to decisionmakers, or they are themselves the ultimate decider. As we have seen, this assertion is supported through empirical research demonstrating the substantial trading advantages of U.S. Senators.[259] In fact, as explained earlier, the evidence suggests that the informational advantage of Senators is greater than that of corporate

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[254] Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979).

[255] The parity-of-information theory was rejected in *Dirks v. SEC*. *See* 463 U.S. 646, 657 (1983) ("Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading."). The equal-access-to-information theory was rejected in *Chiarella v. United States*. *See* 445 U.S. 222, 235 n.20 (1980) (rejecting the proposition that persons having access to information that is not legally available to others should be prohibited from exploiting such information); *see also* Bainbridge, *supra* note 24, at 4-5 (discussing the Court's rejection of both theories).

[256] This concept is derived from Netter, Poulsen & Hersch, *supra* note 33, at 6.

[257] *Id.*

[258] *Id.* at 6-7.

[259] *See supra* subsection I.A.1.

insiders trading in their own firms.[260] Government insiders, then, possess a monopoly over political information that places them at a distinct informational advantage over the marketplace.[261]

Outside actors—lobbyists and hedge funds—reside much further down the continuum. K Street lobbyists are to Washington what analysts and market professionals are to Wall Street. Market professionals are analysts and researchers who expend considerable resources ferreting out little-known, market-moving information. Whereas these market professionals have much more market information than the average small investor,[262] lobbyists possess much more political information than the average constituent. Market professionals expend significant resources acquiring their informational advantages and gain these advantages "through discussions with corporate insiders, following the progress of important litigation, or monitoring news reports and the Dow Jones tape constantly."[263] They analyze the information and make informed, yet speculative, predictions. Similarly, lobbyists keep tabs on the political pulse through discussions with government insiders, monitoring legislative proposals, and attending committee hearings.

The information that market professionals acquire through diligent research is legitimate and can be used in making investment decisions.[264] The Supreme Court has suggested that an informational advantage is improper, however, if it "cannot be overcome with research or skill."[265] Since market professionals are presumed to be acting on information that they gathered through "research or skill," and not through exclusive insider access to information, they reside beyond insiders on the access to information continuum. Through diligent research or investment of resources, the theory goes, any investor could access such information.[266]

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[260] *See supra* notes 63-65 and accompanying text.

[261] This is the basis for Professor Langevoort's conclusion that government insiders are liable under Rule 10b-5. *See supra* note 165 and accompanying text.

[262] Fisch, *supra* note 229, at 222.

[263] *Id.* at 222-23; *see also* MACEY, *supra* note 100, at 13 ("Market professionals will be able to obtain, assimilate, and process information about firms far more quickly than small investors.").

[264] *See* Netter, Poulsen & Hersch, *supra* note 33, at 5 ("Individuals who acquire material nonpublic information in other legal manners, such as legitimate research or accidental tips, may trade on it freely without disclosure.").

[265] United States v. O'Hagan, 521 U.S. 642, 658-59 (1997).

[266] *See* MACEY, *supra* note 100, at 22 ("[I]t could be argued . . . that everyone has 'equal access' because anyone could have hired the analyst who discovers valuable information in the course of his employment. Indeed, anyone could become an ana-

Like analysts and market professionals, lobbyists have the skills and resources to read and interpret the political balance sheets of Washington. Hedge funds have the resources to hire lobbyists. Lobbying firms offer the Washington equivalent of the market pulse.

Average investors could fine-tune their political savvy and access much of the same information that lobbyists provide, in the same way that they could research and access superior market information provided by analysts. One may be surprised to find that political information is more readily available than corporate information. Investors cannot simply call up a company and demand access to decisionmakers; not even shareholders of a company can make such requests. The political process is (at least theoretically) more open and inclusive, as elected officials are responsive to their constituents. Admittedly, powerful, networked lobbyists may get their phone calls to Capitol Hill returned more quickly than a single constituent, but in the corporate arena, large institutional investors or networked market professionals will likewise carry more weight than a single investor.

If one accepts access to information as a theoretical underpinning of insider trading, one would construct a continuum of access to information that placed government insiders alongside corporate insiders and placed lobbyists (and their hedge fund clients) alongside market professionals. The theory would justify defining these government insiders as insiders for purposes of the federal securities laws. At the same time, the access-to-information theory would not go so far as to extend the definition to encompass outside actors trading on political intelligence.

B. *Economic Justifications for Prohibiting Insider Trading*

1. Injury to Investors

The investor-injury argument maintains that insider trading either (1) causes outside investors to trade at an inaccurate price or (2) induces investors to make bad purchases or sales.[267]

The first theory claims that investors who trade alongside insiders with access to information are wronged because they bought or sold at

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lyst."); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 254 (1991).

[267] *See* Bainbridge, *supra* note 131, at 71 (stating these arguments but finding neither of them convincing).

a bad price—a price that did not reflect the inside information.[268] This argument is considered flawed because, on impersonal exchanges, one never knows with whom she is trading.[269] The harm would occur regardless of whether the information was possessed by an insider or another outsider.[270] "It is purely fortuitous that an insider was on the other side of the transaction."[271]

The second theory provides that price discrepancies resulting from insider trading induce investors to make poor decisions.[272] Such injury to investors must be prohibited, it is argued, because investor injury will undermine confidence in the markets,[273] and market integrity is a fundamental aim of insider trading prohibitions. This argument is discredited because, even "assuming that some investors are misled by those effects[,] . . . many transactions would have taken place regardless of the price changes resulting from insider trading."[274]

Putting aside the merits of the investor-injury justification, it appears that government insider trading would harm investors in the same way as corporate insider trading. It is hard to distinguish the two types of insider trading on that level.

2. Injury to Issuers

The issuer-injury justification is not relevant to trading on political intelligence. The justification maintains that insider trading may injure a firm by (1) creating incentives for those lower in the corporate hierarchy to delay reporting information to supervisors; (2) interfering with corporate plans, such as an insider buying stock in a target company during merger negotiations and thereby raising the acquisition cost; or (3) injuring the reputation of a firm.[275] The issuer-injury argument supports a definition of insider trading that is concerned with harm resulting from true corporate insiders. If anything, this justification militates against extending insider trading law to include those who trade on political intelligence, as government insiders cannot possibly injure a company under any of the three threads.

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[268] *Id.*
[269] *Id.* at 72.
[270] *Id.*
[271] *Id.*
[272] *Id.* at 73.
[273] *Id.*
[274] *Id.*
[275] *Id.* at 75-78.

3. Property Rights

Probably the most embraced justification for insider trading prohibitions is the property rights theory.[276] The theory maintains that corporate information is property of the corporation, and that the "conversion of the property for the insider's personal use is a theft."[277] An insider or misappropriator who uses corporate property is a "thief," while a tippee is the recipient of "stolen property."[278] The property rights approach has been discredited, however, because if inside information is truly corporate property, then the government should not involve itself in internal corporate affairs by dictating how those rights are allocated.[279]

A prohibition on insider trading, consequently, assigns a property interest in inside information to the corporation.[280] This theory is congruent to insider trading doctrine developed by the Supreme

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[276] *See generally* MACEY, *supra* note 100, at 67 ("[T]he only conceivable justification for banning insider trading is that such trading involves the theft of valuable corporate property from its rightful owner."); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) (arguing that there exist "several incentive and information effects which suggest that there may be gains from allocating property rights in valuable information to managers as opposed to investors"); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309, 331 (discussing the "business property rationale," which applies only when secrecy is necessary to preserve the value of the information to the firm); Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 718-20 (1980) (discussing the value of internal information and how it is wasteful for an external institution to have to replicate this information); Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 759-71 (1988) (discussing the merits of a property rights approach to insider trading generally and advancing a Lockean theory of insider trading); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 80 (1987) (articulating a "policy basis for the regulation of insider trading . . . that is based on the notion of inside information as property that can be owned and used by or for the benefit of the owner or creator of that property"); Bainbridge, *supra* note 131, at 78-82 ("In short, the federal insider trading prohibition is justifiable solely as a means of protecting property rights in information.").

[277] Fisch, *supra* note 229, at 224.

[278] *Id.*

[279] *See id.* at 225-26 ("[V]iewing inside information as property justifies treating the misappropriation of that property as theft but correspondingly requires the government to defer to firm decisions contractually allocating the entitlement to that property."); *see also* MACEY, *supra* note 100, at 69 ("[T]he way to approach the problem of insider trading is to identify property rights in information. . . . Thus, firms ought to be able to allocate the right to engage in insider trading to whomever they wish . . . ."). This debate is outside the scope of this Comment.

[280] *See* Bainbridge, *supra* note 131, at 78 ("In effect, the federal insider trading prohibition vests a property right . . . in the party to whom the insider trader owes a fiduciary duty to refrain from self dealing in confidential information.")

Court and, as a result, is intertwined with fiduciary duty concepts. As elaborated above, the Court's doctrine distinguishes between those who are fiduciaries or confidants of the source of the information, and those who are not.[281] Those who are insiders cannot trade on the information—corporate property—to which they are privy. The property rights theory maintains that this is because such trading is essentially corporate thievery.[282]

Under the property rights justification for insider trading regulation, we must ask whether political intelligence is property, and, if so, whose property. The argument necessarily depends on a showing that political information is property of the government and, by implication, the American public. Theft occurs when government insiders steal information from the public and use it for personal gain.

Federal corruption and bribery laws are instructive. The federal bribery statute makes it a punishable offense for anyone to confer anything of value upon any public official with intent "to influence any official act."[283] One tenable view considers government corruption to be "the sale by government officials of *government property* for personal gain."[284] The theory presupposes that official action is property belonging to the government and that corruption is the sale thereof. It would seem reasonable to say the same thing of official government information. By extension, then, the misappropriation of official information is theft of government property in the same way as corruption.

The property rights justification for insider trading regulation would support an extensive ban on all trades based on material nonpublic political information. First, government insiders would be stealing government property when they profit from trading on political information. It would be impossible to distinguish the government insider's theft from the corporate insider's. Second, outside actors who trade on political intelligence would also be trading illegally because any information they received from Capitol Hill would be government property. The hedge fund is like the tippee in the corporate context whose tip consists of "stolen property." Trading on stolen

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[281] *See supra* Section II.A.

[282] It is hard to see how this differs much from self-dealing or corporate opportunity doctrines that derive from duty of loyalty concepts in state corporate fiduciary duty law. This may lead one to ask whether federal securities law serves any purpose beyond those already served by state law. If federal securities law is justified on a property rights theory, then the answer appears to be "no."

[283] 18 U.S.C. § 201(b)(1)(A) (2006).

[284] ANDREI SHLEIFER & ROBERT W. VISHNY, THE GRABBING HAND: GOVERNMENT PATHOLOGIES AND THEIR CURES 91 (1998) (emphasis added).

property would be misappropriation, regardless of whether there were a breach of confidentiality.

4. Corporate Governance and Moral Hazard

Insider trading is also deemed harmful because it creates a moral hazard by allowing corporate insiders to profit on bad news. Corporate insiders are able to benefit from poor decisions by selling the firm's stock short or by disseminating "false information about the firm so that they can profit by buying and selling mispriced securities."[285] This argument claims that "allowing insiders to profit on bad information makes managers indifferent between working to make the firm prosperous and working to make it bankrupt."[286] The moral hazard creates a governance issue because officers may make operational decisions that are based on trading potential and not on the merits of the decision.

A similar problem could arise with respect to government insiders who profit on legislative decisions. Like the corporate insider who may bankrupt the firm for personal gain, government insiders may succumb to a moral hazard by making decisions based on potential trading gains and not on what is best for constituents. As Part II explained, government insiders are not required to divest themselves of assets over which they exercise legislative jurisdiction. What is crucial to realize is that insider trading regulation of government insiders will not solve the moral hazard or governance concerns. Prohibiting trading on political intelligence will preclude members of Congress from trading after acquiring material nonpublic political information, but it will not keep them from voting based on preexisting portfolios. An insider trading approach to political intelligence will fail to account for the moral hazard and corporate governance policy concerns.[287]

C. *Fundamental Goal: Financial Market Integrity*

All of the foregoing indicates that insider trading poses a threat to the integrity of our financial markets. This, of course, is the fundamental aim of our securities laws. Insider trading is harmful because it reduces confidence in the markets. Consequently, the federal se-

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[285] EASTERBROOK & FISCHEL, *supra* note 266, at 260.

[286] Carlton & Fischel, *supra* note 276, at 873; *see also* MACEY, *supra* note 100, at 34 (finding that the moral hazard problem presupposes managers who are better compensated if the firm is doing well).

[287] I am grateful to Professor Fisch for bringing this argument to my attention.

curities laws restore this confidence by requiring corporations to make public disclosures.[288] And where corporate information is not disclosed—where it is "inside"—insiders must refrain from trading on the basis of that information.

The underlying harm associated with insider trading justifications—undermining market integrity—does not hold up under a political-intelligence analysis. When government officials trade on political information, the public is indeed outraged. Yet it is not market integrity that is undermined but rather governmental integrity. Public anger is directed not at the financial system but at a political system that is seen as unethical: it is not insider trading but political corruption.

Observe the following logical parallels between trading by government insiders and corporate insiders. Trading by government insiders is bad because public officials are abusing the privileges of elected office. They are personally profiting at the expense of the public. The damage decreases public trust and confidence in the political system. Without trust in government, government cannot function. Political governance laws—the Hatch Act,[289] the federal bribery statute,[290] the Federal Election Campaign Act,[291] the Ethics in Government Act,[292] House and Senate ethics rules,[293] and so forth—serve to remedy distrust in the political system.

Trading by corporate insiders is also bad because corporate insiders are abusing their corporate privileges. They are profiting at the expense of other corporate shareholders and other market participants. This damage decreases shareholder and investor trust in corporations and confidence in the financial system. Without trust in financial markets, corporations cannot function. The federal securities laws were designed and are enforced to remedy distrust of financial markets. Why

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[288] *See* Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (2006) ("[N]ational public interest . . . makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports . . . .").

[289] 5 U.S.C. §§ 7321–7326 (2006) (limiting the ability of federal employees to engage in partisan activities).

[290] *See* 18 U.S.C. § 201 (2006) (criminalizing bribery of public officials).

[291] *See* Federal Election Campaign Act of 1971, Pub. L. No. 92-225, 86 Stat. 3 (1972) (codified as amended in scattered sections of 2 U.S.C.) (reforming the law relating to campaign communications and funding).

[292] *See* Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824 (codified as amended in scattered sections of 2, 5 & 28 U.S.C.) (imposing several restrictions on public servants, including financial disclosure requirements, postemployment activity restrictions, and limits on the receipt of certain outside income, including gifts).

[293] *See* HOUSE ETHICS MANUAL, *supra* note 69; SENATE ETHICS MANUAL, *supra* note 71.

should the federal securities laws be charged with doing the work of political ethics?

Admittedly, government insiders are market players who can affect pricing through investment practices.[294] With government insiders, the primary danger is not a loss of public confidence in the financial system but rather a loss of confidence in the political system. Any market effect is incidental and disappears once a political ethics rule addresses the practice. An ethics approach would achieve the theoretical goals underlying the securities laws by addressing both fairness and property concerns and would do so much more effectively. The final Part of this Comment addresses these alternative proposals.

V. ANALYSIS AND PROPOSALS

This Comment has explored political-intelligence trading through the lens of current insider trading doctrine and its underlying justifications. It has attempted to map insider trading law onto government insiders and outside actors who profit from trading on political information. To do so would have required stretching the doctrine to a point at which insider trading becomes divorced from its statutory bedrock—the Exchange Act—the primary purpose of which is to promote market integrity through disclosure of corporate information. It has never been the province of the SEC to write and enforce political ethics laws.

Even still, we are no less outraged by profiteering politicians today than Thomas Jefferson and James Madison were over 200 years ago. Several theories of why we regulate insider trading—particularly unfairness and property rights—provide a compelling reason to bring trading by government insiders into the fold. As we now see, these concerns are more effectively and appropriately remedied through political ethics laws, not by mutilating insider trading doctrine beyond recognition.

A. *Nature and Characteristics of Political Intelligence*

The analysis so far has revealed several characteristics of political intelligence that distinguish it from the material nonpublic information at issue in classic insider trading cases, thereby making coverage under the federal securities laws inappropriate. This Section briefly

[294] Arguably, government insider trading affects the markets to a much lesser extent than corporate insider trading because government insiders are a relatively small and defined group.

summarizes these differences as they pertain specifically to government insiders and outside actors.

1. Government Insiders

First, the primary harm of allowing government insiders to trade on political information is the threat to governmental integrity. Politicians' abuses of authority are addressed by ethics rules and political governance laws. The federal bribery statute,[295] for example, prohibits the sale of political deeds and could suitably address conversion of government information for personal profit. Accordingly, perceived corruption associated with government insiders' trading should be addressed through ethics reform.

Second, to the extent that governmental insider trading impacts financial markets, the impact is small. Politicians are a discrete, defined group, unlike expansive corporate circles. At most, any harm is incidental and disappears once the primary harm is remedied through ethics laws.

Third, when insiders trade on political intelligence, a fiduciary duty in the traditional insider trading sense is never breached. Part II applied current doctrine to political intelligence and revealed a fundamental weakness. Namely, our insider trading doctrine is inextricably linked with concepts of corporate fiduciary duties, which are difficult to impose on government insiders, let alone outside actors.

2. Outside Actors

First, political intelligence is information that, unlike corporate information, has a public ownership component. Namely, democracy accords the public a right to meet with and receive information from their elected officials. In the earlier discussion of property rights, it was argued that the public owns governmental information and can demand access to it.[296] This is a presumption of the Freedom of Information Act, for example, which requires the government to release information to any person requesting it unless an exemption applies.[297] This is not to say that all political information is "public" in the sense that it is widely known. The important distinction here is that the nature of political information is public, whereas the nature of corporate infor-

[295] 18 U.S.C. § 201.
[296] *See supra* subsection IV.B.3.
[297] 5 U.S.C. § 552 (2006 & Supp. I 2009).

mation is private. Public ownership of information and access to public information make it difficult to argue that political information is equivalent to inside corporate information, which is privately held. Such a finding certainly undermines any claim that outside actors are improperly trading on political information, as the outside actors could be perceived as merely exercising their democratic rights.[298]

Second, trading on political intelligence is highly speculative because it is seldom based on concrete or firm-specific information. Political intelligence is far different than the quintessential corporate inside information. Lobbying firms rarely claim to provide "hot" tips but rather offer general political analysis.[299] Lobbyists may gather a dozen tidbits of information from talking with congressional staff, monitoring legislation, reading the news, or attending congressional hearings. They interpret each separate piece of information and make their best prediction of future legislative activity. The information is relayed to the hedge fund client, who then speculates as to how the market will react in the event that the legislative prediction rings true. There are at least two layers of speculation. Political-intelligence trading is at least as speculative, if not more so, than trading on information gathered by market analysts and researchers, which is perfectly legal.[300] Moreover, it is a far cry from firm-specific

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[298] It is much easier to argue that government insiders are converting public property because their elected positions give them *unique access* to information unattainable by any other person. This does not disrupt the argument as it pertains to outside actors, since all persons have equal access to political intelligence. Equal access, not equal resources, is what matters.

[299] *See* Snyder, *supra* note 100 ("Lobbyists say they more often provide their Wall Street clients with information about how Washington works, rather than hot tips that could move stocks."). "Hot" political tips are at best market information. Unlike "inside information," which is derived from within the corporation, market information is information that "originates from sources other than the issuer and involves events or circumstances concerning or affecting the price or market for the issuer's securities and does not concern the issuer's assets or earning power." Bainbridge, *supra* note 131, at 16; *see also* SZOCKYJ, *supra* note 248, at 5 (describing the reach of insider trading law beyond information from the issuer or about earnings to information that could affect market prices). Both forms of information are covered by insider trading law. Chiarella, for example, was said to be trading on market information that he obtained from tender offer documents because the information was not obtained from the issuer in which he traded but did affect the issuer's market price. Chiarella v. United States, 445 U.S. 222, 231-35 (1980). The information Chiarella received was firm specific and certain. Even the best political information will, in most cases, only be general market information that may or may not affect a host of companies within a given affected industry.

[300] *See supra* Section IV.A.

corporate inside information at issue in landmark insider trading cases and scandals.

Third, outside actors who gather political intelligence are no different than market analysts. This Part concludes by arguing that not only are outside actors performing a legitimate function equivalent to market professionals but also that their information gathering is beneficial for market efficiency and should not be discouraged.

B. *Proposals*

These characteristics of political information militate against bringing it within the purview of the federal securities laws. Yet, in all likelihood, some of this trading should be prohibited. To that end, the following proposals are made.

1. Blind Trusts: An Ethics Approach to Regulating Trading by Members of Congress and Selected Staff

Members of Congress and certain staff[301] should be *required* to put their assets in blind trusts upon assuming their positions. How would the blind trust requirement work? A model already exists but at present is only optional. The Ethics in Government Act of 1978 imposes financial disclosure requirements on public officials in all three branches of government.[302] The Act requires public officials and certain employees to disclose their financial assets annually.[303] To avoid disclosure of exact investments, however, covered individuals can elect to maintain assets in a blind trust.[304] A "qualified blind trust" provides "an optional mechanism for circumventing full disclosure of financial interests while at the same time avoiding conflicts with official duties."[305] It is "blind" because it regulates communications between the trustee and "interested party," so that a trustee "shall not consult or notify any interested par-

[301] This Comment does not delve into the specifics of which staff members should be required to maintain blind trusts but leaves that to legislative determination or further debate.

[302] Pub. L. No. 95-521, 92 Stat. 1824 (codified as amended in scattered sections of 2, 5 & 28 U.S.C.); *see also* Megan J. Ballard, *The Shortsightedness of Blind Trusts*, 56 U. KAN. L. REV. 43, 43-44 (2007) ("The Federal Ethics in Government Act requires certain national policymakers and employees to publicly disclose their financial interests on an annual basis.").

[303] 5 U.S.C. app. 4 § 102(a) (2006).

[304] *See* Ballard, *supra* note 302, at 44, 51.

[305] *Id.* at 49.

ty."[306] In essence, only the trustee will know which securities are held in the trust, thereby making the member of Congress "blind" to the composition of the trust. As a result, members will be unable to make legislative decisions that positively impact their portfolios. Moreover, they will be unable to trade on political information since investment authority will be delegated entirely to the trustee.

Some members of Congress have voluntarily elected to maintain assets in blind trusts.[307] Though the operation of blind trusts in the legislative branch has received scrutiny[308]—namely, for lax enforcement—the more stringent application in the executive branch provides a viable model to follow.[309]

A blind-trust approach is superior to regulating political intelligence through securities laws for several reasons. First, the blind-trust requirement adequately addresses the public policy concerns underlying insider trading law that were identified in Part IV by categorically precluding government insiders from being market participants. Further, such an approach is "fair" because it precludes those with access to inside information from trading on it. It also is a way to prevent "theft" of public property by government insiders, because there is no way for government insiders to reap financial gain. Lastly, it addresses the moral hazard governance concerns that are left unmitigated under an insider trading approach.

Second, the blind-trust approach leaves current insider trading doctrine in place. As the analysis in Part II demonstrated, applying insider trading doctrine to the government context is particularly troublesome.

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[306] 5 U.S.C. app. 4 § 102(f)(3)(C)(i).

[307] *See* Len Costa, *A Wink and a Nod*, LEGAL AFF., Jan.–Feb. 2006, at 18, 19 (reporting that, as of 2006, eighteen U.S. Senators and several U.S. Representatives maintained qualified blind trusts).

[308] *See Hearing on Preventing Unfair Trading by Government Officials*, *supra* note 48, at 4-5 (proposed statement of Alan J. Ziobrowski) (arguing that blind trusts are a good idea for members of Congress but that that the "rules [must] be tightened to clearly define a blind trust making them absolutely blind"); Ballard, *supra* note 302, at 43 (criticizing Senator Frist's blind trust for not being truly blind); Costa, *supra* note 307, at 19 (discussing the failure of Senator Frist's blind trust and noting that "Congress has never been very effective at applying its ethics rules to itself").

[309] As one commentator notes,

> Many legal experts and good-government advocates still contend that blind trusts can be an effective safeguard against conflicts of interest; they point to the successful use of blind trusts in the executive branch and believe that, if Congress were to adopt the same culture of strict enforcement, abuses like those allegedly committed by Frist would be far less likely.

Costa, *supra* note 307, at 19.

There is considerable disagreement over the scope of current doctrine. This Comment has suggested throughout that there is no place in section 10(b) for politics. To hold government officials liable as inside traders would be to mistake our government for a corporation. Even if one disagrees with the argument, it is difficult to deny that the insider trading approach is murky, that applying current doctrine is a real stretch, and that using the federal securities laws to regulate government officials is highly suspect. The blind-trust requirement would achieve the same objectives as insider trading regulation without defining section 10(b) away from its statutory foundation.

Third, the blind-trust approach is more effective at preventing abuse than the insider trading approach. An insider trading prohibition may prevent members of Congress from making investment decisions based on political information, but it will not prevent them from making political decisions based on their preexisting market positions. This means that under an insider trading regime, members of Congress will still be able to vote in a way that maximizes their portfolio values. As propounded in Part I, current congressional ethics laws do not require members to divest themselves or to refrain from voting on matters in which they have a financial interest. Insider trading can account only for the use of information in the market but cannot prevent abuse of position. The latter is an enormous concern because governmental decisions affect entire markets, whereas effects from a single government insider trade are limited. Further, politicians' decisionmaking vis-à-vis their market positions is the pinnacle of corruption and threatens government integrity.

Fourth, a blind-trust requirement provides certainty. Government officials will not need to worry about navigating the murky terrain of insider trading law. Rather, our public officials will be able to go about their jobs certain that they are acting legally. Fifth, an ethics approach avoids another legislative "fix" to our already ad hoc insider trading regime. As Part II's discussion of current doctrine illustrated, insider trading law is ill-defined. It is comprised of legislative mandates, judicial interpretation, and SEC application and enforcement. The contours of insider trading are difficult to ascertain. A legislative approach to bring government insiders under section 10(b), such as the Baird-Slaughter bills, would only add to the confusion. Part III notes that the United Kingdom has adopted this approach, but it has been in the context of a comprehensive legislative definition of insider trading. The United States is far from having such a comprehensive definition.

A blind-trust requirement may be subject to various attacks. Of course, it will be argued that the requirement may deter (wealthy) individuals from seeking public office. However, not only have some current members of Congress elected to establish blind trusts, but such a requirement is much less onerous than alternatives—namely, complete divestiture. With blind trusts, members of Congress will continue to be active market participants, cognizant of the returns on their portfolios. Blind trusts will not "insulate a legislator from the personal and economic interests" of her constituency—a primary concern with divestiture.[310]

A more legitimate criticism concerns whether trusts containing non–publicly traded assets, such as ownership interests in a family business, can ever be deemed "blind." Trusts are not considered "blind" until the covered individual—here, the member of Congress—no longer knows the holdings of the trust. Of course, the member will be aware of the specific assets held by the trust when it is formed, and it is only when the trustee disposes of those specific assets, while purchasing new assets, that the trust qualifies as "blind."[311] The question then becomes how a trustee can dispose of non–publicly traded assets in order to qualify as blind, or whether the member would even want to relinquish ownership stake in, say, a family business. First, with regard to non–publicly traded assets, trustees could sell them in the private market, just not as easily as if the assets were traded on a public exchange. Second, the question of a family business is more challenging. One solution would be to make a de minimis exception allowing trusts to hold family businesses but require the members to recuse themselves from votes that would potentially affect the business. The quintessential family business only infrequently will be materially affected by national lawmaking and, accordingly, is unlikely to present many conflicts. We should be much more concerned with members' investments in large corporations, such as the asbestos-using firms discussed above, that are routinely affected by ongoing legislation.

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[310] *See supra* note 78 and accompanying text (citing HOUSE ETHICS MANUAL, *supra* note 69, at 250; SENATE ETHICS MANUAL, *supra* note 71, at 124).

[311] *See* Ballard, *supra* note 302, at 52 ("When a public official first establishes a qualified blind trust, it cannot actually be 'blind.' By virtue of the newness of the trust, the official knows what assets he transferred into it until a trustee notifies him that the trust no longer holds the asset.").

2. Disclosure by Outside Actors: Shining Light on Political-Intelligence Activities

Political-intelligence firms are the Washington equivalent of market professionals—analysts and researchers who expend considerable time and resources to extract little-known, market-moving information. Part IV showed how market professionals are not deemed "insiders." The reasoning is that these researchers and analysts are simply taking advantage of skills and training that are attainable by any investor with the proper resources. Since virtually no one subscribes to a view that all investors must possess the same resources, there is nothing inherently unfair about trading on information derived by market professionals.

Applying this rationale to K Street leads to the conclusion that Washington lobbyists perform this same function. Any constituent can access her member of Congress, follow political news, and track legislative development, even without a lobbyist. Since access to information is not a problem, there is nothing "unfair" about hiring a lobbyist to provide political intelligence.

Against this backdrop, however, is the political integrity concern that discreet, coordinated efforts by high-powered lobbyists may undermine public trust in government. This is the exact concern animating public disclosure by lobbyists who seek to influence legislation. Disclosure requirements, then, should be extended to cover those who also seek to gain strategic information from Congress for trading purposes. To that end, the Political Intelligence Disclosure Act introduced by Representatives Baird and Slaughter in 2008 provides an excellent vehicle.

Once implemented, disclosure of political-intelligence activities puts members of Congress and their staff on notice. Capitol Hill can decide when and with whom to share information. In the asbestos example, Senator Frist's office would have at least known that it was disclosing the upcoming vote to hedge funds who, presumably, would trade. If Senator Frist's office decided to release the information anyway, it would be signaling that the information is not confidential. Accordingly, the member of Congress makes the conscious decision whether information will be public or not. Lastly, disclosure keeps the public advised of the potential for political corruption by making political-intelligence gathering practices more well-known.

C. *Chilling Effects*

At the outset, this Comment warned that we should not lose sight of public policy objectives, which is easy to do when dealing with such demonized figures as lobbyists, hedge funds, and politicians who are perceived as corrupt. Bringing trading on political intelligence into the fold of federal securities law loses sight of the bigger picture. One concern with the insider trading approach is that it will make political information inherently potent and thereby chill political dialogue[312] and efficient markets.[313] Whether under the current doctrine, with its great uncertainty, or a statutory approach that explicitly prohibits trading on political information, those who possess political knowledge will be playing with fire.

1. Don't Make It a Crime to Write My Congressman

Making political information potentially incriminating will threaten the political process. Central to legislative decisionmaking is communication between elected officials and their constituents. Constituents reach out to Capitol Hill to stay informed and make their

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[312] One law firm has made the argument that the Baird-Slaughter legislation will have a "chilling effect" on political participation:

> [T]he STOCK Act could have a direct, chilling effect on the free interchange of information between the Hill and outside lobbyists.
>
> In its most far-reaching provision, H.R. 5015 would prohibit Members and staff, as well as individuals off the Hill, from disclosing material nonpublic information obtained on the Hill regarding legislation if they have reason to believe that the information will be used to buy or sell securities. This means that Members and staff would have to think twice before sharing otherwise confidential information with any lobbyist or other individual who might conceivably use the information for personal investment purposes. Given that this would be a criminal provision, some Members and staffers might be expected to curtail the sharing of valuable information related to legislation. Moreover, a lobbyist who learned confidential information from a Member or staffer would be at risk if they shared that information with others who then traded on the information.

COVINGTON & BURLING, PROPOSED LEGISLATION ON CONGRESSIONAL "INSIDER TRADING" COULD HAVE FAR-REACHING IMPACT ON LOBBYISTS 2 (2006), http://www.cov.com/publications (follow "E-Alert & Advisory" hyperlink; then follow "2006" hyperlink).

[313] Subsequent to the drafting of this Comment but prior to publication, a congressional committee received testimony from Professor Verret, who similarly argued that regulating investors' use of political information would inhibit market efficiency. *Hearing on Preventing Unfair Trading by Government Officials*, *supra* note 48, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/oihr_070609.shtml (proposed statement of J.W. Verret, Assistant Professor of Law, George Mason University School of Law).

views known. This is important to democracy because it keeps lawmakers in touch with those they govern and guards against congressional insularity. Likewise, lawmakers reach out to constituent groups for feedback on prospective legislation, to vet ideas, and to build consensus. For example, when Congress was considering the public trust fund for claims against asbestos manufacturers, it most certainly reached out to the trade associations representing the victims as well as the manufacturers. This dialogue is valuable because it leads to better-informed and politically viable legislation.

The insider trading approach will potentially make criminals out of those who write their elected representatives. Although falling into the trap is more complicated than merely writing Congress, this is the public perception that will prevail. The perception of members giving political inside information to constituents is enough to chill vital discourse. Members of Congress will be reluctant to exchange ideas with constituent groups, and constituents will hesitate to monitor their elected officials. The result will be an isolated legislative body, scared to bounce ideas off of others, and an American public that views political knowledge as incriminating.

Equally important are the functions that lobbyists serve. Though vilified, lobbyists are essential to the political process. They act as translators to their clients, interpreting political maneuvers and obscure legislative processes. This intermediation is essential for many groups to strategize about and effectively participate in the political process. Insider trading regulation of political-intelligence gathering will inhibit lobbyists from performing these functions, thereby threatening our participatory democracy. Any benefit of bringing political-intelligence trading into the insider trading regime must be weighed against these paramount threats to the democratic political process.

2. Don't Discourage Market Efficiency

An efficient market is one "in which security prices reflect information instantaneously."[314] The idea is that stock prices reflect information that is available to the public, including past prices and current performance.[315] Several forms of market efficiency—weak, semistrong, and strong—are distinguished by the amount of informa-

[314] BREALEY, MYERS & ALLEN, *supra* note 56, at G-5.
[315] *Id.* at 359.

tion that is reflected in a security's price.[316] Market efficiency is good because it allows securities to be fairly and accurately priced.

A substantial amount of information that comes to the market is not publicly released but rather is uncovered by market professionals who expend significant resources to discover the information. It is well understood that market professionals "who expend the resources necessary to develop valuable information about a firm should be allowed to profit from it" as long as they are not breaching a fiduciary duty.[317] Furthermore, market professionals' activities should be encouraged because they lead to efficient markets. These "informed traders" make purchases and sales using their informational advantages, thereby protecting even the "uninformed by driving prices to their correct levels and making it safe to buy in ignorance."[318]

Lobbyists are Washington's market professionals. To the same extent that market professionals' activities are valued for helping to efficiently expose corporate information and accurately price stocks, K Street lobbyists are exposing political information. Why distinguish lobbyists from market professionals, as the Baird-Slaughter legislation proposes? Not only would doing so be inconsistent, it is undesirable to discourage outside actors from expending resources to ensure efficient markets. Mining nonpublic information does not simply help the direct recipient of the information, but encourages accuracy of prices, efficiency of markets, and protection of all investors.

CONCLUSION

Attempts to regulate trading based on political intelligence under the federal securities laws are misguided. First, government insiders' use of information acquired as a result of their official positions is not insider trading, it is political corruption. An insider trading approach only addresses one angle of the picture and leaves political insiders able to make legislative decisions that maximize existing portfolios. Political

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[316] *Id.* The weak form of efficiency posits that current stock prices reflect past prices. *Id.* The semistrong form asserts that current prices reflect past prices as well as all "other published information, such as you might get from reading the financial press." *Id.* The strong form argues that current prices reflect all the information that could possibly be acquired through a thorough analysis of the corporation and the market. *Id.*

[317] MACEY, *supra* note 100, at 4; *see also id.* at 68 ("Market professionals, who acquire a trading advantage by engaging in research rather than by breaching a fiduciary duty, are free to trade.").

[318] *Id.* at 28.

corruption should be addressed by ethics laws, not by distorting U.S. securities law. Specifically, a blind trust achieves the policy goals underlying insider trading law while more effectively combating congressional conflicts. Second, outside actors who acquire, disseminate, and trade upon political information from government sources, without an explicit agreement of confidentiality, are doing nothing wrong. These actors are equivalent to market professionals, who devote resources to ferreting out information that is available to anyone. This service is essential to the efficient functioning of our capital markets.