Congressional Insider Trading: Is It Legal?

Jeffrey Schieberl, J.D., Pepperdine University, Los Angeles, California, USA
Marshall Nickles, Ed.D., Pepperdine University, Los Angeles, California, USA

ABSTRACT

This paper addresses the concern the authors have surrounding the legislation that governs Congressional "insider trading". While members of Congress can legally trade securities (with disclosure) for their personal account for financial gain, the authors believe that it is ethically wrong. This paper also addresses legal issues as well as the SEC position on why Congressional members are exempt from scrutiny or prosecution for insider trading. Since the last State of the Union Address and the call from President Obama for new legislative oversight that would provide visibility and rules designed to curb potential stock trading abuse by members of Congress, the Stop Trading on Congressional Knowledge (STOCK ACT) became law. However, the authors do not believe that the new legislation is sufficient. We contend that any privileged stock market trading activity or the passing of any "insider information" to others by Congress or the Senate for financial gain should be considered not only unethical but illegal. Finally, the paper also attempts to discuss why ethics, trust, and morality come into focus on this topic.

Keywords: Congressional Insider Trading; Stock Act, 2012

BACKGROUND

Early derivations of the word ethics comes from the ancient Greeks and Romans. The former interpretation means character, while the latter means custom. A combination of the two meanings can suggest how members of any given society may interact with each other. Aristotle argued philosophically that the word ethics offers an explanation as to how individuals individually and collectively behave for the common good which is driven by a common belief that there are inherit duties individuals have toward each other {Aristotle, 1981}. While ethical concepts are found in common law, it does not suggest that unethical conduct may be seen as legal. As suggested by Socrates, lying or betraying the confidence of society is usually considered unethical but not always illegal. Aristotle believed that as individuals pursued their own economic interests, society should ultimately benefit as well {Aristotle, 1981}.

APPLICATIONS

The above philosophy has not always worked in practice. If individual economic behavior has generated greed or corruption, society is not better off. Because individuals make up corporations and government, these entities reflect a collective behavior and ethical attitudes of employees, corporate officers, boards of directors as well as government leaders. If corporate or Congressional greed or misconduct should surface and become harmful or frustrating to the community at large, there should be penalties derived from law that are imposed on those individuals or companies in the private sector and if necessary new laws for Congressional members. We feel that society should hold individuals of power equally accountable to ethical and moral behavior in the private as well as public sector. The blurring of law and ethics has prompted many mainstream U.S. professional societies to adopt and enforce codes of ethics for their members. This is also true for members of the United States Congress. However, enforcement is often an internal affair, with committee chairs also members of Congress. A code of enforceable ethics that dictates how the members of a professional body are to behave for the whole of society is what is expected by those inside and outside of any organization that impacts the lives of its citizens.

PRIVATE SECTOR VS. PUBLIC SECTOR

One of the questions that we want to raise in this paper is whether or not there should a different code of ethics, laws, and standards for business executives vs. members of Congress? Milton Friedman, a past Nobel laureate in economics, argues that business has a sole responsibility to its shareholders to make money within the framework of the law {Friedman, 1970). On the other hand, Robert Almender, a professor of philosophy at Georgia State University, contends that business should conduct itself in an ethical and responsible manner irrespective of Friedman's *laissez- faire* ideology {Almender, 1992}. Regarding personal obligations, we believe that individuals operating within the private or public sphere of a predominately capitalistic system have a responsibility to society, the stakeholders of business or to the institution of government, to act in an ethical and trustworthy manner even if not required by law.

The early development of American capitalism (1776 – 1890), was primarily based on the premise of political and economic freedom with a limited role of government. During these times it meant that Congress was not necessarily an enforcer of ethics or morality or much of the general practice of business law for that manner. As a result, this period of American economic development saw the manifestation of corporate greed, immoral and unethical behavior, and the emergence of a large inequality of income among society, although much of this activity was within the law at that time. It later took the passing of several pieces of antitrust legislation (beginning in 1890 with the Sherman Act) and other legislation to attempt to rein in certain corporate monopolies and trusts and the unacceptable individual behavior of several individual business leaders of the time {McConnell, 2009}.

It was Congress that passed antitrust laws that attempted to govern the monopolistic behavior of the private sector or face punitive consequences. As time passed, Congress initiated other laws that attempted to eliminate certain activities in the private sector, such as insider trading of stocks and other securities. These laws were seemingly designed to make it illegal for a privileged segment of society to act on "private" information that had the potential for personal monetary reward. This information is typically not available to the mainstream public. Perhaps Congress passed insider trading laws for the private sector because it felt that individuals who sit on boards of directors or certain committees should conduct themselves in an ethical and moralistic manner as seen by others beyond their immediate peers.

ETHICAL RESPONSIBILITIES OF CONGRESS

A question we want to ask is, what is the difference between the immoral and unethical activity of insider trading in the private sector vs. the government sector? Isn't the public's trust broken in both cases? When politicians meet in secret during Committee meetings, isn't the expectation of voters and the public at large that their elected officials are acting in society's best interest and adhering to their oath of office? Because the public does not have access to timely minutes of sensitive Committee deliberations, voters must trust their elected officials. Once the trust is broken, credibility declines (note the low voter confidence ratings for Congress at just 9 per cent) or falling profits of those privately held companies that break the public trust like banks for example {CBS Poll 10/19-24/2011}.

We believe that the deterioration of trust and confidence in Congress has grown to some extent from the inept self investigation and regulation by the Congressional Ethics Committee as well as bipartisan gridlock. The Ethics Committee is typically autonomous and completely unaccountable to others. Therefore the ethical and moral conduct of any given committee within Congress must be maintained by its members. This is particularly true when the practices of certain committee members in Washington behave in a surreptitious manner both within the Committee and with the knowledge they gained from the meetings. There is not a requirement that Congressional Committee members report their personal stock market investment or trading activity to the public as is the case for private sector executives. We believe that insider trading is legally wrong and unethical. It is a betrayal of trust and can negatively affect individuals within or outside the sphere in which it originated. We further believe this is true whether it originates from the private or public sector.

Although Milton Friedman argued that it should not be surprising to see a corporate executive sincerely believing in morality and ethical behavior in his or her personal life, and then abandon this belief in the pursuit of

profits for the name of the company. In Friedman's book, *Capitalism and Freedom*, he does have an opinion or qualification regarding behavior of those in positions of power or privilege. He states that "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud" {Friedman, 1970}. Should members of Congress be exempt from a framework of behavior professed by Friedman, a staunch conservative and defender of openness and free markets? Although Friedman has described the activities for the private sector, shouldn't Congress, at a minimum be held to similar standards of behavior without deception (breaking of faith while appearing to be loyal to the expectations of the voters)? Friedman also refers to acceptable activities within the rules of the game. How can Congressional members operate within the rules of the game relative to insider trading when there aren't any rules?

LEGAL IMPLICATIONS

The questions that we have posed clearly have legal implications. They necessitate an understanding of how and whether laws enacted by Congress apply to Congress. It is well established that Congress is exempt from the requirements of the Civil Rights Act. Interestingly however, Congress did not exempt itself from the law that prohibits insider trading. One of the unique characteristics of U.S. securities laws is that they are comprised of statutes, SEC regulations, as well as court decisions that interpret those laws and regulations. Simply stated under the SEC's cornerstone rule it is illegal for anyone to "employ any device, scheme or artifice to defraud" in connection with the purchase or sale of a security. {Securities Exchange Act of 1934, Rule 10b5}. Over time the courts have regularly held that individuals engage in fraud or deception, under the SEC cornerstone rule {Securities Exchange Act of 1934, Rule 10b5} when they trade on material, nonpublic information obtained as part of a relationship of trust or confidence.

When exploring these emotionally charged issues it is crucial to understand that the SEC's rules, as interpreted by the courts, simply do not make it illegal for an individual who trades on information that others do not have. The rationale for the position of the courts is that society wants to encourage people to conduct research relative to securities and as a result develop unique information. The objective of the securities laws is to establish a "level playing field" for the corporate insiders, who may have access to a great deal of information, and outsiders, who have access to far less information. It is for these reasons the courts require in essence for an individual's trading predicated upon nonpublic information to be illegal, the individual must have obtained the information in question because of a special, trusted status and/or relationship that establishes a duty to keep the information confidential.

There are essentially two theories of "insider trading." The so-called "classical" theory applies when an individual trades in a company's stock based on information that they obtained from the company, when they have an obligation to keep the information confidential. Members of Congress are not likely to be subject to legal liability under this theory because there is no established or legally recognized duty of confidentiality that they owe to companies in the marketplace. The second theory is referred to as the "misappropriation theory." Under this theory when an individual has a "fiduciary" or similar obligation to another individual the first individual cannot use information obtained from the second individual for their own gain without disclosing the use of the information to the second individual.

It is our view that members of Congress owe the American people as much loyalty as lawyers owe their clients. Such a view supports the argument that when members of Congress use inside information for their own benefit they are misappropriating the information and, therefore, violating the securities laws. However, others, including the SEC, doubt that members of Congress owe such a duty. As Thomas Newkirk, former Associate Director of the SEC's Division of Enforcement, told *The Wall Street Journal*, members don't have "a duty of confidentiality to anybody and therefore ... would not be liable for insider trading." {Lattman, 2006} In addition, Robert Hisami, Director of the Enforcement Division, testified before the Senate in November, 2011 that to win an insider trading case against a member of Congress, the SEC would have to demonstrate that the lawmaker violated a fiduciary or other duty of trust and confidence, and it is not clear that such congressional trading "violates the fiduciary duty he or she owes to the United States and its citizens, or to the federal government as his or her employer." {Greenberg, 2012}.

In spite of the vagueness by the SEC, Congress did in fact take action and the STOCK Act passed the House in February and the Senate in March, 2012. On April 4, 2012 President Obama signed the Act into law (The White House: Fact Sheet: The STOCK Act, 2012). However, despite the Congressional and White House hype given to the bill's signing it initially fell far short of meeting our view of the duty of loyalty that members of Congress owe to the American people. While admittedly the new law did provide for more transparency relative to stock trading engaged in by members of Congress and Initial Public Offerings (IPO's), the application of law was viewed differently by the Senate than it was by the House.

Fortunately the news media has closely followed the behavior of the House and Senate regarding this issue. In a recent CNN report, it was disclosed that, " the STOCK Act requires that any trades of $1,000 or more made on or after July 3, 2012 have to be reported to the House and Senate within 45 days". However, it appeared that the House and Senate have two different interruptions of the above ruling. The CNN report continued by stating that, 'the House members and aides are covered by the STOCK law but their spouses and children aren't covered'. The Senate's interpretation of the Bill did require that spouses and dependants needed to report all stock trades. {CNN Politics, July 19, 2012}.

At present there appears to be not only an absence of a firm and mutual understanding of what the intent of the law is but how it should be interpreted and practiced by the House and the Senate. Therefore, it seems that the SEC regulators or Justice Department prosecutors are unlikely to file cases against members of Congress who pass insider information along to family members. Filing a lawsuit against a member of the branch of government that sets your budget is generally viewed as politically ill advised, but it also poses unique challenges when the legal basis is in question. Finally, the CNN report stated that how the Congress addresses the intended language of the STOCK Act remains to be seen. So, for the present, it appears that unlike the rest of us, members of Congress may still potentially albeit indirectly profit from inside information by allowing their family members access to "privileged information". {CNN Politics, July 19, 2012}.

FINAL COMMENTS

We contend that a member of Congress or the Senate (which includes their family and associates), upon obtaining nonpublic information that is later used to personally trade and profit from stock transactions be considered illegal. We understand that insider trading liability under the misappropriation theory would require proof of a duty of disclosure between the Congressional person and the source of information. The question is whether that duty arises out of fiduciary obligation or by an agreement. Members of Congress are bound by implied obligations created by Congressional ethics rules. Their obligations could be interpreted as being contractual but not necessarily fiduciary duty. Regarding trust, to who are members of Congress responsible for issues of disclosure before insider trading commences? Is it the public at large? Not necessarily, we feel that to be responsible to the public is too vague {United States v. Woodard 2006}. In his State of the Union speech on January 24, 2012, President Obama called for legislation that would make it illegal for Congressional members to engage in insider trading**.** Congress has attempted to respond to the American people's demand for reform and the close scrutiny of the media. Only the passage of time shall tell whether House members comply both with the spirit as well as the letter of the STOCK Act.

AUTHOR INFORMATION

Jeffrey Schieberl, J.D., Pepperdine University, Legal Studies Department, Los Angeles, California, USA. E-mail: jeff.schieberl@pepperdine.edu (Corresponding author)

Marshall Nickles, Ed.D., Pepperdine University, Economics Department, Los Angeles, California, USA. E-mail: marshall.nickles@pepperdine.edu

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13. *United States v. Woodard* 2006,459 F.3d 1078, 1086 (11th Cir. 2006). See generally Jerke, *supra* note 12, at 1483-85 (describing views of courts and commentators who believe that elected official owe a duty to the public).

NOTES

