CONGRESSIONAL INSIDER TRADING: IS MISAPPROPRIATION APPROPRIATE?

By
Adam Warr[i]

INTRODUCTION

There is no shortage of scandals within the realm of the political world—bribery, affairs, miscounted votes, being linked to prostitution rings—the list goes on and on. But there is one ongoing scandal that both the public and lawmakers continue to overlook—Congressional "insider trading." A five-year study conducted from 1993 to 1998 shows that senators in that time period beat the market by an average of 12.3%.[1] This number is quite staggering when considering the fact that corporate insiders during that same time period were only able to outperform the market by 7.5%.[2] This means that senators were outperforming the who's who of the market by nearly 5%.[3] Furthermore, the study shows that senators not only knew the stocks to pick, but knew exactly when to buy and when to sell. "[T]he prices of common stocks bought by Senators tended to stagnate prior to purchase, soar after purchase, and then stagnate again after sale."[4] No doubt these facts have a fishy aroma, but perhaps senators are simply more sophisticated in anticipating trends than the rest of the market participants—to the tune of 12.3%. This author, however, would argue that these skewed results are due to the fact that senators, along with other Congressional officers, have a significant advantage over the average trader because they are able to obtain and use material, non-public information gleaned from their Congressional position to pursue profitable trades in the market. Thus, "while [most] investors spend time worrying how their stocks will do, members of Congress often already know."[5]

Almost everyone has a general idea about what insider trading is. Allegations against celebrities like Martha Stewart[6] and Mark Cuban[7] made insider trading a household phrase.[8] But for those who do not live within the corporate world, the term "insider trading" is often misunderstood. " 'Insider trading' is a term subject to many

---

1. Matthew Barbabella, Daniel Cohen, Alex Kardon & Peter Molk, *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 204 (2008) (citing Alan 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)).
2. Ziobrowski, *supra* note 1, at 673 (Calculating the average return r from the monthly return m using the formula r=(1+m)<12>).
3. Barbabella, *supra* note 1 (citing Leslie A. Jeng, Andrew Metrick, & Richard J. Zeckhauser, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85(2) REV. OF ECON. & STAT. 453, 455 (May 2003) (Calculating the average returns r from the monthly returns m using the formula r=(1+m)<12>)).
4. *Id.* (citing in part Ziobrowski, *supra* note 1, at 674).
5. Bud W. Jerke, *Cashing in on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, 158 U. PA. L. REV. 1451, 1461 (2010).
6. Press Release, U.S. Securities and Exchange Commission, SEC Charges Martha Stewart, Broker Peter Baconovic with Illegal Insider Trading (June 4, 2003) *available at* http://www.sec.gov/news/press/2003-69.htm.
7. Jonathan Stempel, *Court Revives Mark Cuban Insider Trading Case,* REUTERS, Sept. 21, 2010, *available at* http://www.reuters.com/article/2010/09/21/us-sec-cuban-lawsuit-idUSTRE68K33E20100921.
8. Landon Thomas Jr., *Psst. Why Insider Trading Keeps Going*, N.Y. TIMES, May 16, 2004, http://www.nytimes.com/2004/05/16/business/psst-why-insider-trading-keeps-going.html.

definitions . . . and encompasses both legal and prohibited activity."[9] In other words, not all trading on the basis of inside information is inherently illegal. However, most references to the term "insider trading" typically refer to the illegal acts taken by those who are trying to gain an unfair advantage over other participants in the market by trading on material, nonpublic information. Melissa Robertson, an SEC official, defines insider trading as

> [T]he trading that takes place when those privileged with confidential information about important events use the special advantage of that knowledge to reap profits or avoid loss on the stock market, to the detriment of the source of the information and to the typical investors who buy or sell their stock without the advantage of 'inside' information.[10]

Just as there are few who know that not all trading on the basis of inside information is illegal, it is also a little-known fact that members of Congress and Congressional staffers are arguably legally permitted to use material, nonpublic knowledge they gain from their positions in Congress to make trades within the market.[11] Debatably, Congressional traders do not fall within the scope of insider trading laws,[12] which prohibit trading on the basis of insider information under only three theories: (1) the classical theory, (2) the tipper/tippee liability, and (3) the misappropriation theory.

This article argues that, contrary to this popular wisdom, trading by members of Congress on the basis of material nonpublic information *is* within the scope of current insider trading laws. In particular, this article contends that Congressional trading falls within the scope of the misappropriation theory.

Part II of this article examines the policy rationales for prohibiting insider trading and demonstrates that holding members of Congress liable for insider trading under the misappropriation theory furthers those rationales. Part III.(A) will apply the classical theory to trading by Congressional officers, explaining why members of Congress usually fall outside the scope of this theory. Part III.(B) of this article will analyze Congressional trading in light of the tipper/tippee doctrine and ultimately conclude that only a small subset of Congressional trades fall within the scope this theory. Part III.(C) will examine Congressional trading under misappropriation theory and will conclude that

---

9. Thomas C. Newkirk & Melissa A. Robertson, Speech by SEC Staff: Insider Trading- A U.S. Perspective at 16th International Symposium on Economic Crime (Sept. 19, 1998) (transcript available at http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.).

10. *Id.*

11. Brody Mullins, *Bill Seeks to Ban Insider Trading by Lawmakers and Their Aides*, WALL ST. J., Mar. 28, 2006, http://blogs.wsj.com/law/2006/03/28/bill-looks-to-ban-insider-trading-for-lawmakers-and-their-aides/.

12. *Id.* (quoting former SEC official Thomas Newkirk speaking on the point of the legality of Congressional insider trading: "If 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 . . . [and] is not breaching a duty of confidentiality to anybody and therefore he would not be liable for insider trading.").

Congressional traders *should* be held liable for insider trading under the guidelines of the misappropriation theory. Part IV of this article will discuss alternate means of prohibiting insider trading by members of Congress. Part V concludes the article with a brief discussion of why Congressional traders fall within the scope of insider trading laws and how holding Congressional traders accountable for insider trading ultimately furthers the policies of insider trading law.

I. Policy Rationales for Prohibiting Congressional Insider Trading

Many policy rationales have been considered in the contemplation of insider trading laws.[13] Some examples include maintaining trust in the marketplace and keeping the marketplace free of those who would exercise an unfair advantage over other investors. Such policy rationales are just as applicable to the prohibition of Congressional insider trading as they are to other cases of insider trading, if not more so.[14] After all, Congressional officers should be pillars of the community and are entrusted by the public to use their offices to further the interests of the American people, not for personal gain.

The policy rationales for prohibiting certain types of insider trading are often contested.[15] One of the strongest arguments for supporting such a prohibition is that there must be an inherent trust in the marketplace for investors to be willing to part with their money. "Our markets are a success precisely because they enjoy the world's highest level of confidence. Investors put their capital to work—and put their fortunes at risk—because they trust that the marketplace is honest. They know that our securities laws require free, fair, and open transactions."[16] Congressional trading would most certainly interfere with faith in the marketplace because of its inherent unfairness and because it is an incremental step toward replacing marketplace confidence with distrust. Some people, however, would argue that all forms of insider trading should be allowed. There are many reasons for this contested standpoint, one of which is the belief that there are no real victims involved when an insider trade is executed.[17] Proponents of the victimless argument contend that those who purchase or sell shares in the marketplace are going to do so regardless of whether inside trades occur. Hedge fund manager and author, James Altucher, describes insider trading as not only victimless, but as criminalizing something that is actually helping people. He backs his opinion with the following hypothetical:

> I'll give you a simple example. Let's say I know I want to buy stock XYZ. I've been saving up money from my newspaper route because I did my

13. *See, e.g.,* Newkirk & Robertson, *supra* note 9.
14. *Id.*
15. *Id.*
16. *Id.* (quoting Arthur Levitt, Chairman, U.S. Sec. and Exch. Comm'n, A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading, Address Before the SEC Speaks Conference (February 27, 1998) (transcript available at 1998 WL 92164).
17. *Id.; see also* James Altucher, Market Watch, "Why Insider Trading Should Be Legal," May 17, 2011, *available at* http://www.marketwatch.com/story/why-insider-trading-should-be-legal-2011-05-17.

> research and I think XYZ is a great company. Let's say there's someone else, some nefarious insider, who knows that XYZ is a fraud. We do the dirty deed together: he sells me his shares. Then the XYZ fraud comes out, the stock goes to zero and I lost all my money I had put in the stock and the guy who sold me his shares got away with the whole thing. He's rich now. He's on the beach. Girls in bikinis are refilling his drinks. He never has to move off that beach chair again.
> Who is the victim? Well, you might think: I am. I just lost all or most of the money I had put on the stock. But I should be thanking the guy who sold me his shares. How come? Well, I wanted to buy that stock anyway. If he hadn't come along and sold those shares to me, I would have paid a higher price. If I paid more for the stock, I would have lost more money. That's common sense. The more insiders selling me shares of the fraud, the less I would lose.[18]

This hypothetical sounds somewhat rational, but Mr. Altucher fails to consider the full implications of the insider's transaction. What about those traders who had to sell their XYZ stock for a lower price because the insider was able to sell first and get a premium price? Are they not considered victims? What about the guy who lost half the value of his XYZ position before he could sell his stock because of the panic sale caused by the insider? Is he not considered a victim? And does not Congressional insider trading have the same victims? Insider trading, Congressional or otherwise, does not just have an effect on the buyer and seller in single transaction; it also has an effect on the particular stock holders as well as future buyers and sellers.

Furthermore, the victimless argument fails to consider the harms that insider trading has on the options market.[19] "Professional option writers write options only in response to a particular demand. Where that demand comes from an insider possessing material non-public information, the option writer suffers a loss that would not otherwise have occurred."[20] Congressional insider trading is no different. It, too, has an adverse affect on the underwriters and executors of option contracts. In short, the victimless argument in both the corporate and Congressional realm fails because it does not consider the full implications of insider trading and its comprehensive effect on the market.

One of the strongest arguments for permitting insider trading is the market efficiency argument. This argument is premised on the idea that permitting insider-trading helps the market become more efficient because it allows for more immediate adjustments in price, which, in turn, reflects a more accurate market value for a particular stock.[21] In other words, insiders are more efficient at moving the market in the direction it should go because they can buy and sell shares more quickly as a result of their having access to

---

[18] Altucher, *supra* note 17.
[19] Robertson, *supra* note 9.
[20] *Id.*
[21] *See* Stanislav Dolgopolov, THE CONCISE ENCYCLOPEDIA OF ECONOMICS, "Insider Trading," *available at* http://econlib.org/library/Enc/InsiderTrading.html.

inside information.[22] Therefore insider trading, according to the market efficiency argument, will benefit all those who invest in the market because of the quick market adjustments that result due to trading based on insider information. However, the market efficiency argument, much like the victimless argument, fails to consider the full implications of insider trading on the market as a whole. Insider trading may more quickly reflect a more accurate valuation within the market. However, the practice of insider trading is inherently unfair, and the permitting of insider trading would very likely dissuade investors, both present and future, from participating in the market. If insider trading were allowed, investor trust would likely be lost because non-insiders would be disadvantaged by their lack of inside information.[23] Such mistrust in the market has already manifested itself in the European marketplace, and the U.S. marketplace could suffer similar effects if insider-trading laws were further relaxed.[24]

> [O]ne of the main reasons that capital is available in such quantities in the U.S. markets is basically that the investor trusts the U.S. markets to be fair. Fairness is a major issue. Even though it sounds simplistic, it is a critical factor and one that is absent, really to a surprising degree in many of the sophisticated foreign markets. . . .The common belief in Europe that certain investors have access to confidential information and regularly profit from that information may be the major reason why comparatively few Europeans actually own stock. [This may] partially explain why the U.S. markets are so active and why so much money is available for those companies that seek to enter U.S. markets[25]

Congressional insider trading would likewise have the effect of causing investors to distrust the market because Congressional officers—due to their access to material, non-public information—would have an unfair advantage over the average trader.

Though there are valid arguments against insider trading regulations, the arguments that support a more stringent stance on insider trading far outweigh those against it. The market is a fickle machine. For the most part, it consists of average traders with average market knowledge.[26] These traders are nervous. And why shouldn't they be? After all, they are putting their money out in the marketplace with no guarantee of a return. They only have the hope that the market will treat them well, and at the very least, treat them fairly. If the U.S. were to relax its insider trading laws, the market would lose

---

[22] *See, e.g.,* Lisa Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661 (1992).
[23] *See* Robertson, *supra* note 9.
[24] *Id.*
[25] *Id.* (quoting James A. Silkenat, *Overview of U.S. Securities Markets and Foreign Issuers*, FORDHAM INT'L L.J. s4 (1994)).
[26] *Id.* (citing Arthur Levitt, Chairman, Sec. Exch. Comm'n, Testimony Concerning Appropriation for Fiscal Year 1999 Before the Subcommittee on Commerce, Justice, State and Judiciary of the Senate Committee Appropriations, 1998 WL 1083614 (March 19, 1998)).

its perceived fairness, and thus, traders would lose faith in the system.[27] Such a loss of faith would most certainly have a devastating effect on the market. Thus, insider trading should "[have] utterly no place in any fair-minded, law-abiding economy," most especially here in the U.S.[28] Congressional insider trading is no exception.

All of the preceding policy rationales are just as applicable to Congressional insider trading as to other forms of insider trading. After all, Congressional insider trading *is* insider trading. It causes the exact same problems in the marketplace which other types of insider trading cause. Therefore, the rest of this article is dedicated to establishing that—consistent with these policy rationales—Congressional insider trading is *presently* prohibited under current insider trading law, more specifically through the misappropriation theory.

II. INSIDER TRADING AS APPLIED TO CONGRESSIONAL OFFICERS

Section 10(b)-1 of the Securities Exchange Act prohibits the use of manipulative or deceptive devices or contrivances with respect to securities.[29] Rule 10(b)-5, promulgated pursuant to §10(b), further specifies that it is "unlawful for any person . . . to employ any device, scheme, or artifice to defraud . . . to engage in any act, practice, or course of business . . . in connection with the purchase of sale of any security."[30] Courts have recognized three theories of insider trading pursuant to this rule: (1) the traditional theory of insider trading; (2) tipper/tippee liability, and (3) the misappropriation theory.

A. TRADITIONAL THEORY AS APPLIED TO CONGRESSIONAL OFFICERS

The traditional, or classical, theory prohibits corporate insiders from using nonpublic information to trade in their own company's stock.[31] Classical theory insider trading liability is based on the "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[32] Insiders include both corporate insiders (corporate directors, executives, employees, etc.) and temporary insiders (attorneys, accountants, etc.) who have access to nonpublic information about the company and owe a duty to shareholders due to a professional relationship with the corporation.

The traditional insider trading theory cannot be applied to Congressional officers unless the Congressional officer is also a corporate insider. Under ethics rules, members

---

[27] *See* Silkenat, *supra* note 25.

[28] Robertson, *supra* note 9 (quoting Arthur Levitt, *A question of Investor Integrity: Promoting investor confidence by Fighting Insider Trading*, Address Before the "SEC Speaks" Conference, 1998 WL 92164 (S.E.C.) (February 27, 1998)).

[29] 17 C.F.R. § 240.10(b)-1.

[30] 17 C.F.R. § 240.10(b)-5.

[31] *See* United States v. O'Hagan, 521 U.S. 642, 651-52 (1997) (citing Ghirardelli v. United States, 445 U.S. 222, 228 (1980)).

32 *Chiarella,* 445 U.S. at 228.

of Congress are not allowed to contemporaneously serve in Congress and practice a profession for compensation that involves a fiduciary duty.[33] Thus, Congressional officers are not allowed to hold insider positions while employed by the government, and the traditional theory can, therefore, not be applied. However, the misappropriation doctrine, and to a lesser extent, tipper/tippee liability can and should be applied to Congressional officers to create liability for their trading on nonpublic information gained as a result of their government positions.

B. Tipper/Tippee Liability as Applied to Congressional Officers

Due to the nature of their jobs, congressional officers are often rubbing elbows with the upper echelons of the corporate world—CEOs and other corporate executives included. One would be naive to assume that congressmen do not at least occasionally receive inside information in their various meetings with such prominent corporate insiders. In such circumstances, congressional officers that trade on such "tips" might be liable for unlawful insider trading under the "tipper/tippee" doctrine, as set forth in *Dirks v. SEC*.[34]

Under the tipper/tippee doctrine, an outsider can be found liable for insider trading if the outsider receives material, non-public information from an inside tipper.[35] In *Dirks*, the Supreme Court held that outside tippees can be held liable for unlawful insider trading if three elements are met: 1) the tipper has breached a fiduciary duty by disclosing the information, 2) the tippee knows or has reason to know the tipper has breached his/her fiduciary duty, and 3) the tipper received some kind of benefit.[36]

A tipper must breach a fiduciary duty in the disclosing of information in order to establish liability under the tipper/tippee scenario. The Supreme Court has held that in order to establish a tipper/tippee relationship, "it thus is necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty."[37] The tipper must therefore owe an obligation of confidence to an existing principal.

Corporate insiders may share inside information with members of Congress without breaching a fiduciary duty to their principal.[38] For instance, corporate insiders may be compelled by law to reveal inside information to government officials. Under such circumstances the insider would not be classified as a tipper because there is no breach of fiduciary duty.[39] For example, a pharmaceutical CEO may be compelled to

---

33 *See* Senate Rule XXXVII 5(a)(3), http://rules.senate.gov/public/index.cfm?p=RuleXXXVII, House Rule XXV 2(c), http://www.rules.house.gov/singlepages.aspx?NewsID=160&rsbd=165.
[34] *See generally* Dirks v. SEC, 463 U.S. 646, 659-61 (1983).
[35] *See id.* at 659.
[36] *Id.* at 659-61.
[37] *Id.* at 661.
[38] *See O'Hagan*, 521 U.S. at 654 (Stating that "an employee's undertaking not to reveal his employer's confidential information 'became a sham' when the employee provided the information to his co-conspirators in a scheme to obtain trading profits." (quoting in part Carpenter v. United States, 484 U.S. 19, 27 (1987)).
[39] *See Dirks*, 463 U.S. at 654.

disclose to the FDA detailed reports pertaining to a new type of oral contraceptive that needs be ingested only once a month. Under such circumstances, the CEO would not be considered a tipper because the company understands that such disclosure is required in order to gain FDA approval and sell their product. Therefore, the CEO would not have breached his or her fiduciary duty. Thus, the congressional officer that purchases or sells securities on the basis of the received information would not be liable for insider trading under tipper/tippee liability.

In addition to being compelled, corporate insiders may offer up inside information because they believe that doing so will ultimately benefit the company.[40] For instance, the above mentioned CEO may choose to voluntarily share inside information with a member or members of Congress with the ultimate purpose of achieving a positive benefit for his or her company. This act, like compelled sharing of information, would not qualify as a breach of fiduciary duty because the corporate insider is looking out for the best interests of the company.[41] In such an instance, there is no misappropriation of information. In essence, the insider in this instance is really fulfilling his or her fiduciary duty by sharing the information because he or she thinks that doing so will benefit the company. And once again, the government official is able to trade based on the inside information because, like the tango, it takes two to establish liability under the tipper/tippee doctrine. Without a tipper, there can be no tippee. If, however, the CEO voluntarily shares inside information not for the benefit of the company, he would be considered a tipper and both he and the congressional officer would be liable under the tipper/tippee doctrine so long as the congressional officer makes a trade on the basis of the relayed information.

The second element needed to establish liability under the tipper/tippee doctrine is that the tippee must know, or have reason to know, that the tipper has breached his or her fiduciary duty. Thus, a congressional officer must know that the tipper is breaching his or her fiduciary duty to be held liable under the tipper/tippee doctrine. However, this is very difficult to prove because the would-be tippee (congressional officer) will not likely know if his or her tipper is in fact breaching a fiduciary duty. As mentioned above, when a corporate insider is compelled to submit information to government officials or does so for the benefit of his or her company, there is no breach of fiduciary duty[42] Thus, a congressional officer will not likely know the tipper is breaching a fiduciary duty unless the tipper explicitly states or heavily implies the point. Establishing sufficient evidence to establish such a case would be difficult, to say the least. Thus, congressional officers are once again allowed to trade based on this inside information without violating the tipper/tippee doctrine.

The third element of tipper/tippee liability is that the tipper must receive some kind of benefit from sharing the information. The tipper's benefit may be pecuniary in nature, or could include something as simple as a perceived reputational benefit.[43] Again,

---

[40] *See id.*
[41] *See id.*
[42] *See id.*
[43] *Id.* at 663.

problems are encountered when insiders are compelled to share information with government officials because the insider gains no benefit when compelled to share information and congressional officers are left with yet another loophole in which they can trade non-public information. Similarly, there are problems establishing this third element when a corporate insider voluntarily shares information for the benefit of his company because he is not receiving any kind of benefit himself. There may be instances where the corporate insider might receive a benefit for lobbying their company cause before a member or members of Congress. This, however, would make no difference because there is still no breach of a fiduciary duty on the corporate insider's part and no knowledge of a breach on the congressional officer's part. The only time congressional officers would be liable under the tipper/tippee doctrine is if officials trade based on confidential information they know or have reason to know was shared from an insider by his own free will, not for the benefit of the company, and that the insider is receiving some sort of benefit, pecuniary or otherwise. Thus, the required elements needed to pin tipper/tippee liability on a congressional officer are rarely established, if ever.

This outcome is troubling as far as policy is concerned. Much of the reason that insider trading laws are in place is to establish an overall trust in the market and to keep people from having an unfair advantage over other traders in the market. Yet when government officials are allowed to trade based on non-public information gleaned through the call of their profession, such trades potentially endanger the public's trust in the market as well as give government workers an unfair advantage over the rest of the investing public. This is neither fair nor does it help with trust in the market.

While tipper/tippee liability exists in Congress, it is extremely hard to prove. It only applies in a very narrow scope. The problem of insider trading by members of Congress is more expansive than can be reached by the tipper/tippee doctrine. Therefore, this article turns to the misappropriation theory as a more viable means of prohibiting Congressional insider trading.

C. Misappropriation Doctrine as Applied to Congressional Officers

The theory of misappropriation first appeared in 1981,[44] but the Supreme Court did not officially accept the misappropriation doctrine until 1997 in *US v. O'Hagan*.[45] In *O'Hagan*, a lawyer was found guilty of misappropriating information when his law firm represented the Grand Metropolitan PLC regarding a potential tender offer for common stock of the Pillsbury Company.[46] Though O'Hagan was not personally involved in the Grand Metropolitan representation, he learned of the tender offer and then purchased Pillsbury stock options based on this information, ultimately netting a profit of $4.3 million through his trades.[47] The case did not fall within the traditional theory because

---

[44] U.S. v. Newman, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir. 1983), *cert. denied*, 464 U.S. 863 (1983).
[45] *See generally O'Hagan*, 521 U.S. 642.
[46] *See id.* at 647-49.
[47] *Id* at 647-48.

O'Hagan owed no duty to Pillsbury.[48] He was a temporary insider of Grand Metropolitan via his firm, and under the traditional theory, owed a duty to Grand Metropolitan only.

Despite his not being liable under the traditional theory, the Supreme Court found that O'Hagan was liable under the misappropriation theory.[49] The court found that O'Hagan owed a duty to the source of the information—the firm—and should have either disclosed to the firm his intention to trade based on this information or he should have abstained from trading altogether.[50]

i. Element #1: Duty to the Source of Information

The court in *O'Hagan* recognized that there are several important criteria needed to establish liability under the misappropriation theory. First, a trader must owe a duty to the source of the information.[51] "The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10(b)-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[52] Thus, when someone gains information through a source to which a duty of confidence or fiduciary duty is owed, that someone cannot use the given information for trading purposes. This element ensures that people do not abuse positions of trust for their own profit.

> The essence of the Rule [10(b)-5] is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.[53]

This duty to the source requirement, however, is problematic when considered in light of Congressional trading for two reasons. First, this requirement, when applied to Congressional trading, begs the following question: who is the source of the nonpublic Congressional information on which Congressional officers are allegedly allowed to trade? There are two possible answers to this question. The first is that Congress itself is both the originator and the creator of all non-public Congressional information. If this is true, then Congressional officers could not, and should not be held liable under the misappropriation doctrine for trades made using non-public Congressional information because these officers, in essence, are the *source* of the "inside" information, and as such, are able to use the information in whatever way they please.

---

[48] *See id.* at 651-52.
[49] *Id.* at 653.
[50] *Id.* at 654-55.
51. *Id* at 652.
52. *Id*.
53. SEC v. Tex. Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968) (quoting Matter of Cady, Roberts & Co., 40 SEC 907, 912 (1961)).

The second argument (which this author supports) suggests that Congress is not the source of all non-public Congressional information, but that Congressional information comes from other sources. In essence, there are two types of Congressional information that can be used to make profitable trades on the market. First is the information that Congressional officers receive from publicly traded companies. This includes both information freely given to Congress by company insiders (e.g., a senator is good friends with the CFO of the company who freely shares information with the senator) and information that the company is required to give to Congress (e.g., in order to get a certain permit, the insider must submit particular company information to government officials).

In addition to corporate insiders, there is another source of Congressional information—the American people. The American people are the ones that bring issues and ideas to Congress. They write letters and let Congressional officers know about the issues that face the United States Thus, Congress is not the originator of Congressional information, but merely a facilitating body that takes outside information and molds it into useable laws and policy for the benefit of the electing public. As Mark Twain once stated, "None but Gods have ever had a thought which did not come from outside."[54] The same can be said concerning non-public Congressional information. Congressional information comes from outside. Congressional officers are not gods who can self-conjure information for laws and policy. Congress simply takes the outside information and uses it to draft/sponsor bills, plans, policies, and laws. But the American people are the *true source* of Congressional information.

DUTY OF CONGRESSIONAL OFFICERS TO THE AMERICAN PEOPLE:

If established that the American people, and not Congress, are the source of Congressional information, liability under the misappropriation theory still requires that Congressional officers owe a duty to the American people. SEC rules specify that "only an expectation, not a guarantee, of confidentiality is required."[55] So do Congressional officers owe a duty to the American people? In other words, do the American people expect that Congressional information will remain confidential and not be used for the purposes of personal gain on the part of Congressional officers? It almost seems a silly question to argue. Joseph Kalo argues that "deeply engrained in the American people is a belief that public office and confidential information acquired as a result of holding such office, should not be used for private gain."[56] New York Representative, Louise Slaughter, offers further support of this expectation in stating that, "[t]he American

54. MARK TWAIN, *What is Man?*, THE COMPLETE ESSAYS OF MARK TWAIN, 339 (Charles Neider, 2000).
55. Andrew George, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL'Y REV. 161, 164 (2008).
56. *Id*.

people expect Members and staffers to work on their behalf and to represent their interests, not to increase the returns on our investments and fatten our stock portfolios."[57].

Congressional officers, by the very nature of their appointment, owe a duty to the American people and should be prevented from trading on non-public Congressional information.[58] Senate and House rules come just short of stating that Congressional officers owe a fiduciary duty to the American public.[59] Both House and Senate rules state that Congressional officers are not allowed to serve in Congress while practicing a profession for compensation that involves a fiduciary duty.[60] These rules, of course, serve to ensure that Congressional officers do not have a conflict of interest that may interfere with their Congressional duties, but also implies that Congressional officers owe a duty to their office, and by implication, to their constituents, the American people.

There is also evidence that the American people are essentially a collective principal to whom Congress owes a fiduciary duty. The Constitution, the document that defines Congress, states that "WE THE PEOPLE OF THE UNITED STATES . . . establish this CONSTITUTION."[61] Congressional officers take an oath to "defend the Constitution against all enemies, both foreign and domestic,"[62] and in this oath is an assumed duty to the establishers of the Constitution—We the People of the United States. Furthermore, the fact that Congressional officers are both elected by and have their salaries paid by the American people assumes an inherent duty to them. At the very least, it demonstrates that the American people are a principal to whom Congressional officers owe a fiduciary duty.

In the mail/wire fraud context, courts have repeatedly recognized that Congressional officers owe a fiduciary duty to the public.[63] A breach of this fiduciary duty has, until recently, been prosecuted under the honest services prong of 18 U.S.C.S. § 1346, which defines "scheme or artifice to defraud" as a "scheme or artifice to deprive another of the intangible rights of honest services." However, the Supreme Court in a recent case, *Skilling v. United States*, narrowed the *criminalization* of "defrauding of

---

57. Barbabella, s*upra* note 1 (quoting Louise Slaughter, Press Release, Congressman Brian Baird's Newsroom, *Reps. Baird and Slaughter Introduce Legislation to Prohibit Insider Trading on Capitol Hill* (2007), *available at* http://www.house.gov/apps/list/press/wa03._baird/stockact.html).
58. *Id.* at 216 (quoting Joseph Kalo, *Deterring Misuse of Confidential Government Information: Proposed Citizens' Action*, 72 MICH. L. REV. 1577, 1581 (1974)).
59. Senate and House Rules, *supra* note 30.
60. *Id.*
61. U.S. Const. pmbl.
62. Senate Oath of Office, http://www.senate.gov/artandhistory/history/common/briefing/Oath_Office.htm, House Oath of Office, http://clerk.house.gov/member_info/memberfaq.aspx (The oath of office is the same for both Senate and House Members. The oath is as follows: "I do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter: So help me God").
63. *See, e.g.,* United States v. Silvano, 812 F.2d 754, 759 (1st Cir. Mass. 1987); United States v. Lopez-Lukis, 102 F.3d 1164, 1169 (11th Cir. 1997); United States v. Woodward, 149 F.3d 46, 57 (1st Cir. 1998); United States v. Sawyer, 85 F.3d 713, 724, 729 (1st Cir. 1996).

honest services" as mentioned in §1346 to include only bribes and kickbacks. However, the Court makes clear that it is in no way meant to rebut the premise that members of Congress owe a fiduciary duty to the public.[64] For example, in *United States v. Silvano*, the court recognized that a city official owed duties to the citizens of the State.[65] The court states that there is "an underlying theory that a public official acts as 'trustee for the citizens of the State . . . and thus owes the normal fiduciary duties of a trustee, e.g., honesty and loyalty' to them."[66] *United States v. Lopez-Lukis*, another mail/wire fraud case, speaks specifically to the point of government officials using their position for pecuniary gain and how such an action breaches a duty owed to their constituents and to the public in general, thus defrauding them of honest services:

> [W]hen a political official uses his office for personal gain, he deprives his constituents of their right to have him perform his official duties in their best interest. Elected officials generally owe a fiduciary duty to the electorate. When a government officer decides how to proceed in an official endeavor—as when a legislator decides how to vote on an issue—his constituents have a right to have their best interests form the basis of that decision. If the official instead secretly makes his decision based on his own personal interests—as when an official accepts a bribe *or personally benefits from an undisclosed conflict of interest*—the official has defrauded the public of his honest services.[67]

Congressional insider trading is essentially the act of accepting personal benefits from an undisclosed conflict of interest and thereby defrauds the public of a Congressional officer's honest services. Although *Silvano* and *Lopez-Lukis* are both mail/wire fraud cases, both courts' policy rationales are readily applicable to the world of congressional insider trading. Congressional officers are trustees for the citizens of the state and owe them a fiduciary duty. Thus, Congressional officers should have the best interests of constituents, not the furthering personal interests, at heart.

The American public is the source of congressional information. It is the public who supplies the information from which Congressional officers profit in their insider trading. Furthermore, the American public is essentially a principal to whom Congressional officers owe a fiduciary duty. The public elects and pays the salaries of Congressional

---

64. Skilling v. United States, 130 S. Ct. 2896, 2905 (2010). (Notice that the Supreme Court narrows only the §1346 scope of *criminalization* to include bribes and kickback schemes. The Court's explains the reasoning for its narrow criminalization is to avoid due process questions that might arise in the future. "Reading the statute to proscribe a wider range of offensive conduct, we acknowledge, would raise the due process concerns underlying the vagueness doctrine. To preserve the statute without transgressing constitutional limitations, we now hold that §1346 criminalizes *only* the bribe-and-kickback core of . . . case law.").
65. *See* Silvano, 812 F.2d at 759.
66. *Id.* (quoting in part United States v. Mandel, 591 F.2d 1347, 1363 (4th Cir. Md. 1979)).
67. *Lopez-Lukis*, 102 F.3d at 1169 (emphasis added).

officers, the officers take upon themselves an oath to defend the Constitution, and in doing so, impliedly subject themselves to the service of seeking out the best interests of the American people.[68] Thus, when Congressional officers trade on non-public congressional information, they are breaching a fiduciary duty owed to the American people and thereby establish the first element of the misappropriation theory.

ii. Element #2: Abstain From Trading or Disclose

Under the misappropriation theory, a person who gains access to confidential information and owes a duty to the source of that information must either disclose to the source his or her intent to trade based on the received information or abstain from trading.[69]

> A person commits fraud "in connection with" a securities transaction, and thereby violates 10(b) and Rule 10(b)-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, 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 the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[70]

United States v. Sawyer, another mail fraud case, speaks directly to the misappropriation theory's abstain or disclose principle and narrows the argument specifically to the duties of public officials.[71] In *Sawyer*, a lobbyist pled guilty to charges against honest services. The *Sawyer* court makes clear that if an official is secretly making decisions based on personal interests in his or her capacity as a public official, then "[a] duty of disclosure arises ... from the general fiduciary duty a public official owes to the public."[72] The court further states "the obligation to disclose material information inheres in the legislator's general fiduciary duty to the public."[73] The *Silvano* court speaks to this point of disclosure as well, and states that public officers have "the affirmative duty to disclose material information [that] arises out of [his or her] fiduciary

68. Senate and House Oaths of Office, *supra* note 62.
69. *See generally O'Hagan*, 521 U.S. 642.
70. Robertson, s*upra* note 9.
71. *See generally Sawyer*, 85 F.3d at 730.
72. *Id*.
73. *Id*. (quoting United States v. Woodward, 149 F.3d 46, 62 (1st Cir. 1998)).

relationship to his or her employer."[74] From these cases, it can be inferred that Congressional officers who act in behalf of their own personal interests—i.e., make decisions to better the position of their personal portfolio—rather than acting for and on behalf of their constituents have a duty to disclose such acts to the public.

In addition to the common law references of a duty to disclose or abstain, the United States Code implies that government officials owe such a duty to the American public. Title 18 section 1346 makes it a crime to "devise by scheme or artifice to defraud"[75] and defines the term "scheme or artifice" [to] include a "scheme or artifice to defraud another of the intangible right to honest services."[76] A "deprivation of intangible right to honest services" can include the public's deprivation of a public official's "honest and faithful performance of an official's duties."[77] Furthermore, "a public official can steal his honest services from his employer [in two ways]: (1) the official can be influenced or otherwise improperly affected in the performance of his duties; or (2) the official can *fail to disclose* a conflict of interest, resulting in personal gain."[78] Thus, Congressional officers are essentially stealing their honest services from the American people they serve when they fail to disclose intent to trade based on non-public congressional information because such an action qualifies as a conflict of interest that results in personal gain.

Thus, the two elements of the misappropriation theory—owing a duty to the source of information, and failing to abstain or disclose trades made on the basis of such information—are met when Congressional officers make trades based on material, nonpublic information gained from their congressional duties. The American people—not Congress—are the source of congressional information. Thus, Congressional officers owe a fiduciary duty to the American people and breach this duty when they make trades based on information gained in the course of their congressional duties while failing to disclose such trades.

III. ALTERNATE MEANS OF PROHIBITING CONGRESSIONAL INSIDER TRADING

There are rules in place that govern insider trading, but in light of the insider trading problem that exists in Congress,[79] it is obvious that the current rules do not sufficiently guard against the practice of congressional insider trading. For instance, there is a provision in the Code of Ethics of Government Service (Code of Ethics) that provides that government employees should "never use any information coming to [them] confidentially in the performance of governmental duties as a means for making private

74. *Silvano*, 812 F.2d at 759.
75. 18 U.S.C.A §1341.
76. 18 U.S.C.A §1346.
77. United States v. Bryan, 58 F.3d 933, 942 (4th Cir. 1995) (abrogated by United States v. O'Hagan, 521 U.S. 642 (1997)(quoting in part, United States v. Barber, 668 F.2d 778, 784 (4th Cir. 1982)).
78. United States v. Woodward, 149 F.3d 46, 57 (1st Cir. 1998) (emphasis added) (citing United States v. Sawyer, 85 F.3d 713, 724, 729 (1st Cir. 1996)).
79. *See, e.g.,* Barbabella et al., *supra* note 1; *see also* Jerke, *supra* note 5.

profit."[80] This provision applies to "all Government employees, including officeholders."[81] However, this provision has little enforcement value because it is not a legally binding statute.[82]

There are also rules that have been promulgated by both the House and the Senate Rules and Ethics Committees—each of which would seem to prohibit the act of Congressional trading.[83] However, the rules promulgated by these committees are worded in such a vague and subjective manner as to leave much to the interpretation of the rule's reader.[84] Furthermore, the House and Senate Ethics Committees have little bark and less bite.[85] They rarely prosecute legislators and usually do so only in the most disreputable of cases.[86] This demonstrates that Congress's self-policing of insider trading is essentially ineffective to the point of non-existence.

Some Congressional officers, however, have recognized a problem does exist with Congressional insider trading and have proposed new rules in an effort to remedy the problem. Two such Congressional officers are Washington Representative Brian Baird (retired) and New York Representative Louise Slaughter, the two initiating sponsors of the Stop Trading on Congressional Knowledge Act (STOCK).[87] This bill was first

---

80. Jerke, *supra* note 5, at 1467 (quoting the Code of Ethics of Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958)).
81. *Id.*
82. *See id.*
83. *See* OPEN CONGRESS, *Senate Rule XLIV—Congressional Directed Spending and Other Related Items, available at* http://www.opencongress.org/wiki/Senate_Rule_XLIV_-_Congressionally_directed_spending_and_related_items (The Senate rules state that "[n]o Member, officer, or employee shall knowingly use his official position to introduce, request, or otherwise aid the progress or passage of congressionally directed spending items, limited tax benefits, or limited tariff benefits a *principal purpose* of which is to further only his pecuniary interest, only the pecuniary interest of his immediate family, or only the pecuniary interest of a limited class of persons or enterprises, when he or his immediate family, or enterprises controlled by them, are members of the affected class." (emphasis added). There are two words—"principle purpose"—that leave a gaping loophole in this provision and in essence these words allow Congressional officers to use their professional position for personal gain such as insider trading. A Congressional officer can vote in such a way to line his own pockets so long as the officer's self-interests are not the "principle purpose" behind the vote. This "principle purpose" wording essentially invalidates any bite that Senate Rule XLIV might have otherwise had on Congressional insider trading); *See also* HOUSE OF REPRESENTATIVES COMMITTEE ON RULES, Code of Official Conduct, House Rule XXIII(3), *available at* http://www.rules.house.gov/singlepages.aspx?NewsID=159&rsbd=165 (XXIII(3) states that "[a] Member, Delegate, Resident Commissioner, officer, or employee of the House may not receive compensation and may not permit compensation to accrue to the beneficial interest of such individual from any source, the receipt of which would occur by virtue of influence improperly exerted from the position of such an individual in Congress").
84. *Id.*
85. Barbabella, *supra* note 1 at 220 (A report released by the House and Senate Ethics Committees in which the committees admit that "[a]ctual disciplinary actions by the full Senate or House have, in fact, been relatively rare." It also notes that only nine Senators and only twenty-two Representatives have been censured in Congressional history) (quoting *Enforcement of Ethical Standards in Congress*, rules.house.gov/archives/jcoc2ac.htm (surveying internal ethics committees)).
86. *Id.*
87. H.R. 2341, 110th Cong. (2007); *See also* H.R. 682, 111th Cong. (2009) (Brian Baird was the original sponsor of STOCK, but has since retired. *See* Chris Cillizza, *Baird Retires in Washington State*, WASH.

introduced in the House on March 28, 2006,[88] however, the bill did not make it past the House Agricultural Committee. STOCK has since been reintroduced to Congress on two other occasions, only to be stymied twice again by the House Agricultural Committee. STOCK was reintroduced a fourth time on May 17, 2011.

> In a series of procedural moves, the bill was referred to six House committees (Financial Services, Agriculture, House Administration, Judiciary, Ethics, and Rules) on March 17, 2011, then re-referred and 'discharged' from five of those committees (all but Rules) and referred to all six committees again on March 29, 2011.[89]

"As of May 25, 201[1], Congress has taken no additional action."[90] If STOCK does end up passing, it will serve to prohibit commodities and securities trading "based on nonpublic information" relating to Congress, to require additional reporting by "Members and employees" of Congress of securities transactions, and for other purposes."[91] Essentially, STOCK will undo the ambiguity of Senate and House rules and provide a hard and fast rule by which Congressional officers will be held accountable. However, it is unlikely that STOCK will pass given its unfavorable history. Thus, Congressional insider trading will likely continue unless it is prohibited by other means.

IV. Conclusion—Congressional Insider Trading is Already Prohibited Under the Misappropriation Theory

This author argues that Congressional officers are already liable for trading based on material, non-public information under current insider trading laws—more specifically, under the misappropriation theory. Liability under the misappropriation theory requires an existing duty to the source of the material, non-public information.[92] History, precedent, and common sense demonstrate that such a duty exists between Congressional officers and the people of the United States. Congressional officers pledge to defend the

---

POST, Dec. 9, 2009, http://voices.washingtonpost.com/thefix/house/baird-retires-in-washington-st.html.)

88. Barbabella, *supra* note 1, at 201–02 (STOCK failed to make it very far in its initial appearance before the House in spite of Representative Slaughter's visibility as chairperson of the House Rules Committee. The Act did not advance past the House Agricultural Committee, then was reintroduced in the 110th Congress where it did not advance again, and was reintroduced for a third time in the 111th Congress).

89. *What is the Stop Trading on Congressional Knowledge Act?*, ProCon.org, http://insidertrading.procon.org/view.answers.php?questionID=1032 (last accessed May 31, 2011). (STOCK "was [re]introduced to Congress on March 17, 2011 by Rep. Timothy J. Walz (D-MN) with cosponsors Representatives Raul Grijalva (D-AZ), David Loebsack (D-IA), Louise Slaughter (D-NY), and Niki Tsongas (D-MA)").

90. *Id.*

91. *Id.*

92. United States v. O'Hagan, 521 U.S. 642, 654–55 (1997).

Constitution of the United States.[93] Therein is an inferred duty to "We the People of the United States;" after all, it is the people who both elect Congressional officers and pay their salaries. Therefore, the People are essentially a principal to Congressional officers. In addition, the People give Congress much of the information it uses for legislation and decision-making. Thus, the People of the United States, as both source and principal of Congress, are owed a fiduciary duty by Congressional officers.

A Congressional officer's fiduciary duty to the people has also been established through common law.[94] There are numerous cases, several of which have been cited in this article, that establish the fact that Congressional officers are entrusted to act in the best interest of the People and owe those people a fiduciary duty.[95] Congressional insider trading falls far short of serving the best interest of the People and case law has aptly recognized that such action is out of harmony with that fiduciary duty.[96] This fiduciary duty has been established in mail and wire fraud cases as well, the application of which extends into the realm of Congressional insider trading.[97]

Once the fiduciary duty prong of the misappropriation theory is established, would-be inside Congressional traders have a duty to either abstain from trading or disclose that they intend to trade on the basis of the inside information.[98] Thus, Congressional officers, owing a fiduciary duty to the American people, are held to this same standard and must either abstain from insider trading or disclose their intention to make such trades.

There is no reason that Congressional officers should be beyond the reach of the misappropriation theory. After all, one of the main purposes of insider trading laws is to maintain trust in the marketplace. Congressional officers, by the graces of the American people, are given access to material, non-public information that has value in the marketplace. When Congressional officers use this information to participate in insider trading, they have an unfair advantage over other traders and this unfair advantage may dissuade future investors from participating in the market.[99] This type of insider trading hurts not only the individual investors that participate in the trade, but has a far greater effect on the market as a whole—an unseen effect that could potentially cause great distress in the marketplace. Why, then, does the SEC balk at prosecuting Congressional insider trading? Undoubtedly, it is because SEC officials are hesitant to bite the hand that feeds them. "[T]he SEC may have little incentive to tangle with the Senate, given their relationship. Senators approve members of the SEC's governing body, as well as the agency's budget."[100] However, this conflict of interest is no excuse for the lack of enforcement of Congressional insider trading and the SEC needs to take a stand against

---

93. House and Senate Oaths of Office, s*upra* note 62.
94. *See, e.g., Silvano*, 812 F.2d; *Lopez Lukis*, 102 F.3d at 1169; *Sawyer*, 85 F.3d at 724, 729 and *Woodward*, 149 F.3d at 57.
95. *Id.*
96. *Id.*
97. *Id.*
98. *See, e.g., O'Hagan*, 521 U.S. at 651–52.
99. *See* Levitt, *supra* note 16 and Silkenat, *supra* note 25.
100. George, *supra* note 55 at 172 (quoting Joseph N. DiStefano, *Senators' Stock Picks Bring Profit, Scrutiny*, PHILA. INQUIRER, Nov. 7, 2004, at E1).

the practice. After all, "[i]f insider trading is harmful, then it must be at least as harmful when people at the highest levels of government partake in it. Seemingly, this behavior goes to the heart of the SEC's mission 'to protect investors' and to 'maintain fair, orderly, and efficient markets.' "[101] Giving Congressional officers immunity from insider trading under the misappropriation theory not only flies in the face of justice, but also makes a mockery of the trust placed in Congressional officers to act as representatives for, and on behalf of "WE THE PEOPLE."

---

i. J.D./M.B.A. Candidate, University of Idaho & Washington State University, December 2011. I would like to thank Professor Wendy Couture for her thoughtful insights and excellent source recommendations throughout the writing process. I would also like to thank my wife, Susannah, and daughter, Evie, for their loving support and encouragement.

---

101 *Id.* at 171 (quoting in part U.S. SEC. AND EXCH. COMM'N, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, http://www.sec.gov/about/whatwedo.shtml).