Testimony of Peter J. Henning
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Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee on Oversight and Investigations:

Thank you for the kind invitation to testify before the Subcommittee on Oversight and Investigations on the STOCK Act (H.R. 682) and related issues concerning trading by Members of Congress, their staff, and other government officials and employees while in possession of material non-public information obtained through their positions in the federal government.

I am a Professor of Law at Wayne State University Law School in Detroit, Michigan, where I have been on the faculty since 1994. I teach and write in the areas of White Collar Crime, Securities Regulation, and Professional Responsibility, all of which are relevant to the topic of the hearing today. Prior to joining the Wayne State University faculty, I worked for four years (1987-1991) as a staff attorney in the Division of Enforcement of the United States Securities & Exchange Commission (SEC), and then for three years (1991-1994) for the United States Department of Justice in the Fraud Section of the Criminal Division. While I was at the SEC, I participated in the investigation and civil prosecution of insider trading cases. I have a particular interest in insider trading because of my experience and scholarly interests.

The STOCK Act will, *inter alia*, extend the prohibition on insider trading to Members of Congress, their staff, and other federal employees. This is important legislation that recognizes information with the potential for significant market impact can come from a variety of sources beyond just the company whose securities are traded and Wall Street. Those who serve in government must uphold the highest standards of integrity, and H.R. 682 will help ensure that there is a means to enforce the insider trading laws in an area in which there have been few cases and some uncertainty regarding the scope of the prohibition.

I appreciate the opportunity to address four issues in connection with the Subcommittee's hearing:

1. The Scope of the Insider Trading Prohibition;
2. Insider Trading and the SEC Staff;
3. The STOCK Act (H.R. 682);
4. Favoring Personal Financial Interests.

1. The Scope of the Insider Trading Prohibition

While the prohibition on insider trading is well known, the statutory basis for it is surprisingly skimpy. The law has largely been developed by the judiciary rather than Congress. Insider trading is a form of securities fraud that is prohibited by Rule 10b-5 (17 C.F.R. § 240.10b-5), which provides:

> 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.

The Rule is based on § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)), which outlaws the use of any "manipulative or deceptive device or contrivance" in purchasing or selling securities. The text of Rule 10b-5 says nothing specifically about insider trading, and the SEC first pursued such cases in the 1960s. Since then, it has found widespread support in the federal courts, which have shaped its contours over the years, and in Congress, which has enhanced the SEC's authority to seek penalties for such violations.

The Supreme Court's two seminal decisions in the field are *Chiarella v. United States*, 445 U.S. 222 (1980), and *United States v. O'Hagan*, 521 U.S. 642 (1997). Taken together, they require the government to prove a defendant (civil or criminal) breached a fiduciary duty, or other duty of trust and confidence, by trading on the basis of material nonpublic information. The fiduciary duty can be owed to the corporation whose securities are traded (*Chiaralla*), or to any other party from which the information was misappropriated (*O'Hagan*). The key issue in an insider trading case, particularly a misappropriation case, is identifying the duty owed to the source of the information, and then establishing that the trading was on the basis of that information.

Members of Congress, their staff, and other federal government employees have the same fiduciary duty that any employee owes to his or her employer to preserve the confidentiality of information and not engage self-aggrandizement to the detriment of the employer. Using information received as part of one's job and then trading on it in the markets is clearly wrong because it breaches the employee's fiduciary duty to put the employer's interests first.

As with any legal prohibition that is developed through judicial decisions, the contours of the doctrine are not completely clear. The law of insider trading first developed around classic corporate insiders, like officers and directors of companies, and those who work directly with companies in relation to their transactions and operations, like lawyers, accountants, and even printers. As the cases move further afield, however, the law becomes more nebulous, and it has never been decided whether information a Member of Congress or their staff have about pending legislation is covered by Rule 10b-5's prohibition. The information arising from the legislative process is different from the usual insider trading case that involves issues directly relevant to a corporation's operations or prospects.

Insider trading cases involving government employees have arisen from the federal government's own issuance of securities, *i.e.* Treasury bonds. For example, there have been cases brought against government employees for tipping others about pending government actions in the Treasury bond market. *See In re Blythe & Co*., 43 S.E.C. 1037 (1969); *United States v. Rough*, No. 88-425 (D.N.J. 1988). This type of trading (or tipping) fits comfortably in the insider trading paradigm of a person learning information about a pending transaction and then buying (or selling) in advance of public disclosure.

In the current economic environment, in which the federal government has gotten involved in the operations of corporations to an unprecedented degree, there is a greater opportunity for a government employee who has highly material information that will impact the securities and commodities markets to trade on it. This is not traditional corporate inside information, so the application of Rule 10b-5 to trading on such information could be subject to a successful challenge.

H.R. 682 fills a potential gap that could develop in the law if a court were to find that trading on legislative or governmental information fell outside of the insider trading prohibition of Rule 10b-5. The legislation makes it clear that Congress wants the SEC and Commodity Futures Trading Commission (CFTC) to extend the ban on insider trading to an area about which it is not clear whether current law would apply. This change would ensure that in a future civil enforcement action or criminal prosecution the argument that the law of insider trading cannot be stretched to information generated on Capitol Hill or inside a federal agency will fail.

2. Insider Trading and the SEC Staff

SEC Inspector General H. David Kotz's Semiannual Report to Congress, submitted in 2009, refers to an investigation of securities purchases and sales by members of the Enforcement Division staff that may have involved trading on material nonpublic information obtained in relation to their duties at the Commission. The SEC's Conduct Regulation 5 (17 C.F.R. § 200.735-5(a)(2)) clearly prohibits trading on inside information and tipping. For example, it states:

> Members and employees are prohibited from recommending or suggesting the purchase or sale of securities:
>
> (i) Based on non-public information gained in the course of employment; or
>
> (ii) Which a member or employee could not purchase because of the restrictions of this rule, in any circumstance in which the member or employee could reasonably expect to benefit from the recommendation, or to anyone over whom the member or employee has or may have control or substantial influence.

The Commission's rules require that any securities purchased be held for six months, and that staff members may not buy options or futures contracts, which are often used in insider trading schemes. H.R. 682 makes it clear that a violation of Rule 10b-5 would subject a SEC staff member to civil and criminal sanctions in addition to any employment-related action that could be taken for a violation of the internal Conduct Regulations.

While that would be a positive result, in my opinion it does not go far enough. When I worked in the Enforcement Division, my colleagues and I stayed away from investing in the shares of individual companies because of the risk that there could be even the slightest hint of an appearance of impropriety. Moreover, we were never sure when a company might come up in an investigation, and so rather than risk having to recuse ourselves from a case we did not invest in individual companies.

Rather than the current rules that restrict investments in individual company stock, I believe the Commission – or Congress – should prohibit anyone at the SEC, from the Commissioners on down, from buying or selling the shares of publicly-traded companies or any entity subject to SEC regulation while they are employed there.[1] Given its role in policing the securities markets, the SEC needs to be completely above reproach, and such a prohibition would avoid any possible temptation to trade on information garnered from work at the Commission.

[1] For those who own shares of a company before joining the Commission, the usual government rules on placing investments in a trust or disposing of them properly would still apply. Thus, a person would not be locked into an investment just because he or she came to the SEC.

The number of investment-related options available to investors has expanded significantly in the past decade, particularly with the advent of exchange-traded funds (ETF) that allow an investor to purchase an investment in a basket of companies in a particular industry or sector. The possibility that a staff member might use confidential SEC information to trade in an ETF or mutual fund is quite small because the return would be so diffuse that any gain (or loss avoided) would in all likelihood be insignificant.

While a prohibition on owning the shares of individual companies or regulated entities would place a greater restriction on SEC staff than on those in any other branch, department, or agency of the federal government, the opportunity to work at the Commission is a privilege. The cost of such a rule would be minor, at best, and I doubt it would affect the ability of the SEC to recruit or retain talented staff members because they could still invest in ETFs and mutual funds within the Commission's current guidelines. To the extent someone would rather "play the market" by investing in individual company shares than work at the Commission, I suspect that is a loss the SEC could suffer rather easily.

3. The STOCK Act (H.R. 682)

A. Tipper/Tippee Liability

In addition to clarifying the scope of the insider trading prohibition, the STOCK Act effectively expands insider trading law related to tipping others about material nonpublic information on which they trade. Under the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), to hold a person liable as a tippee the government must show the fiduciary relationship of the tipper to the source of the information, that there was a *quid pro quo* in passing the information, and the tippee knew or should have known of the tipper's breach of duty in passing the information. The *quid pro quo* can be shown by a monetary reward or other pecuniary benefit to the tipper, that the information was a gift by the tipper to family or friends, or that the tipper realizes some reputational benefit from passing the information.

Section 2(a) of H.R. 682 omits the *quid pro quo* element by directing the Commission to adopt a rule that prohibits trading while in possession of information "obtained from a Member or employee of Congress, and such person knows that the information was so obtained." This change makes it easier to establish the elements of a violation because the government would not have to prove any benefit passed between the tipper and tippee, only that the tippee knew the source of the information. Another insider trading prohibition related to tender offers is Rule 14e-3 (17 C.F.R. § 240.14e-3), and it dispenses with the *quid pro quo* requirement, so the STOCK Act's approach to the tipper/tippee situation would not represent a radical departure in insider trading law.

Dispensing with the *quid pro quo* element would also be important to extend the prohibition to non-government workers who participate in the legislative process. There may be substantial involvement by non-governmental persons and organizations in the drafting of bills and the effort to seek their enactment, which is a normal and quite acceptable part of the process by which our laws are made. Those participating in the legislative process who are not employed directly by Congress can come within the insider trading prohibition of H.R. 682 if they receive the information from a congressional source and then trade on it, even if there is no *quid pro quo* provided to the source.

In the law of insider trading, the Supreme Court recognized those who have come to be known as "temporary insiders" and are also covered by the obligation not to trade on material nonpublic information. In *Dirks*, the Court stated,

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

I doubt that those who participate in the legislative process would be viewed by a court along the same lines as a lawyer or investment banker retained to assist a client in a merger, for example. An interest group is not considered to have a fiduciary relationship with Congress when its representative suggests language for a bill, nor would consultations with an organization to gain its support be viewed as privileged or otherwise subject to a duty of trust and confidence. Therefore, the extension of the prohibition to those who obtain the information from a Member or employee of Congress and know the source of that information can bring these outside groups within the prohibition.

One potential gap in H.R. 682 in extending the insider trading ban to non-employees who participate in the legislative process is that there is no clear prohibition on tipping by these people. For example, an interest group representative may receive nonpublic information about pending legislation that will have a significant impact on a particular company or industry, and that person tells a friend so that he or she can profitably trade on the information. Under the Supreme Court's tipper analysis in *Dirks*, the tippee "steps into the shoes" of the tipper by providing the *quid pro quo*, but it is not clear whether that same approach would apply to tipping legislative information. The bill could be clarified so that a person who received material nonpublic information about legislative action would be explicitly prohibited from disclosing the information to another for the purpose of that person trading on

the information, and the person receiving the information who knows (or should know) its source also could not trade or tip.

The tippee liability section appears to impose a higher intent element than the Supreme Court adopted in *Dirks*. The Court stated that "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." (Italics added). The STOCK Act, however, provides that the person is liable if he or she "*knows*" that the information was obtained from a Member of Congress or their staff. This appears to require proof of actual knowledge of the source of the information, rather than the less restrictive objective reasonableness test that would impose liability if a person "should know" the source of the information.

It may be worth considering whether this change in the intent level for tippee liability was done for the purpose of requiring proof of actual knowledge, because that would make it more difficult to pursue a case successfully when the government must prove a defendant's subjective intent, for example by allowing a defendant to offer a mistake or ignorance defense.

B. Material Nonpublic Information

The STOCK Act covers trading while in possession of "material nonpublic information, as defined by the Commission . . . ." To this point, the SEC has not adopted a definition of materiality, and it is not clear whether the bill would require the Commission to adopt one. The term "material" has been given a broad reading by the Supreme Court to cover information for which there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or invest. *Basic Inc. v. Levinson*, 485 U.S. 224, (1988); *TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438 (1976). This has been a workable definition that the courts and Commission have extensive experience applying, and any regulatory definition would likely mimic the Supreme Court's language.

The Supreme Court's definition of materiality is quite flexible, and its application to legislative actions would require a determination of the point in the process when information rises to the level of being material to a reasonable investor. As the members of the Committee are keenly aware, the path of legislation can be quite tortured, and it is rarely clear at what point a bill has progressed to the point that it is likely to become law and, in turn, affect a company. Courts generally apply the probability/magnitude test, which considers the likelihood of the action and its impact on the corporation. Under the SEC rule that would be adopted pursuant to the STOCK Act, there would need to be a determination of the probability of the particular legislative act and its importance to the company whose shares were traded.

Given the fact that the legislative process involves so many different inputs and considerations, it might be helpful if the legislative history of the Act provided some examples of situations in which the information would and would not be material to give the courts and the SEC some guidance as to the circumstances in which the prohibition should be applied.

C. "Legislative Action" and the Speech or Debate Clause

The legislation refers to trading while in possession of material nonpublic information about "any pending or prospective legislative action" relating to a company's stock. The term "legislative action" is not defined in the statute, although its meaning is fairly clear in judicial decisions. In *United States v. Brewster*, 408 U.S. 501 (1972), the Supreme Court stated, "A legislative act has consistently been defined as an act generally done in Congress in relation to the business before it."

By adding new provisions to the Securities Exchange Act of 1934 and the Commodities Exchange Act, both the SEC and CFTC will be authorized to initiate investigations of Members of Congress and their staff for possible violations of the rules adopted pursuant to the law. While the two agencies are the front-line for enforcing the insider trading prohibition, a violation of the new rules related to legislative actions could trigger a criminal investigation because any violation of SEC and CFTC rules can be prosecuted in a criminal case by the Department of Justice. 7 U.S.C. § 13; 15 U.S.C. § 78ff.

The STOCK Act would open Congress to investigations by the Executive Branch if there is credible information of a violation of the rules adopted pursuant to the legislation. In my experience, both SEC and Department of Justice investigations are quite thorough, involving extensive review of documents, e-mails, telephone records, and financial information. An SEC case usually consists of both investigative testimony, in which the witness is placed under oath, and subpoenas for documents. A criminal investigation often includes grand jury testimony and subpoenas for records, although a search warrant can be executed to seize evidence, which is even more intrusive.

The key focus in an insider trading investigation is determining when the person trading (or tipping) obtained the information, and how it was transmitted. From there, a determination of the "materiality" of the information – its importance to investors – must be made, so the probability of the particular legislative act and its potential impact on the company whose shares were traded would have to be ascertained. Making these assessments may involve examining information from a number of sources, including interviews and testimony from Members of Congress, their personal staff, and committee staff in addition to reviewing documents and records about the legislative process.

The possibility of an investigation involving Members of Congress raises issues related to the protection afforded by the Speech or Debate Clause of the Constitution, which provides that "for any Speech or Debate in either House, [Senators and Representatives] shall not be questioned in any other Place." U.S. CONST. ART. I, § 6, cl. 1. In *Brewster*, the Supreme Court explained the scope of the constitutional protection to mean that "a Member of Congress may be prosecuted under a criminal statute provided that the Government's case does not rely on legislative acts or the motivation for legislative acts." In *Gravel v. United States*, 408 U.S. 606 (1972), the Supreme Court extended the constitutional protection to congressional staff members in certain circumstances, holding "that the Speech or Debate Clause applies not only to a Member but also to his aides insofar as the conduct of the latter would be a protected legislative act if performed by the Member himself."

An individual Member of Congress can waive the constitutional protection afforded those in the Legislative Branch from inquiry into legislative acts, but any waiver must be express. The STOCK Act would not operate as such a waiver, but it would authorize inquiry by the SEC, CFTC, and Department of Justice into trading on material nonpublic information by those who work for the Congress. That inquiry can easily trigger constitutional issues regarding the protection afforded by the Speech or Debate Clause. The recent decision of the United States Court of Appeals for the District of Columbia Circuit in *In re: Grand Jury Subpoenas* (unsealed July 9, 2009) shows just how complex the Speech or Debate Clause issue can be when the Executive Branch seeks materials from a Member of Congress related to legislative acts.

4. Favoring Personal Financial Interests

The final point I wish to address concerns the interesting question whether a Member of Congress who owns shares in a company with investments in his or her district, or which comes within the jurisdiction of a committee on which the Member serves, would be acting improperly by supporting a program in the district that also helps the company or considering legislation in committee that might enhance its financial prospects. The insider trading prohibition in the STOCK Act only applies to the purchase or sale of a company's securities on the basis of material nonpublic information. It does not address the potential conflict of interest arising from legislative action that can favor a company in which the Member already owns shares. In other words, absent buying or selling stock, there is no insider trading so H.R. 682 would not apply.

The federal statute governing conflicts of interest by favoring one's personal financial interests, or those of one's family, is 18 U.S.C. § 208(a), enacted in 1962. That provision, however, only covers employees of the Executive Branch and those who work for the Federal Reserve, not Members of Congress or their staff.

The issue of conflicts of interest is broader than just insider trading, which is one type of conflict but only applicable in a narrow set of circumstances. It may be worth considering whether further study of the issue of financial conflicts of interest involving Members of Congress and their staff should be undertaken to ensure that legislative authority is not misused for personal benefit. The same issues related to the Speech or Debate Clause outlined above would also apply if some form of § 208 were applied to Members of Congress and their staff.

Thank you for the opportunity to address the Subcommittee on this important topic, and I am happy to respond to any questions the Members may have at this time or in the future. I have submitted a copy of my C.V. for your information. I have no direct interest in the legislation, and do not represent clients in any matters related to the subject of this hearing.