Statement of Proposed Testimony
House Subcommittee on Oversight and Investigations
Hearing on Preventing Unfair Trading by Government Officials
By
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I'd like to begin by thanking the Chairman and other members of this subcommittee for the opportunity to testify on the subject of public disclosure and Congressional conflict of interest. The current system, as I have come to understand it, is complex, severely flawed and in need of serious restructuring. Although I am personally convinced that creating a set of rules which would completely eliminate conflicts of interest by government officials is likely impossible, I do believe the system could be greatly improved by the implementation of some relatively simple and low cost changes.

I began my involvement in this area some 14 years ago quite by accident. While surfing television channels one evening in May, 1995, I stumbled across an ABC network program called "Day One". The story basically presented a study by Professor Greg Boller at the University of Memphis whose research had revealed "that the practice of stock purchases *(by members of Congress)* somehow coinciding with legislative activity is fairly sizable". Representatives Sonny Montgomery, Nancy Johnson, and Bob Michel were interviewed for the piece, generally arguing that this was merely accidental coincidence although the former House Republican leader, Bob Michel, did observe that "…you get a lot of temptation around here and a lot of opportunities to have conflict of interest." Personally, I found the story unfair. Admittedly the situation didn't look good but, in fact, no evidence was offered that members of Congress had actually profited from these investments. However the story provided me with the seed for an idea to test whether or not members of Congress do earn "abnormal returns" from their stock transactions.

The concept of abnormal returns is fundamental in the science of finance. Despite claims by stockbrokers, financial analysts, and all types of financial pundits, many years of academic research has shown that the ability of investors to consistently "beat the market" when armed only with information available in the public domain is virtually nonexistent. Time does not permit an explanation here. However, I have attached an article which I wrote in 2005 to explain why beating the market is so difficult. The evidence is, in fact, so strong that academics generally regard any individual or group of individuals who possess that ability to be "inside traders" or, at the very least, people trading with an informational advantage. That is, they are assumed to be trading on the basis of information not available to other regular market participants. We do not necessarily know the source, or the nature of the information they possess, however we are quite certain that they know things the rest of us do not know.

The most important ingredient in a good abnormal return analysis is an accurate record of stock market transactions. This would include the dates members of Congress bought

stock, the dates they sold stock and how much they bought or sold. For this we used the Financial Disclosure Reports (FDRs) which each of you submit annually.

Getting the FDRs turned out to be a challenge. Because "The Ethics in Government Act was written to provide the public with a tool to determine if senior government officials might have conflicts in matters in which they determine public policy", as a member of "the public" I assumed that I could easily obtain copies of the FDRs. I also assumed that the information contained in the FDRs would be precise, sufficiently detailed and accurate. I was wrong on all counts.

We began with the House of Representatives (1985) for the simple reason that the House publishes their reports in several volumes and distributes them to Federal document depositories every year. Thus access is free to all and the House FDRs are widely available. However, this is not to suggest that the information on these forms was easy to use, complete or even accurate. The information on the forms is not computerized. Thus the information had to be manually read and physically entered into our computer database, a task that literally took years. The care used to fill out FDRs varied widely and they were frequently difficult if not impossible to read. Many were handwritten. Some FDRs were missing. We also found that many FDRs were incomplete or inaccurate. Assets would inexplicably disappear from one year to the next or conversely assets would suddenly appear without a record of a transaction in either case. Finally the value of transactions was reported only within very broad ranges. I would suggest that "Over $1,000,000" is rather imprecise.

The Senate was another matter altogether. In addition to the problems described above, the Senate offered new obstacles. Senate FDRs are not published or distributed. They are housed at the Senate Office of Public Records. After having filed our first request for Senate FDRs in September 1998, we were advised that the Senate Office of Public Records only retained FDRs for 6 years. After 6 years, all Senate FDRs were destroyed. Furthermore, they required $0.20 per page to copy the FDRs. This amounted to approximately $300 per year or over $1800 for the entire 6 year set. Lastly, they required a written request signed by me officially "requesting to review the documents". Naturally I appealed the decision (particularly the $1800) citing the practices of the House as precedent. I was subsequently advised that the House was "in violation of the statute." Once published in a library, House FDRs could not be destroyed after 6 years as required by law. They further argued that library publication made it impossible to keep a written record of every person who viewed these documents which was also mandated by statute. Lastly, our appeal for a cost waiver was denied since "Facilitation of financial analysis was not the intent or goal of the Act." After 15 months of wrangling and intervention by Senator Max Cleland, I finally gave up. With Senator Cleland's help, I found copies of some Senate FDRs from other organizations who had already purchased them and some we ultimately purchased from the Senate Office of Public Records at $0.20 per page. The final cost was substantial.

At this juncture I would like to make an important point. If "The objectives of financial disclosure are to inform the public about the financial interests of government officials in

order to increase public confidence in the integrity of government and to deter potential conflicts of interest" as stated in the House Ethics Manual, then **financial disclosure, as it is currently practiced, is a dismal failure.** From my personal experience, I found that access to the FDRs, in particular the Senate FDRs, is difficult unless you happen to live in Washington. It is intimidating since records are kept of everyone who reviews them. And it can be expensive. Some FDRs are invariably missing and when you find them they are often difficult to read, incomplete or just wrong (untrustworthy). But all these shortcomings aside, the most significant problem is that the system fails to link financial disclosure to legislative behavior. I would submit that an FDR without an accompanying voting record is useless. A member of Congress may own a thousand shares of the XYZ Company. But if he or she does nothing to intentionally support the legislative interests of XYZ, there would, in fact, be no real conflict of interest whatsoever. Taking this one step further, even an abbreviated voting record is insufficient. Significant changes in the law which may benefit or hurt an industry or a company are often neatly hidden away in vastly larger unrelated legislation in much the same fashion as "cash-for-clunkers" was recently attached to a large national defense appropriation. Thus to fairly judge the conflicts of interest for my Representative or my Senator, I must not only have a copy of his or her FDR, I must also be intimately familiar with the details of every piece of legislation that he or she has ever voted for or against. I would argue that this is an impossible standard for any American. At best, financial disclosure is harmless aside from a false sense of trust it may provide. But to argue that it deters conflicts of interest is profoundly naïve.

Returning to the results of our study, the procedure for calculating abnormal returns is well established in the academic literature. In simple terms, we used stock price data available from the University of Chicago, made some technical adjustments and then compared the profits earned by members of Congress to profits earned by the market as a whole. The difference is the abnormal return. Finally, we tested to see if that difference was statistically significant or merely random. Precise details of the analysis can be found in our paper which is available on the internet.

The results of our studies were conclusive. Common stock investments made by Senators beat the market by approximately 1% per month or 12% per year from 1993 to 1998. Common stock investments made by members of the House of Representatives earned a lower abnormal return of approximately 1/2% per month or 6% per year from 1985 to 2001. To put these numbers in their proper perspective, a recent study by Professors Jeng, Metrick and Zeckhauser showed that, corporate insiders earned an abnormal return of 1/2% per month when trading shares of their own respective company's stock from 1975 to 1996, roughly equal to the returns earned by members of the House and much less than the abnormal returns earned by Senators. Finally, although in studies of this type one can never totally eliminate the possibility of random luck, after statistical analysis we can state with a 95% confidence level that some members of Congress are trading with a substantial informational advantage.

I would further note that the results and conclusions of the "Senate study" have gained widespread acceptance among financial academicians throughout the country. In

addition to being published by the *Journal of Financial and Quantitative Analysis (JFQA)*, one of the most well respected academic journals in finance, the Senate study was named "Best Paper of the Year" by JFQA's editorial board which is made up of many of the most distinguished professors in the finance field. Ironically, the House study has never been published. The reason most commonly given by academic journals when refusing to publish is that the House study contains nothing new. "It has already been clearly established that members of Congress trade with an informational advantage." Thus the House study adds nothing to the "body of knowledge."

With respect to H.R. 682, I confess I am neither an attorney nor am I an expert on insider trading. That having been said, I am generally supportive of making insider trading illegal for members of Congress and their staffs. It is likely to have some positive effect. However, historically speaking, convicting an individual of insider trading has always been a difficult task. The threshold of "beyond reasonable doubt" is extremely high. In my view, the vast majority of insider trading goes undetected as evidenced by the fact that corporate insiders continue to earn significant abnormal returns despite the best efforts of the SEC to monitor their trading activities. Thus I am doubtful that making insider trading by members of Congress illegal will eliminate the problem.

That being the case, I would offer a change to H.R. 682 which would also not eliminate the Congressional insider trades but would help level the playing field for other investors and improve confidence in the markets. Specifically, the 90-day transaction reporting requirement in H.R. 682 is much too long. For decades, financial analysts have tracked the trading activities of corporate insiders for signals about the financial health of the companies they manage. Large scale buying activity by the corporate insiders of a company is regarded as a positive indication of a forthcoming but, as yet, nonpublic event which is likely to produce significant stock price growth in the future. Conversely, large scale selling activity by the corporate insiders potentially signals the existence of a serious nonpublic problem known only to the insiders which is likely to depress the company's stock price. Many investors watch these signals and react accordingly. For this reason, among others, current law requires corporate insiders (corporate officers, directors, and beneficiary owners) to report to the SEC within two business days after they trade the stocks of their own companies. The SEC then makes this information public almost immediately.

I would suggest that members of Congress should be required to abide by the same rule. Investors could then carefully monitor the day-to-day trading activity of Congress and react accordingly. In essence, if you can't beat them, join them. I would further suggest that these reports should be made to the SEC, not the Clerk of the House of Representatives or the Secretary of the Senate. The SEC is charged with enforcement of insider trading laws, has the expertise to monitor trading activities and is well equipped to distribute the Congressional trading information to the public rapidly.

Another matter that I ran into during this Congressional journey was the subject of blind trusts. A blind trust is an excellent vehicle for members of Congress to utilize if they wish to be immune to charges of conflict of interest. However, such trusts must be truly

blind. The term blind meaning that the legislator has absolutely no idea what assets are held in trust. A number of members of Congress claim "blind trust" on their FDRs, thus avoiding certain reporting requirements. However the Senator Frist case proved to be a perfect example of a flawed blind trust. I would suggest that the rules be tightened to clearly define a blind trust making them absolutely blind.

I was also asked to comment on the practice of members of Congress investing in a major company in his or her district. I'm in favor of it. It aligns the interest of the Member with the interests of the community he or she serves in a similar way that stock options align the interest of the corporate executive with the interest of the stockholders. If anything, this practice should be encouraged, not discouraged.

To summarize my testimony:

1. I find the financial disclosure statutes to be a totally ineffective means of dealing with conflicts of interest. Financial disclosure reports can be difficult to get, expensive, hard to understand, and erroneous. Furthermore the system ignores the necessary linkages between the personal financial interests of the government official and the actual behavior of the government official. It is the legislative actions of the government official that concern us, not what he or she owns.

2. The evidence is overwhelming that some members of Congress trade common stock based on nonpublic information. Unfortunately, I see no way of completely eliminating the practice.

3. I support H.R.682 with modification. Although H.R.682 is unlikely to eliminate conflicts of interest, it should reduce it. However, the bill should be changed so that government officials should be required to report transactions within two business days to the SEC with the intention that such transactions be made public as quickly as possible. This regulation is consistent with reporting requirements imposed on corporate insiders. While doing little to eliminate conflicts of interest, it puts ordinary investors on a more equal footing with government officials.

4. Rules associated with blind trusts should be tightened. A blind trust should be truly blind.

5. I have no objection to legislators investing in businesses located in his or her district or state. It financially aligns the interest of the legislator with the community he or she represents. I believe this is consistent with the intentions of the Founding Fathers.

Again, I thank you for this opportunity to present my views to this subcommittee.

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