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Insider Trading Laws Do Not Apply to Members of Congress. No, Seriously.

 By [Justin Rohrlich](#) Oct 13, 2011 5:30 pm

And not only are Senators and Congressmen immune, their aides are, too.



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Earlier today, Galleon Group founder Raj Rajaratnam was convicted and sentenced to 11 years in prison on insider trading charges involving 35 stocks, among them **Google (GOOG)**, **Advanced Micro Devices (AMD)**, **IBM (IBM)**, and **Goldman Sachs (GS)**.

However, if Rajaratnam had been a US Senator rather than a \$7 billion hedge fund manager when he made the trades in question, there would be no criminal proceedings at all. Believe it or not, the Securities and Exchange Act does not apply to members of Congress, according to Craig Holman, legislative representative at government watchdog group Public Citizen.

"Any inside, non-public knowledge they gain can be acted upon," Holman told me back in February. "Some of the stories are just... breathtaking."

Surprised? You may be even more surprised to learn that congressional staffers and lobbyists are also exempt from insider trading regulations.

Even Henry Manne, the economist who famously made a case for legalizing insider trading in his book "Insider Trading and the Stock Market" [draws the line here](#). In an email to ProCon.org, he wrote:

In my 1966 book I said unequivocally that insider trading by any government officials on information received in the course of their work should be outlawed. The economic consequences of this trading on stock prices will be the same as any other informed trading, but there are many other aspects to the economic argument for legalizing insider trading generally that just will not pass the 'smell test' for government officials. The compensation argument for corporate insider trading cuts in exactly the opposite direction for government officials. We do not want them to receive extra compensation or outside compensation for doing their jobs. And, of course, all too frequently their access to this information is merely another form of a bribe, and that sure as hell is not legal.

Congressional insider trading is not a new phenomenon; a handful of media reports have surfaced over the past several years, but, as Holman said, the story "never really stuck."

In a 2009 article on The Hill's "Congress Blog," Holman [explained the loophole](#).

"The Securities and Exchange Commission (SEC) does not have the authority to hold employees of Congress or the Executive Branch liable for using non-public information gained from official proceedings for insider trading. Under current law, 'insider trading' is defined as the buying or selling of securities or commodities based on non-public

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information in violation of confidentiality -- either to the issuing company or the source of information. Most federal officials and employees do not owe a duty of confidentiality to the federal government and thus are not liable for insider trading."

Of course, members of Congress do owe a duty of confidentiality to the citizenry by whom they were elected. That's why congressional ethics rules specifically state that members must not use privileged information gleaned during the course of their duties for personal gain." But the rule is just a rule; it is not legally binding, and the SEC has never brought an enforcement action against any member of the Senate or the House.

A couple of years ago, a radio segment on American Public Media looked at [two cases of suspicious financial activity](#) that took place on both sides of the aisle during the initial days of the financial crisis back in September, 2008.

"A year ago this week Treasury Secretary Hank Paulson and Fed Chairman Ben Bernanke dashed to Capitol Hill. They hastily met with a small group of congressional leaders to tell them that the country was teetering on the edge of financial catastrophe," correspondent Steve Henn said. "Paulson and Bernanke asked Congress to spend hundreds of billions to save the banks."

The next day, according to personal financial disclosures, Henn said that John Boehner, who was GOP House Minority Leader at the time --and was present at the meeting --"cashed out of a fund designed to profit from inflation" and "[s]ince he sold, it's lost more than half its value." Henn also pointed out that Senator Dick Durbin, an Illinois Democrat, "sold more than \$40,000 in mutual funds and reinvested it all with Warren Buffett." Durbin was also at the meeting.

But insider trading is a notoriously difficult charge to prove. Durbin said that, "like millions of others he was worried about his retirement." Boehner said his "stockbroker acted alone without even talking to him," and both men say they did not benefit from information picked up from Paulson or Bernanke.

As for staffers, one example reported by the *Wall Street Journal* this past October involved an aide to Republican Senator Mike Crapo of Idaho, a member of the Senate Banking Committee.

Filings show that the aide, Karen Brown, traded **Bank of America (BAC)** stock seven times in 2009, buying on three occasions in April and selling in September, for a minimum profit of 43%.

The *Journal* noted that the purchases were made while BofA was [discussing the results of the government's stress tests](#). When the findings were made public on May 7, a few short weeks after Brown established her position, the bank's stock rose as investor confidence returned.

Senator Crapo's office says Brown's husband was the one actually doing the trading, "independent of any direction from Mrs. Brown," and that she later filed an amended financial disclosure form reflecting this. A spokeswoman added, "There is no relation between Senator Crapo's service on the Banking Committee and any decisions made by Mr. Brown regarding the trades in question."

A 2004 study in the *Journal of Financial and Quantitative Analysis* titled "Abnormal Returns from the Common Stock Investments of the US Senate," examined Senators' mandatory financial disclosure reports between 1993 and 1998.

"Our goal in this research is to determine if the Senators' investments tend to outperform the overall market," Georgia State business professor Alan Ziobrowski wrote. "Such a finding would support the notion that Senators use their informational advantage for personal gain. We test whether the common stocks purchased and sold by US Senators exhibit abnormal returns.

Assuming returns are truly 'incidental,' we hypothesize that US Senators should not earn statistically significant positive abnormal returns on their common stock acquisitions (the null). Rejection of the null, i.e. a finding of statistically significant positive abnormal returns, would suggest that Senators are trading stock based on information that is unavailable to the public, thereby using their unique position to increase their personal wealth."

What Ziobrowski and his co-authors found was that during the period studied, US Senators' stock portfolios annually outperformed the market by 12%. Over the same period, US households annually underperformed the market by 1.4%.

"These results," they concluded, "suggest that Senators knew appropriate times to both buy

and sell their common stocks.”

Ziobrowski later told an interviewer, “I mean, they do better down market, up market. They just outperform the average. We have every reason to believe they are trading on information that the rest of us don't have.”

The real danger, he said, “is that you are going to have in some cases congressman that will literally vote or act against the interests of their constituents in favor of their portfolio.”

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