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### SHOCKER: Legislators' Investments Generating "Abnormal Returns"

By [Justin Rohrlich](#) May 25, 2011 01:40 PM

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THE LUCKIEST GUYS IN THE ROOM?



A new study titled "Abnormal Returns From the Common Stock Investments of Members of the U.S. House of Representatives," in the journal *Business and Politics*, [finds that](#) "a portfolio that mimics the purchases of House Members beats the market by 55 basis points per month (approximately 6% annually)."

The abstract explains:

A previous study suggests that U.S. Senators trade common stock with a substantial informational advantage compared to ordinary investors and even corporate insiders. We apply precisely the same methods to test for abnormal returns from the common stock investments of Members of the U.S. House of Representatives. We measure abnormal returns for more than 16,000 common stock transactions made by approximately 300 House delegates from 1985 to 2001. Consistent with the study of Senatorial trading activity, we find stocks purchased by Representatives also earn significant positive abnormal returns (albeit considerably smaller returns).

The Center for Responsive Politics [says](#) this "indicates that members of Congress have a significant information advantage in making financial investments when compared to average, and even corporate, investors."

Of course they do. But what really makes their trades different from those of "average, and even corporate, investors" is that, unlike employees of Goldman Sachs, JPMorgan, or the Blackstone Group, it is perfectly legal for congressmen and women to trade on inside information.

No, seriously.

We [took a look](#) at the phenomenon of Congressional legislators and their surprisingly successful investment portfolios back in February. One reason they might beat the market so handily, with such consistency, could have something to do with the fact that insider trading laws don't apply to members of Congress.

Or their staff members.

No, seriously.

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. "Some of the stories are just... breathtaking."



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The "previous study" the authors of the new House of Representatives paper refer to was published in 2004 by Georgia State University business professor Alan Ziobrowski in the *Journal of Financial and Quantitative Analysis* and 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," 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)," he continued. "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.](#)"

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 says, the story "never really stuck."

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

"The Securities and Exchange Commission 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 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

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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 stock seven times in 2009, buying on three occasions in April and selling in September, for a minimum profit of 43%.

The *Journal* notes 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."

Two years ago, in the *Yale Journal of Regulation*, Maureen O'Hara, the Robert W. Purcell Professor of Finance at the Johnson Graduate School of Management, Cornell University and Jonathan Macey, the Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law at Yale University, wondered why [no legal framework regarding this had yet been set up](#).

"The idea that the SEC -- the administrative agency ostensibly in charge of protecting the nation's capital markets -- would not at least attempt to formulate a rule, much less an enforcement strategy, to combat insider trading by federal elected public officials seems particularly strange in light of the clear public policy problems involved in this sort of trading" they wrote. "[N]onpublic information creates perverse incentives for these officials, and introduces innumerable distortions and the potential for immeasurable harm in a legal system in which public trust and confidence is critical. With the SEC unwilling to take any sort of initiative against insider trading by senators and other congressional officers, Congress has been left to police itself. Not surprisingly, this effort has not been a success."

For this reason, Congresswoman Louise Slaughter, along with Congressmen Tim Walz and Brian Baird (who has since retired), has repeatedly introduced the "Stop Trading on Congressional Knowledge Act," or STOCK Act that would make it illegal for members of Congress to trade stocks based on inside information.

Before he left office, Baird told a reporter that no hard evidence exists that insider trading is a widespread problem in Congress.

"But in a town that trades on information," he said, it's "almost a certainty."

Victoria Dillon, Congresswoman Slaughter's press secretary, told me that the bill has not garnered much support among lawmakers.

"The first time this legislation was introduced, 14 people endorsed it," she said. "The last time, it got nine," she said. "Congresswoman Slaughter is saying, 'We shouldn't have the opportunity to do this. It shouldn't be legal. This is not one of the more complex pieces of legislation. This is common sense.'"

Dillon said Slaughter plans on reintroducing the STOCK Act and that it is "still a legislative priority for Congresswoman Slaughter."

Melanie Sloan, executive director of the Center for Responsibility and Ethics in Washington and a former federal prosecutor, doesn't see a bright future for Slaughter's initiative.

In her words, "There's rarely support for things that limit lawmakers' behavior."

And Robert M. Stern, president of the Center for Governmental Studies, said, "I don't think [I would hold my breath for that one.](#)"

Still, it's not as if Congress hasn't instituted *any* regulations regarding stock ownership in an effort to curtail insider trading. For example, The Senate Armed Services Committee forbids staff and presidential appointees requiring Senate confirmation from owning stocks or bonds in 48,096 companies that have Defense Department contracts.

The Senators themselves?

19 of the 28 senators on the Committee held assets in companies among the prohibited 48,096 between 2004 and 2009, worth a total of \$3.8 million to \$10.2 million.

Come on now, you [didn't think the rules would actually apply to them](#), did you?

*POSITION: No positions in stocks mentioned.*

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