CONGRESSMEN AS SECURITIES TRADERS

Larry E. Ribstein

WITH ALL OF THE ATTENTION being given to insider trading by hedge funds and malfeasance by corporate executives, it's worth reminding ourselves that the politicians who seek to impose discipline are themselves no angels.

An important study published seven years ago revealed that U.S. senators were reaping returns from stock trading that strongly suggested they were trading on an informational advantage. Profits depended on their seniority, and therefore, presumably, power to influence legislation.[1]

This led to a legislative proposal in 2006 (the STOCK Act) aimed at prohibiting this trading.[2] Steve Bainbridge has written an article supporting this prohibition with some modifications. He argues:

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1 A.J. Ziobrowski et al., *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANT. ANAL. 661 (2004).

2 For the most recent version of the STOCK Act, see H.R.682 – Stop Trading on Congressional Knowledge Act, 111th Cong., thomas.loc.gov/cgi-bin/query/z?c111:h682: (vis. Mar. 14, 2011).

> Congressional insider trading thus is undesirable in the first instance because it creates incentives for members and staffers to steal proprietary information for personal gain. The massive increase in federal involvement in financial markets and corporate governance as a result of the financial crisis of 2008 has made opportunities to steal such information even more widely available to government officials. Second, it gives members and staffers incentives to game the legislative process so as to maximize personal trading profits. Third, inside information can be utilized as a pay-off device. Fourth, it gives members and staffers incentives to help or hurt firms, which distorts market competition.[3]

It will not surprise the cynical that the act was not swept to adoption by the regulatory fever with which Congress has been seized in recent years. Congress apparently is so worried about corruption by corporate money it can't be bothered with its own conflicts of interest.[4]

When the STOCK Act was originally proposed I wrote:

> Congress's insider trading is bad because it gives our lawmakers the wrong incentives. Do we really want to give Congress more reasons to hurt and help particular firms?
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> In fact, Congress's trading is worse than trading by corporate insiders, which at least might be rationalized as a way to let employees cash in on their productive efforts.[5]

Indeed, one might even argue that trading on non-public knowledge is bad *mainly* when it's done by politicians. As long as this trading doesn't interfere with property rights in information, it encourages socially productive investigation and monitoring, as Bruce Koba-

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3 Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 299-300 (2011) (footnote omitted).

4 See, for example, the Democracy is Strengthened by Casting Light on Spending in Elections Act. For the most recent version, see H.R.5175 – DISCLOSE Act, 111th Cong., thomas.loc.gov/cgi-bin/query/F?c111:4:./temp/~c1112U3fa9:e911: (vis. Mar. 14, 2011).

5 Larry Ribstein, *Congress' insider trading*, IDEOBLOG, busmovie.typepad.com/ideoblog/2006/03/congress_inside.html (Mar. 29, 2006; vis. Mar. 14, 2011).

yashi and I have argued.[6] If it does interfere with property rights, it can be handled by contract and state law rather than by a sweeping federal law.[7]

But should we ban Congressional trading? It's not really classic insider trading because it doesn't involve theft of information belonging to somebody else. Also, as I said in my original post, "it might even be a good idea to require [Congressmen] to own stocks (say, index funds) to encourage them to think like shareholders rather than politicians." I also noted in a later post (in 2009) that "[f]rom a purely market standpoint, we should actually want this trading, because it brings information into the market."[8]

I added in that 2009 post that there would be severe problems with any regulation of Congressional trading, just as there is with insider trading generally:

> [O]ur dynamic and liquid markets provide infinite opportunities to use information; and the information Congress has is so damned useful. Just about everything Congress does has some implication for some part of the market, and possibly the whole market. (Is a legislator who knows about an impending GM bailout ok if he trades in any stock but GM?) Congress people can decide not to act as well as to legislate.

Even if we prohibited all trading by Congressmen, what about tipping? Richard Painter notes that there will still be private briefings for campaign contributors:

> If, for example, the government is going to help labor at the expense of bondholders in a particular bailout, should government officials be permitted to tell allies in organized labor this information before it is disclosed to securities mar-

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[6] Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21 (2006).

[7] *See* Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998).

[8] Larry Ribstein, *How to stop Congress from insider trading*, IDEOBLOG, busmovie.typepad.com/ideoblog/2009/10/how-to-stop-congress-from-insider-trading.html (Oct. 9, 2009; vis. Mar. 14, 2011).

> kets? If so, labor leaders and the investment funds they control have the potential to gain a lot more than preferential treatment in the bailout.[9]

Hedge funds, of course, will want to nose around these briefings. Even after the current hedge fund insider trading trial has been concluded, it will still be legal for traders to fit together "mosaics" of immaterial non-public facts.

And who will enforce the law? The highly tainted post-Madoff SEC?[10] Congress itself? Its inaction on the STOCK Act after five years indicates Congress's zest for regulating in this area.

As if we needed more complications, along comes new evidence from political scientists Andrew Eggers of Yale and Jens Hainmueller of MIT. Here's the abstract of their article, *Political Capital: The (Mostly) Mediocre Performance of Congressional Stock Portfolios, 2004-2008*:

> We examine stock portfolios held by members of Congress between 2004 and 2008. The average investor in Congress *under-performs the market by 2-3% annually*, a finding that contrasts with earlier research showing uncanny timing in Congressional trades. Members also invest disproportionately in local companies and campaign contributors, and these "political" investments outperform the rest of their portfolios (local investments beat the market by 4% annually). Our findings suggest that informational advantages enjoyed by Congressmen as investors arise primarily from their relationships with local companies, and that widespread concerns about corrupt and self-serving investing behavior in Congress have been misplaced.[11]

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[9] Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 153 (2009).

[10] *See* Larry Ribstein, *The SEC's shrinking credibility*, TRUTH ON THE MARKET, truthonthemarket.com/2011/03/11/the-secs-shrinking-credibility/ (Mar. 11, 2011; vis. Mar. 14, 2011).

[11] Andrew Eggers & Jens Hainmueller, *Political Capital: The (Mostly) Mediocre Performance of Congressional Stock Portfolios, 2004-2008* (Jan. 6, 2011), ssrn.com/abstract=1762019 (cited in Christopher Shea, *Week In Ideas*, online.wsj.com (Mar. 12, 2011; vis. Mar. 14, 2011) (emphasis added).

The authors explain the discrepancy with the prior study primarily as a "result of a reduction in the informational advantages of members of Congress between the period they study (1993-1998) and the period we study (2004-2008), a decrease in members' willingness to act on these informational advantages (perhaps because of increased scrutiny applied to their investments), or simply a change in luck."[12]

The authors argue that Congressmen's advantage regarding local companies results from their ability "to make judgments about the quality of senior corporate management and other hard-to-observe characteristics of local and other connected firms by virtue of their extensive interactions with these firms in the course of campaigns and lobbying.

In other words, based on this study Congress is making perfectly legal and efficiency-enhancing judgments about corporate management. However, the authors note that

> [o]ur study does not inspire much confidence about the average financial savvy of members of Congress, outside of the performance of their local investments (which after all constitute only about 6% of the average member's investments). Even considering the strong performance of members' local investments, they could have conserved their own wealth, and insulated themselves from ethical questions as well, by cashing in their stock holdings and buying passive index funds instead.[13]

Based on all of the above, here's what I would suggest:

- Let Congress invest. It not only gives them a stake in their regulation, but also takes advantage of their legitimate informational advantage.
- Educate Congress about the capital markets. It would help their legislation and prevent them from dying poor.

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[12] *Id*. at 3.

[13] *Id*. at 27.

- Protect against corruption by mandating disclosure not only of trades but also tips. In other words, as little as I like Regulation FD, there might be some benefit to imposing something like it on Congress. It seems from comparing the two stock market studies that Congress was deterred from the worst insider trading by the scandal of several years ago. This indicates that disclosure will have an effect. Moreover, a simple prohibition just drives the trading underground, inhibiting enforcement and losing the market efficiency benefits of the trade.
- Reduce opportunities for all kinds of corruption, including by trading. In other words, as I said in my most recent post on Congressional trading, we should "decrease government involvement in the economy. That is, after all, the source of the insider trading problem, and it has been exacerbated by the government's increasingly acting like a private firm in buying up huge chunks of the formerly private sector."[14]

In short, the solution to this problem, like the solution to many other problems, is less government.

[14] Ribstein, *How to stop Congress from insider trading*, IDEOBLOG, note 8 above.