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THE LEGITIMACY OF POLITICAL INTELLIGENCE TRADING AND THE THREAT OF INSIDER TRADING BY THE TREASURY DEPARTMENT

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**The Legitimacy of Political Intelligence Trading and the Threat of
Insider Trading by the Treasury Department**

TESTIMONY

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Before the House Committee on Financial Services
Subcommittee on Oversight and Investigations Hearing entitled
“Preventing Unfair Trading by Government Officials”

2:00 p.m. on Monday, July 13, 2009
2128 Rayburn House Office Building

Chairman Moore, Ranking Member Biggert, and distinguished members of the Subcommittee, it is a privilege to testify in this forum today. My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

I have no professional opinion as a securities lawyer regarding trading by members of Congress or their staff. As a citizen and a taxpayer, however, I commend this Committee's interest in the conflicts faced by legislators trading in the market. I also appreciate concerns that have been raised about trading by individuals serving in executive agencies, particularly SEC Enforcement Staff.

However, changes to Congressional ethics rules and agency policies can address those concerns far more efficiently than the sweeping changes to the Securities Exchange Act included in Section 2 of this bill. Today I will highlight some of the risks posed by Section 2, which limits a private investor from trading on information obtained from government sources. I will also bring to your attention a special immunity provision in the Securities Exchange Act that currently protects insider trading by the Treasury Department, something this bill does not address.

When considering the SEC's mission to protect capital markets, it is important to remember that capital markets have winners and losers, that's part of the rules of the game. If that were not the case, then no investor would have an incentive to expend time and resources to become informed about investments, and the efficiency of capital markets, so important to our standard of living, would disappear.

By targeting investors who seek information about how pending regulation may affect their companies, Section 2 of this bill penalizes resourceful investors. It also inhibits investment managers and pension fund trustees from fulfilling their duties to their investors to maximize returns.

The prospect of sweeping financial regulatory reform and the federal government's controlling ownership in a variety of publicly traded companies, including Citigroup, Bank of America, and nearly two hundred other banks has introduced a level of political risk never before seen in American capital markets.

The SEC's mandate to protect capital formation and investors is not implicated when investors stay informed about this political risk, using information obtained through political intelligence services, or through researching laws by speaking with members of Congress, their staff, and executive agency staff. Quite the opposite, informed trades actually enhance the efficiency of capital markets.

I am also concerned that using insider trading as a vehicle to address this committee's concerns would have the unintended effect of actually harming the effectiveness and legitimacy of current insider trading law. This bill would expand the definition of insider trading in a way that abandons its original foundation in fiduciary duty principles and returns to a time prior to the *U.S. v. Chiarella* case, when the SEC espoused a dangerous position that all trades made in which one party has superior knowledge to another were prohibited.

Now that I have addressed some concerns with what this bill does, I would like to highlight a danger to capital markets that this bill does not address. The Treasury Department enjoys immunity from insider trading liability. Section 3(c) of the Securities Exchange Act also exempts employees acting in their official capacity from the Exchange Act. Section 3(c) reads in part "No provision of this title shall apply to any executive department... or employee of any such department,... acting in the course of his official duty as such,... unless such provision makes specific reference to such department." As this bill does not specifically mention the Department of the Treasury, it would not amend Section 3(c).

Through TARP, the Treasury Department obtained a controlling interest in most of the automotive and financial sectors. The goal was to help increase the stock price of TARP firms and help them raise private capital. I am concerned that the prospect of insider trading by Treasury officials acting in their official capacity will cause share of those companies to trade at a discount and also threaten Treasury's ability to eventually privatize these businesses.

To be clear, even if this bill passes, staffers at the Treasury and the Federal Reserve who trade shares on behalf of the federal government will still be able to engage in insider trading. What is more, this type of violation would not need any expansion of insider trading law to address. It would already be covered under the traditional, classical theory of insider trading but for the special exemption the federal government enjoys under Section 3(c).

The securities laws are a finely interwoven fabric of complex regulations. When amending them, care must be taken to ensure that a change in one area does not harm the design of the system as a whole. For this reason I would urge this Committee to strike Section 2 from this bill. I would also recommend that this Committee consider amending Section 3(c) of the Exchange Act such that the exemption no longer applies to trading shares purchased by the Federal Reserve or the Treasury Department using funds authorized under the Emergency Economic Stability Act.

I thank you for the opportunity to testify, and I look forward to answering your questions.