BALTIMORE-WASHINGTON FINANCIAL ADVISORS

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Equity & Integrity: Addressing Congressional Trading

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Introduction

One of the major pillars of America's ethos is the concept of the free market, where everyone has a fair shot at success. In the 21st century, a major part of this market has become fully digitized and tradable securities including stocks and bonds are one of the main avenues for wealth creation. To regulate this highly lucrative market, the government spends approximately $3 billion[1] a year. However, when taking a deeper look into this so called "free market" it becomes obvious that there is one class of society that appears to have an advantage. Ironically, that class of society is the lawmakers themselves. Members of Congress possess an advantage in the market that tilt the scales in their favor. This advantage stems from the non-public information they know and the influence they wield as the elected members of Congress. All the people in congress have access to information encompassing forthcoming legislation, possible economic stimulus, regulatory decisions and more. Armed with such knowledge, lawmakers have an inherent advantage in making informed investment decisions, raising valid questions regarding fairness and equal opportunities within the market. Furthermore, the influence wielded by members of Congress in shaping legislation cannot be disregarded. Through their ability to introduce bills, advocate for specific policies, and participate on committees, lawmakers have the power to massively impact the financial market.

This poses a conflict of interest where they must decide whether to promote legislation that improves American's lives, or the legislation that improves the returns of their portfolio.

In this paper we will address the history of insider trading and explore solutions to the financial conflicts of interest that exist within Congress. By addressing perceived imbalances and

[1] Gov spending on SEC URL

implementing meaningful reform, we can rebuild trust in the government, and restore confidence in the free market.

Insider Trading

Insider trading is a problem as old as the financial market itself. The Security and Exchange Act (SEA) of 1934 was created to ensure fairness in financial markets by regulating financial professionals, public business, and brokers. The SEA regulates the market by requiring that companies register to be put on public markets and publicize their internal finances. The SEA also regulates financial proxies, margin trading, and audits[2]. The SEA also created The Securities and Exchange Commission (SEC) to monitor the markets and market participants to ensure the system stays fair. The SEC has strict punishments for those who exploit their non-public knowledge to profit in the market by insider trading. The maximum punishment for insider trading is 20 years in prison and a $25 million fine[3]. To avoid these punishments, companies go quite far out of their way to ensure that none of their executives or employees even get the opportunity to trade using insider information. Many public companies use blackout trading periods which stops their executives from trading during earnings announcements. Some companies go even further, requiring their executives to get permission from their Chief Legal Officer before making any trades involving their company or industry[4]. It would be reasonable to assume that standards like this would exist for politicians as well. The reality is the government employs virtually no safeguards to prevent insider trading.

[2] Securities Exchange Act of 1934 URL
[3] Insider Trading: Definition, Rules, Punishment and Penalties URL
[4] How Insider Trading Is Prevented in Corporations URL

The STOCK Act

The aptly named Stop Trading on Congressional Knowledge Act or STOCK ACT was signed into law on April 4th, 2012, with overwhelming bipartisan support[5]. The STOCK act recognizes that members of Congress are subject to U.S. securities laws barring trading on material non-public information. The STOCK act requires that those in congress, along with their spouses and dependent children, publish their trading activity within 30 days of making a trade[6]. The STOCK Act was designed to stop congressional insider trading in the same way the Security and Exchange Act of 1934 did. But now, 10 years after the STOCK act passed it has proven to not be effective.

Since the passing of the STOCK act there have been 0 charges brought against any sitting member of Congress for violating insider trading laws. This lack of enforcement has allowed congress people to continue trading without restrictions. The punishment for failure to disclose a trade is a fine of two hundred dollars.

This is no more than a slap on the wrist for Congressmen, the majority of whom are millionaires. A Business Insider report found that at least 48 members of congress, both Democrats and Republicans, have violated the disclosure rules of the STOCK Act.

[5] Roll Call Vote 112th Congress - 2nd Session URL
[6] STOCK Act: Meaning, Overview, Criticisms URL

This is Colorado's Democratic Senator, John Hickenlooper. In May 2020 Hickenlooper took almost a year to disclose trades that combined we worth between $500,000 and $1.3 million. Then, in June, he failed to disclose purchases of up to $1.2 million by his wife and was late to report the sale of up to $300,000 of assets.[73]

Pictured above is Republican Senator in Kentucky, Rand Paul. According to the Washington post, Paul was sixteen months late to disclose stock purchases by his wife, Kelly Paul. In the late disclosure, it was found that in February 2020 his wife purchased shares in a biopharmaceutical company that was manufacturing an anti-viral COVID-19 treatment[8]

Non-disclosure volitions of these magnitudes would have resulted in an underwhelming $200 fine for both Congressmen, while both their net worth estimates are over a million dollars.

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[7] 78 members of Congress have violated a law designed to prevent insider trading URL
[8] Kentucky Sen. Failed to disclose wife's stock trade URL

Rand Paul and his wife are far from the only congress members to have taken suspiciously timed trades before the United States shut down due to the Covid-19 outbreak.

The Effect of COVID-19

The STOCK Act received a lot of media attention in 2020 because several members of Congress allegedly violated the STOCK Act by trading stocks at the start of the pandemic, anticipating the recession that was to come. There were numerous investigations by the SEC into the trading activity of congressmen but there were no charges brought against anyone and most investigations were closed.[9] One such investigation was into the trading history of the Republican Senator from North Carolina, Richard Burr. During 2020 Richard Burr was the Chairman of the Senate Intelligence committee. On January 24, 2020, before any Covid lock downs had taken place, he was briefed in a private meeting about how bad the Coronavirus was projected to become. On January 31st at 12:40, pm just 7 days after his briefing, Burr sold $110,000 in stocks. At 3:40pm that same day the White House announces that it is restricting people from coming to the U.S. if they had been to China in the last 14 days. Burr did not just stop selling there. By February of 2020, Burr had moved approximately $1.2 million of his wealth from stocks to Treasury bonds.[10] This incident has been investigated by the SEC, but the investigation was dropped. When asked about why the investigation was dropped, an SEC spokesperson declined to comment. It would be exceedingly difficult to argue that this was not insider trading, especially knowing that Richard Burr was one of three Senators that voted against the STOCK act in 2012.

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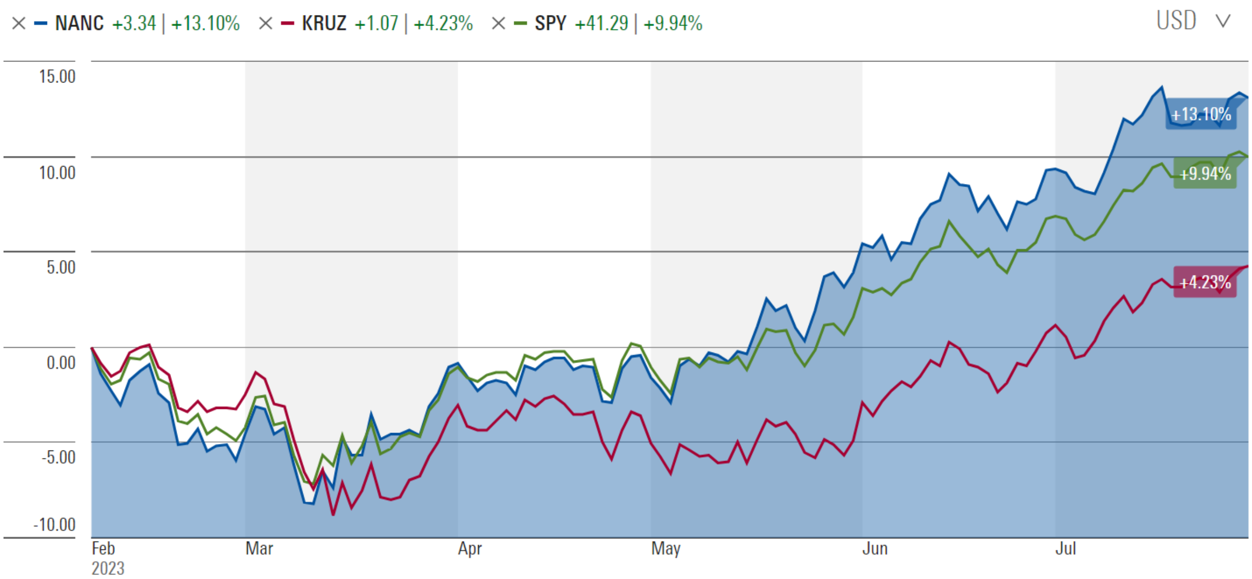
[9] SEC Inquiry into former senator's stock sales is closed without Charges URL

[10] Unsealed FBI docs reveal a flurry of calls and stock trades by Sen. Burr in early 2020 URL

Public Reaction

It is no secret to the public that congress has an advantage in the stock market. Since the STOCK Act of 2012 congressmen have been required to publicly disclose their trades. This provision of The Stock Act is designed to make it easy for the government, and the public to ensure that Congress is not insider trading. However, it had the consequence of allowing the public to see exactly how congress members trade the market, calculate their returns, and copy their trades. Websites including Capitol Trades, Unusual Whales, and Quiver Quantitative have begun tracking the trading activity of congress members to make it easy for the public to inspect returns and copy trades. The website Unusual Whales has gone as far as creating two exchange traded funds that track the holdings of congressmen based on their party affiliation. Ticker symbol NANC matches the trades made by Democratic members of congress and their spouses, while Ticker symbol KRUZ does the same for Republican members of congress. [11]These two funds allow investors to easily copy the trades of congress by buying into either fund. Since their inception in February 2023, NANC has beaten the S&P 500 by 3% and KRUZ has underperformed the S&P 500 by over 6%. These funds are only six months old as of now, therefore the collection of future data will be extremely beneficial to draw more accurate conclusions about their efficacy. However, it will be remarkably interesting to see how these funds perform in the long term.

[11] New ETFs with tickers NANC, KRUZ aim to track lawmakers' stock buys, as ban on congressional trading looks unlikely before midterm elections URL



KRUZ v. NANC v. SPY

Loopholes in the Stock Act

With a surplus of evidence pointing to congress people committing crimes, how has no sitting congress member been charged with insider trading? It turns out that insider trading can be an incredibly difficult action for the SEC to prove. Members of congress have knowledge of information about the broad market. For example, Richard Burr knew before any of us that Covid-19 would shut down the world and was able to make trades based on this information. That is not typically the type of insider trading the SEC investigates. SEC has much more experience prosecuting individuals with non-public information about singular companies, rather than broad market information. For example, former Netflix engineer Sung Mo Jun received nonpublic information about subscriber data from Netflix. Mr. Jun then used this information to profit $434,086 and helped his brother make $215,419 trading Netflix stock. After an investigation by the SEC, Sung Mo Jun was sentenced to 2 years in prison and a $15,000 fine.[12]The difference between prosecuting Sung Mo Jun and Richard Burr is proving the materiality of their information.

In order for information to be material, it must have had an impact on the investor's trading decisions. Proving the materiality of information pertaining to companies like Netflix is straight forward and has precedent. However, the SEC seems to have trouble proving the materiality of information pertaining to the whole economy. When it comes to information about the entire economy, the trader must still interpret how it will affect the specific securities before making a trade. For example, in the case with Richard Burr, knowing he was trading hours before large announcements are very suspicious. Even so, it does not prove that he used his private knowledge to make trades.[13] This happens to be quite a large loophole that lawmakers have exploited to make money in the market.

Another way lawmakers avoid getting charged is by having their spouses, children, or other family members invest for them. Former speaker of the house Nancy Pelosi is the most famous politician to allegedly use this tactic. Her husband Paul Pelosi has an amazing record of accomplishment in the stock market and thanks to the STOCK Act's disclosure rules, we can review it. According to a report by Unusual Whales, the Pelosi's netted a 56.15% return in 2020 on their investments in stocks and options, while the market climbed an unprecedented 36%. This could be attributed to an incredibly lucky year for the Pelosi's, but it begins to look more suspicious when you investigate the details of their past trades. In March 2021 Paul purchased $5 million worth of Microsoft stock and two weeks later, the U.S. Army reported that it will be entering in a $22 billion deal to buy augmented reality headsets from Microsoft. This sent

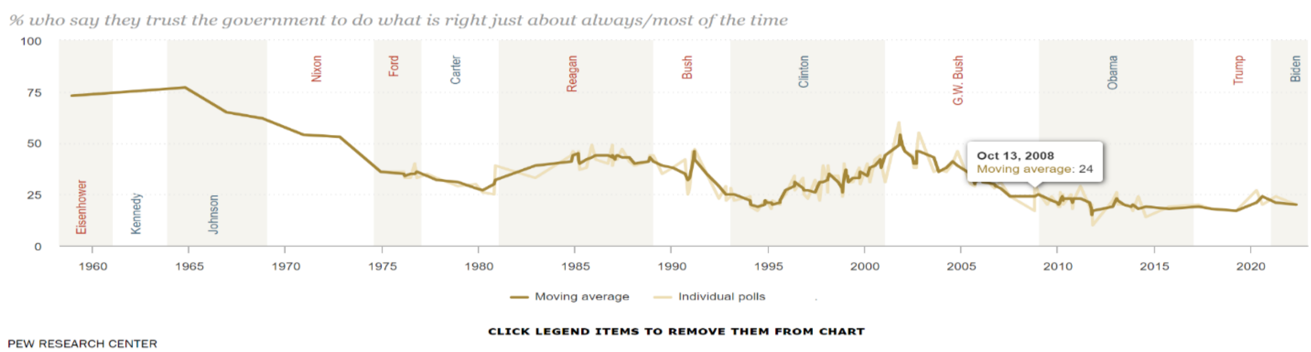
[12] Former Netflix Engineer Sentenced to Prison for Insider Trading.URL

[13] How Senators May Have Avoided Insider Trading Charges URL

Microsoft stock on a sharp rise after the announcement. He also purchased $5 million worth of Nvidia stock options a month before the government allocated $52 billion in subsidies to semiconductors to compete with China.[14] Paul Pelosi's trades are convenient, and always perfectly timed right before public announcements from the government.[9] The New York Post reported that the Pelosi's have made approximately $30 million form trading the technology companies that Nancy Pelosi was responsible for regulating as the Speaker of the House.[15] When a spouse is making the trades, it becomes even harder for the SEC to prove the materiality of their insider information.

Why is this Important

The main reason for banning insider trading in congress is not to stop people from making money but to regain the people's trust in the Government.



Public Trust in Government 1958-2022

The graph above[16] shows how public trust in the Government has changed in the past 64 years. As seen above, public trust in the government has more than halved since 1960. The cause

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[14] Pelosi and a lifetime of trading.URL

[15] Nancy Pelosi makes millions off tech stocks – and scoffs at push to ban congressional trades URL

[16] Public Trust in Government: 1958-2022. Pew Research Center. URL

for the decline stems from many things. When politicians are caught avoiding questions, being deceitful, and acting for their own self-interest then trust naturally fades. This is a problem of connectivity. Specifically, citizens feel like they do not have much influence or knowledge of the interworking's of the politicians. They in turn feel less connected and have less sympathy toward them. The underlying system of the government contributes to the disconnect. From a citizen's perspective, politicians have not seen true consequences for their actions. Much of the problem lies beyond the politicians themselves, it involves the regulation and enforcement on them. If you were to ask yourself "Would I participate in insider trading if I knew I could get away with it or only pay a small fine," what would be your answer? It would be no surprise if many would have no problem proceeding with the unlawful behavior. This is what the reality of many politicians' lives look like, they end up acting within the governmental system in place. The system has not placed enough importance on preventing the problem of unlawful trading. Insider trading among politicians certainly is not right, but not much is stopping them from acting ethically. Requiring that politicians abide by an ethical trading strategy has an abundance of positive effects for society. Politicians have been seen putting their best interest over who they should be helping. Many people are left with a sour taste in their mouths when they hear the word politician. This is not beneficial as politicians are supposed to be entrusted with protecting and providing for the community, which involves knowing information the public does not have.

How Congress has Reacted

Since the stock act there have been a couple attempts by lawmakers to create legislation that stops insider trading. In January 2023, Republican Senator from Missouri Josh Hawley created the Preventing Elected Leaders from Owning Securities and Investments or PELOSI Act. This bill prohibits congress members and their spouses from holding any individual stocks during their time in office. They would, however, be able to purchase diversified mutual funds and Exchange Traded Funds. If any congress member was caught buying individual stocks their profits would be given “back to the public” by donating it to the U.S Treasury as punishment. The ethics committees of Congress would also be able to enforce fines and decide if they wanted to publicize violations of the PELOSI Act.[17]

Congressman Chris Pappas from New Hampshire introduced a similar act called The Transparent Representation Upholding Service and Trust (TRUST) in Congress Act. The TRUST in Congress Act would outright ban members of congress and their spouses and dependent children from trading any securities. The only way they could own stock while in office would be by investing through a qualified blind trust.[18] A qualified blind tool that allows people to grow their money in the market, without being exposed to any conflicts of interest. To establish a qualified blind trust an individual and trustee (who invests the money) must apply to the Senate Select Committee on Ethics to be approved. This approval process requires the individual and the trustee to submit documents that the committee can use to verify the legitimacy of the trust. Upon approval the individual can turn all their assets over to the trustee, where the Trustee twill have full control of the investments in the trust.[19]

The most recent attempt to reinforce the STOCK Act was by Oregon’s Senator Jeff Merkley with the creation of the Ending Trading and Holdings in Congressional Stocks (ETHICS) Act. This act does the same thing as the TRUST in Congress Act by requiring blind trusts and adds to it by outlining the punishments for violations of the act. The penalty for

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[17] Hawley Announces ‘PELOSI Act,’ Reintroduction of Bill to Ban Lawmakers from Trading Stocks URL

[18] Pappas Helps Reintroduce TRUST in Congress Act

[19] Qualified Blind Trust URL

continuing to trade while still in office would result in a fine greater than one month's pay, or 10% of the invested assets. Breaking the rules of a Qualified Blind Trust would result in a $10,000 fine.[20]

Solution

The evidence presented above strongly supports the notion that Congress should not be allowed to have full access to the stock market due to the significant conflict of interest and the lack of adequate enforcement of insider trading laws. To address this problem, the best solution is to mandate that members of Congress invest their money through a Qualified Blind Trust, ensuring they have no knowledge of the securities in which their money is invested, and they cannot make investments themselves. This approach eliminates any possibility of insider trading or conflicts of interest, while allowing Congress to invest their money, and make market matching returns. Some may argue that requiring they invest through a qualified blind trust puts too much of a restriction on Congress. When asked if congress should be banned from trading in the stock market Nancy Pelosi replied:[21] "No, we are a free-market economy, and we should be able to participate in that."

It is true, we do have a free market and that everyone should participate in. However, the law makes it clear: Those who have non-public information, are not able to freely trade stocks. If that law applies to the employees of public companies, it should most definitely apply to our lawmakers. Moreover, this solution bolsters public trust in government institutions and better safeguards the public interest. It also allows lawmakers to focus on their legislative duties without the distraction of active stock market participation. By setting an example of ethical

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[20] Ending trading and holdings in Congressional Stocks (Ethics) act - senate. (n.d.). URL
[21] Nancy Pelosi says federal lawmakers should be able to trade stock in office: 'This is a free market' URL

behavior, Congress can demonstrate their commitment to transparency and accountability. In conclusion, the establishment of a Qualified Blind Trust requirement for members of Congress is a necessary step to improve overall trust in our government. It aligns with the principles of a fair market, and reinforces the trust placed in our elected representatives to act in the best interests of the public. The people of congress are our civil servants. We have placed a lot of trust in them to ethically do their job and represent our interests. The Leader of the government ethics Initiative, Walter Shaub, said it best: [22]

> "We have entrusted these people with great power. They owe us great transparency."

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