An Ethical Justification for the Proscription of Congressional Insider Trading

On 17th May 1792, two dozen New York securities merchants met to sign the Buttonwood Agreement, thereby establishing the New York Stock Exchange and a formal protocol governing the purchase and sale of stocks. In the centuries since, both the magnitude and influence of capital markets have expanded considerably, and their regulation has become increasingly imperative. The Securities Act of 1933 – a component of Franklin Roosevelt's *New Deal* platform – introduced legislation that governed the primary issuance of securities including equities and fixed income instruments. Soon thereafter, Congress enacted the Securities Act of 1934 which addressed secondary market activity. The 1934 Act also created the Securities and Exchange Commission, an independent regulatory authority tasked with enforcing federal securities law. The primary objective of the SEC was to provide an equitable environment for the investing public by outlawing and limiting the prevalence of insider trading, market manipulation and similarly nefarious practices. Interestingly, the SEC's first chairman – Joseph Kennedy Sr. – was intimately familiar with insider trading after personally employing it and various other market manipulation measures in amassing his fortune during the unregulated pre-crash market of the 1920s.

The fact that Kennedy – a man who routinely handicapped markets in his favor – was appointed to uphold the regulatory framework established by the 1933 and 1934 Acts is somewhat unsettling. However, as these practices were not yet deemed illicit, one could argue that his trading activities could not be judged as criminal by the laws of his day. Yet, nearly one hundred years on and after the passage of multiple new pieces of securities legislation (including the '40 Act, Sarbanes-Oxley and so on), evidence of insider trading among congressional representatives still abounds.

In one of the relatively minor instances of this ongoing issue, Representative John W. Rose of Tennessee was reported to have sold between $100,000 and $250,000 of Wells Fargo common equity in late 2019, months before a committee on which he served issued a critical report regarding the firm's outlook and the attendant decline in the price of its shares. The STOCK Act (for *Stop Trading on Congressional Knowledge*) of 2012 was passed by Congress under the Obama Administration to restrict this exact behavior – the trading of securities by congressional representatives on the basis of material non-public information obtained in the course of their regular duties. Proposed by Congressman Brian Baird, the STOCK act was immensely popular and received nearly universal support, capturing a 96-3 vote in the Senate and 417-2 in the House. Although our congressional leaders publicly professed their support of this policy, the myriad evidence of curiously opportune – almost prophetic – trade timing would suggest that these representations were merely for optics. It appears that, in the zero-sum game of secondary market activity, Congress is perpetuating the existence of the sort of unlevel playing field that Joe Kennedy once competed on.

The 1934 Act outlawed insider trading because of its adverse impact on those market participants incapable of gaining access to privileged information. It seems, however, that the enforcement of insider trading restrictions is not universal. Whereas, company executives, investment bankers, corporate attorneys and other professionals who comprise or interface with management teams are subject to these rules, members of Congress are often somehow excluded. This inconsistent enforcement of the law yields preferential treatment not afforded to all members of society and is, therefore, inequitable; to support this assertion, we can invoke multiple ethical frameworks in analyzing the extent of Congress's wrongdoing.

The theory of ethical fundamentalism contends that decision-making should be derived from an external source of rules or commands. Fundamentalists believe that an individual cannot independently decide the distinction between right and wrong; rather, their actions should be governed by some external entity that establishes precedent. In determining the *rightness* of any issue, one can rely on religious doctrine, longstanding cultural traditions or an organization's previously-accepted best practices. Fundamentalism stipulates that ethical behavior follows from the elimination of variance from these historical norms; that is to say, within the context of a business enterprise or – in this case – a regulatory organization, the ethical choice is the one that is consistent with previous responses to the same scenario.

As mentioned, the law requires that those who may have increased exposure to protected information are (largely) restricted from utilizing said information in the purchase and sale of securities. These limitations apply broadly across individuals engaged in activity in the corporate sector including to employees of firms with publicly-traded equity and fixed income instruments, as well as to those who work in capacities that support corporations including investment bankers, management consultants, auditors, analysts at ratings agencies and so on. On examination, it appears that the enforcement of securities laws is particularly strong within the investment banking industry. As an example, healthcare coverage bankers are prohibited from transacting securities not only of the companies that they have advised but also for all firms categorized within the healthcare sector according to the Global Industry Classification System. Moreover, healthcare bankers are restricted from allocating personal capital to healthcare-focused ETFs, mutual funds and other passive vehicles under the assumption that they may possess privileged information about the sector in advance of its public disclosure. Among the purported merits of index-like products such as these is the diversification afforded to investors; they generally contain hundreds of individual components, and the idiosyncratic events associated with of any one of these components are often offset by those of another. Thus, it is unlikely that a healthcare banker could have material information that would enable him/her to make accurate prognostications about an entire ETF's forward performance; yet, the rules governing coverage bankers retain this rather onerous standard. On a related

note, regulators also require a division between the Sales & Trading (i.e. the public market) and Corporate Finance (private market) divisions of an investment bank, commonly referred to as *The Chinese Firewall*. In order to limit the likelihood of information leakage from bankers on the private side to their colleagues in the securities segment, digital conversations (email, text, etc.) between investment bankers and the S&T team are automatically flagged and restricted by the bank's IT department, and in-person communications must be monitored by a regulatory compliance official.

Evidently, then, the degree of oversight that investment bankers are subject to is quite severe, suggesting that adherence to securities law is of considerable importance. The consequences of failing to observe these regulations – including the restriction on insider trading activity – involve revocation of securities licenses and prison sentences. Utilizing the fundamentalism framework, the punitive measures for violation of securities law are clearly established within the context of the investment banking industry. Yet, members of Congress who routinely serve on committees that investigate corporate activity and therefore possess nonpublic information are not held to the same standard. At present, the law provides that Representative Rose and his congressional colleagues are not restricted from the purchase or sale of single issue equities (or other securities) of any company as long as their trades are reported within 45 days of their settlement. Likewise, there is no restriction on index products including ETFs, mutual funds, closed-end funds and related vehicles. It is apparent, then, that the law applies differently across societal segments; our elected officials are governed by a different set of standards than the ones defined for those employed in the corporate sector – a violation of the primary principle of ethical fundamentalism.

It follows from the above argument that the enforcement of securities law lacks universality. The concept of adherence to a universal rule was formally defined by Immanuel Kant in the 18th century. Kantian ethics argues that morality exists when all individuals act in the same manner. Further clarifying this concept, Kant posited that – in order to be considered universal – an ethical rule must satisfy two conditions: consistency and reversibility. The former advances the notion that all problems should be similarly addressed without exception, while reversibility suggests that an actor must abide by the same principles he imposes on others. A core consideration of Kantian ethics is that all human beings are of unique dignity and should be regarded as equals, regardless of their station in life. These principles form the basis of Kant's categorical imperative – an absolute, non-negotiable rule that should hold universally in all circumstances. If we accept the categorical imperative as true, then it is reasonable to assert that all individuals should receive equal treatment in legal proceedings.

However, as we have observed, the enforcement of securities law fails to satisfy the conditions of Kant's categorical imperative. For evidence of this claim, we can refer to multiple episodes of alleged insider trading that occurred over the previous

decade. In 2014, Mathew Martoma, an associate of Stephen A. Cohen, was prosecuted for the largest instance of insider trading in history by Preet Bharara, former United States Attorney for the Southern District of New York. Two years earlier, Bharara brought similar charges upon Rajat Gupta and Raj Rajaratnam, co-conspirators in a similarly large illicit securities transaction. Martoma and Rajaratnam were stripped of their securities licenses, and all three men are in the midst of serving prison sentences averaging ten years in length. On the other hand, congressional representatives including Ro Khanna, Tommy Tuberville and the aforementioned John Rose who have demonstrated histories of questionable trading practices have not been investigated for their transgressions to the same extent as Martoma et. al. and have not been sentenced accordingly. Thus, there is a blatant inconsistency in the application of the law, violating the first condition of the categorical imperative – that a universal rule should apply in all circumstances. Moreover, if we underscore the fact that Congress is the legislative branch of government, then we observe that the principle of reversibility is, likewise, violated for our legislators are not beholden to the same standards as those whom they govern. Taken together, Congress's failures to display both consistency and reversibility in the interpretation and enforcement of the law constitute a failure to apply the categorical imperative. Thus, their actions are deemed unethical by the Kantian framework.

Building on the foundations established by Kant, John Rawls advanced his *Social Justice Theory*. Like Kant, Rawls believed in equality among all and, therefore, supported Kant's stance on equal treatment. Where Social Justice Theory differs from the Kantian theory is in its assertion that the achievement of just, ethical treatment requires consideration of the least advantaged members of society. Priority is assigned to this segment because there is a possibility that we may be relegated to this category at some point in the future (if we do not already belong to it in the present). As a practical matter, in order to frame situations from the perspective of the disadvantaged, Rawls suggested employing a *veil of ignorance,* a hypothetical construct in which one is blind to his/her position in society. By approaching the process of legislation behind a veil of ignorance, we protect the most vulnerable in society because we cannot reject the notion that we are in the vulnerable group ourselves.

Perhaps the most salient element of Rawls' theory is its emphasis on the plight of the marginalized, underprivileged class. The securities legislation of 1933 and 1934 was enacted largely to protect the masses from the predatory trading practices that characterized markets in the early 20th century. The preponderance of insider trading and market manipulation that occurred in prior periods was viewed as inequitable; those who had preexisting affiliations with the corporate and financial elite continued to enrich themselves at the expense of outsiders – in Rawl's parlance, the *least advantaged.* Moreover, it was believed that – left unrestricted – insider trading would perpetuate existing social stratifications and preclude social mobility. For instances in which

the principles of the 1934 Act have been upheld and those guilty of insider trading have been prosecuted, we can claim that the interests of the least advantaged – those without access to privileged information or capital balances large enough to corner markets – have been protected. U.S. Attorney Bharara's anti-insider trading campaign is a demonstration of prioritizing the interests of the disadvantaged in a manner that is consistent with Rawl's Social Justice Framework. However, Congress's transgressions in the securities markets and the subsequent apathy towards policing this behavior constitute a failure to protect the vulnerable group and are, therefore, unethical by the same principle.

A possible counterpoint to the above argument is to question the illegality of insider trading altogether. Several noteworthy economists, including Nobel Laureate Milton Friedman, have suggested that insider trading is not as nefarious as is commonly believed and that trades on privileged information can actually enhance market efficiency and price discovery, thereby ultimately yielding a net benefit to society. On a related note, it has been reported that congressional representatives who have utilized privileged information in their securities selection have not actually generated additional portfolio return; rather, they have often underperformed common benchmarks including the S&P500 and the Russell 1000 indices. Whether either of these assertions is credible is immaterial. The fact remains that – as defined by the Securities Act of 1933, the Securities Act of 1934, the '40 Act, the STOCK Act and several subsequent documents – insider trading is an illicit activity that is outlawed in all publicly-traded securities markets in the U.S. Therefore, regardless of the outcome of insider trading – whether it yields investment gains or losses – it is expressly prohibited, and members of Congress who participate in this behavior are in violation of the law. Willful disregard for the prevailing legal code is, in and of itself, unethical. Moreover, as described in the preceding arguments, the inconsistent interpretation and preferential application of this legislation is, likewise, ethically and morally corrupt.