Politics et Cetera
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In this Issue

THEY SAID IT

It is impossible that the upper class of a nation can become corrupt, frivolous, or emasculated without affecting deeply and widely the whole body of the community. Constituted as human nature is, rich men will always contribute largely to set the tone of society, to form the tastes, habits, ideals and aspirations of other classes. In this respect, as in many others, the gradual dissociation of the upper classes from many forms of public duty is likely to prove a danger to the community.

W. E. H. Lecky, "Democracy and Liberty," 1896.

CORRUPTION, REDUX.

As you may or may not have heard, longtime liberal icon and former House Ways and Means Committee Chairman Charlie Rangel was smacked last week with charges of serious corruption by his fellow Congressmen and Congresswomen. The House Ethics Committee – a study in paradox if ever there was one – conceded that Rangel has been at least marginally naughtier than is acceptable and should, therefore, be made an example of (sic). Rangel will now face a public trial and, if convicted, will likely be expelled from the House.

None of this should surprise anyone, of course. Rangel's corruption and – most galling, given his position as the nation's chief tax-law author – his tax evasion have been a matter of public record for months. Speaker of the House Pelosi has worked tirelessly to avoid this inevitable conclusion, hoping to stave off Rangel's public humiliation and the likely discontented and passionate response it will bring from the Black Congressional Caucus, which has defended Rangel vigorously. But in the end, Rangel's malfeasance was simply too hefty to ignore, particularly in a year in which the majority party is looking for sacrificial lambs with which to placate the public.

In any case, Rangel's undeniable corruption and his fellow House members' reaction to it give us an opportunity this week to return to the subject of corruption and its effects on the public discourse.

Long time readers will likely remember that we spent most of the 1990s riding two particular hobbyhorses – corruption and terrorism – predicting that each would, in its own way, present a formidable threat to the financial markets, to the rule of law, and indeed to the country itself over the course of what was then the "next" century.

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Needless to say, one of those two threats – that of terrorism – proved us tragically and cheerlessly prophetic less than a year into said century and, in so doing, changed the very nature and tenor of politics in Washington and throughout the world. In the almost nine years since, nearly every aspect of human endeavor – political, cultural, religious, financial – has been seen through the lens of global terrorism and the wars that were launched in response to it.

But while the threat of terrorism has dominated the headlines, the risks posed by corruption have not receded, but have likely increased exponentially as a direct result of the expansion of the global economy, the ongoing process of economic integration, and the extension of the reach of government.

In fact, in many ways and at the current moment, corruption may pose an even greater risk to the nation and to the nation's financial system than global terrorism does. This is not, of course, to say that terrorism has, in any way, receded as a threat. It is merely to note that the risks posed by corruption are real and acute, yet are treated with notably less urgency and seriousness by nearly all parties because the business of corruption is both less glamorous and more complicated than terrorism. What all of this therefore suggests is that the world is, quite probably, completely unprepared for the political, economic, and social ruin that corruption could generate.

Charlie Rangel is a symbol of the corruption that plagues our ruling class, but he is, sadly, only a tiny, fractional part of the problem. Rangel's mistake, if you will, was in being stupid enough to get caught. Apparently, he was convinced that he was untouchable and got careless. That happens.

What happens even more often, though, is that the members of our political class don't get as reckless as Rangel did, which is to say that they go on about their business of lying, cheating, and stealing, all the while insisting that they are your moral betters, the people to whom *you* should be held responsible for transgressions that all but certainly occur only in their fevered imaginations.

Consider, for example, the newly passed financial regulation law. This thing, for whatever benefits it may or may not bring, was, from the start, a case study in moral obtuseness. Seriously? The Dodd-Frank bill? The name itself is a putrid reminder of the pathetic lack of seriousness that corruption engenders in the body politic.

How, pray tell, can an organization purport to exude moral righteousness when it names its new regulatory effort for two men who would, were they not in Congress, likely be in prison for violations of the very law that this new act is supposed to strengthen? More to the point, we guess, how can Congress purport to regulate and "clean up" an industry that has for years been one of the principal playgrounds for Congressional crooks of all stripes?

Regulatory reform of some sort may or may not be necessary. But that debate should be had far away from the ruling class that has routinely been among the greediest hogs at the trough of corruption that is supposedly being reformed.

And, for the record, the 30-plus Senators and Senate staffers (including the aforementioned Chris Dodd) who received what *The Hill* newspaper calls "loans that offered sweetheart deals or special treatment" from Countrywide Mortgage are but the tip of the proverbial iceberg here. The corruption and moral obtuseness on Capitol Hill goes far deeper.

Don't believe us? Well, take a quick look at a recent paper presented by Stephen Bainbridge, a professor at the UCLA School of Law, regarding the extraordinary investment acumen of the members of the U. S. Senate.

Bainbridge begins with the following background material.

> The common stock investment portfolios of United States Senators beat the market by 12% a year, on average, between 1993 and 1998, according to a study by economist Alan J. Ziobrowski

> and his collaborators. In sharp contrast, the common stock investment portfolios of U.S. households as a whole underperformed the market on average by 1.4% a year during the relevant period.
>
> Even more striking, corporate insiders investing in their own company's stock only beat the market by about 6% a year on average during that period.
>
> The Ziobrowski study's results strongly imply that some Members of Congress are using nonpublic information to make trading decisions. Over time, even professional investors do not systematically beat the market. This basic premise of efficient capital markets theory has been confirmed by many academic studies. The only important exception to the rule is corporate insiders trading in their own corporation's stock. The obvious and generally accepted explanation for insiders' ability to beat the market is their access to and use of material nonpublic information about their company.
>
> It seems unlikely that United States Senators as a group have such unique investment skills that they can outperform not only the market as a whole but also corporate insiders over an extended period. Instead, it seems more reasonable to assume that the superior returns found by Ziobrowski result from Senatorial access to—and use of —material nonpublic information about the companies in whose stock they traded . . .

Bainbridge continues, noting that Ziobrowski's publication of these results prompted the following response from *The Wall Street Journal*, which further elucidates what, exactly, is driving the Senate's remarkable performance:

> The senators . . . appeared to know exactly when to buy or sell their holdings. Senators would buy stocks just before the shares suddenly would outperform the market by more than 25%. Conversely, senators would sell stocks that had been beating the market by about 25% for the past year just when the shares would fall back in line with the market's performance.

But if U.S. Senators are trading on material, nonpublic information, they should be held accountable by law, should they not? That's illegal, right?

Well . . . no.

You see, for just about everybody else in the world, trading on inside information is illegal. If you happen to be the world's best napkin decorator and fitted-sheet folder, for example, you can even wind up doing time for such offenses. But if you're a privileged member of the ruling class, you can do whatever you want to do, apparently, and there is, to paraphrase the former Vice President and current harasser of masseuses, Algore, "no controlling legal authority."

And that, as it turns out, is the point of Stephen Bainbridge's new paper on the Senate and its miraculous investment results: exposing the loophole that allows our "moral betters" in Congress to evade the spirit of the law, even as they technically obey the letter of the law and even as they continue to expand said law in general to make everyone else's lives more complicated and difficult.

Bainbridge's explanation for the legality of Congress's insider free-ride is, naturally, quite complicated. And if you are truly interested in the subject matter, we'd suggest reading that explanation in full (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633123). In the meantime, here are the highlights:

> The phrase "insider trading" is properly understood as a term of art, because it in fact is a misnomer in two significant

ways, both of which are relevant to the analysis of the legality of such trading by government employees. First, the federal securities laws' prohibition of so-called "insider" trading encompasses many corporate outsiders. Accordingly, Congressmen, their staffers, and other government officials and employees are not exempt from liability for trading on the basis of material nonpublic information simply because they are not corporate insiders.

Second, the prohibition encompasses not just inside information, but also so called market information. "Inside information" refers to "information which comes from within the corporation or affects the price of corporate stock because of its reflection of a corporation's expected earnings or assets." "'Market information' refers to information that affects the price of a company's securities without affecting the firm's earning power or assets . . . Examples include information that an investment adviser will shortly issue a 'buy' recommendation or that a large stockholder is seeking to unload his shares or that a tender offer will soon be made for the company's stock." The distinction rarely matters in insider trading cases, however, because the law imposes liability for misuse of both inside and market information.

Members of Congress and government employees potentially have access to both inside and market information. They can learn inside information when a corporation confidentially discloses such information during the course of a Congressional hearing or investigation, for example . . .

As we shall see below, in the vast majority of cases, only the misappropriation theory will be relevant to insider trading by Members of Congress and other governmental officials.

In *U.S. v. O'Hagan*, the Supreme Court resolved an emergent split between those circuits that had accepted the misappropriation theory, as the Second had done in *Newman*, and those that had rejected it, as the Fourth and Eighth had done. Although the Court endorsed the misappropriation theory as a valid basis for insider trading liability, it did so in a way that left the misappropriation theory as yet another misnomer. As defined by the court, the misappropriation theory does not deal with theft of inside information—or, at least, not directly— but rather holds that a fiduciary's undisclosed use of information belonging to his principal, without disclosure of such use to the principal, for personal gain constitutes fraud in connection with the purchase or sale of a security and thus violates Rule 10b-5.

The Court acknowledged that misappropriators have no disclosure obligation running to the persons with whom they trade. Instead, it grounded liability under the misappropriation theory on deception of the source of the information; the theory addresses the use of "confidential information for securities trading purposes, in breach of a duty owed to the source of the information." According to the Court, "a fiduciary's undisclosed, self serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." So defined, the

Court held, the misappropriation theory satisfies § 10(b)'s requirement that there be a "deceptive device or contrivance" used "in connection with" a securities transaction.

Where a Member of Congress, a Congressional staffer, or other government information obtains material nonpublic information in the course of their duties and then uses it to trade in the stock of the relevant issuer, their conduct could be colloquially described as a theft of the information, but under *O'Hagan* any potential insider trading liability under the misappropriation theory would require proof of a duty of disclosure between the official and the source of the information. The initial question is whether that duty must arise out of a fiduciary duty or whether the requisite duty can be created, *inter alia,* by agreement. This is so because, as we shall see, while Congressional aides and other government employees have duties arising out of both their fiduciary relationship with their employer and their employment contract, Members of Congress are bound only by the implied obligations created by Congressional ethics rules . . .

Of whom are Members of Congress agents or fiduciaries? With whom do they have the requisite relationship of trust and confidence out of which the requisite duty to disclose before trading arises? The only logical candidate is the electorate. Although there is some precedent in other contexts for the proposition that "a public official . . . owe[s] a fiduciary duty to the public to make governmental decisions in the public's best interest," such a duty would be irrelevant to the problem at hand. What is needed under insider trading law is either a duty to the person with whom one trades or to the source of the information, not some generalized duty to members of the public in the abstract. Accordingly, the predominant view, as stated by former SEC enforcement official Thomas Newkirk, is that "[i]f a congressman learns that his committee is about to do something that would affect a company, he can go trade on that because he is not obligated to keep that information confidential . . . He is not breaching a duty of confidentiality to anybody."

Under current law, there is no serious doctrinal obstacle to applying the misappropriation theory to employees of the Congress, the Executive Branch, and other governmental agencies. As to Members of Congress, however, there is a strong argument under current law that their trading cannot be punished under either the classic disclose or abstain or the misappropriation theory.

Much of the remainder of Bainbridge's article revolves around the effects of Congressional insider trading and a proposal to rectify the problem, namely the **"**Stop Trading on Congressional Knowledge Act" (The Stock Act). Regarding the former, this much, we think, is obvious. As Bainbridge notes, one critical problem is "unfairness," which arises from the fact that only Members of Congress are thusly indemnified. Of course, if we had a nickel for every law or regulation that applies to all of us, but from which Congress is exempted, we'd be rich men indeed.

The bigger, more relevant problem, though, is what Bainbridge terms "perverse incentives," which, naturally, suggests that Members of Congress are, to some or another extent, drawn to policy issues and solutions not simply because they pique their personal interests but because they can promote their financial interests as well. Or as Bainbridge puts it:

> 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.

As far as the solution to this problem goes, Bainbridge cites the STOCK Act. He also notes that this bill has been introduced in three successive Congresses, but has – *mirabile dictu* – received little support each time. Of course, if Congress were actually serious about addressing this issue, it could do so any time a relevant opportunity arises – like, for example, legislation intended to "reform" the financial markets. Better yet, Members of Congress *could simply stop trading using material inside information, legal capacity, be damned.* In order for that to happen, though, Members would have to take their duty to the electorate seriously. And is there anyone in the world still naïve enough to believe that they are, as a collective, capable of such patriotism?

For the record, this above should be considered a "rhetorical question." We know the answer, obviously.

All of this relates to the two most important developing themes in the study of Washington and politics: the ruling class's ongoing propensity for believing that it should, by virtue of its majesty, live by different rules than the rest of us; and the related acknowledgement that the "game" of politics is rigged by men and women who have lost all sense of propriety.

Obviously, as we have seen with the new financial regulation law and as Stephen Bainbridge argues convincingly in his study of Congressional insider trading, both of these themes affect our business acutely. But we are hardly alone.

The corruption endemic in this nation's ruling class is both tiresome and incredibly destructive. And it affects policy decisions and effectiveness in more ways than we can even contemplate.

In closing, we'll offer just one, rather unrelated but, we think, imperative example of this destructiveness.

You will note, that lately the Obama administration has been discussing corruption a great deal in its attempts to shape the discussion over the war in Afghanistan. And, you will note, that Obama et al. appear to be giving themselves an "out" in this war by claiming that our Afghani partners are irredeemably corrupt and thus represent a threat to this nation's mission in that benighted land. Along these lines, the *Associated Press* reported a few weeks back that:

> U.S. Attorney General Eric Holder was in the Afghan capital to talk with officials about improving the justice system and fighting corruption Wednesday, a day after Afghanistan's top prosecutor defended himself against allegations that he's being pressured not to pursue cases against powerful figures.
>
> Corruption and an ineffectual court system have undermined public trust in President Hamid Karzai's government. The Obama administration and other donor nations, who need Karzai to be perceived as a credible partner, are pushing him to clean up bribery, graft and corruption.

Pardon our cynicism, but this strikes as bizarre. For starters, in his previous existence, the very same Eric Holder was, you may recall, the Clinton Justice

Department official who green-lighted the Marc Rich pardon, which prompted liberal scold Richard Cohen to write the following about him nearly two years ago:

> Holder was Clinton's deputy attorney general, and he played a significant role in the pardon. When asked by the White House what he thought about a pardon for Rich, Holder replied, "Neutral, leaning towards favorable." These four words have stalked him since.
>
> Rich was a commodities trader who amassed both a fortune and some influential friends in the 1970s and '80s. Along with his partner, Pincus Green, he was indicted in 1983 on 65 counts of tax evasion and related matters. Before he could be prosecuted, however, he fled to Switzerland. There he remained, avoiding extradition and eventually arranging to be represented by Jack Quinn, a Washington lawyer and Clinton's onetime White House counsel – in other words, a certified power broker. Quinn did an end run around the Justice Department's pardon office and went straight to Holder and the White House. With a stroke of a pen, justice was not done.
>
> Holder was not just an integral part of the pardon process, he provided the White House with cover by offering his go-ahead recommendation. No alarm seemed to sound for him. Not only had strings been pulled, but it was rare to pardon a fugitive – someone who had avoided possible conviction by avoiding the inconvenience of a trial. The U.S. attorney's office in New York – which, Holder had told the White House, would oppose any pardon – was kept ignorant of what was going on. Afterward, it was furious.

And we expect Hamid Karzai and the-gang-that-couldn't-steal-straight to take us and our demands for accountability seriously?

Seriously?

We could go on, we suppose, with the comparisons between American ruling-class corruption and corruption in Afghanistan. But what would be the point? First, we'd be playing the left's moral equivalence game, which would diminish the real and severe problem of Afghani corruption. And second, we'd get sidetracked, turning this piece about the effects of general corruption among the American ruling class into a bitch-fest about the Obama administration's hypocrisy. That might be fun, we'll concede, but it would distract from the larger purpose of this piece, namely to note the broad, system-wide threat that political corruption presents.

Good ol' Charlie Rangel may deserve what is coming to him. But he's not the only one. And tossing this one, octogenarian crook out on his keister isn't going to fix the corruption problem in American government. Charlie Rangel will be sacrificed, and then the Congress will move on, hoping desperately that no one else will have to be sacrificed to keep the whole crooked scam from being exposed.

And still our betters wonder why the country is so "angry."