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CRISIS FOR ALL, OPPORTUNITY FOR SOME

In the summer and fall of 2008, the world economy hovered on the brink of catastrophe. A combination of too much bad debt and a burst housing market bubble threatened to push the American economy over the edge, with much of the rest of the world likely to follow. In Washington, D.C., dramatic and historic decisions involving trillions of dollars were made in rapid succession in an effort to contain the crisis. The Permanent Political Class played a central role in the drama as the government broke precedent after precedent.

For members of Congress, the crisis meant momentous votes, long hours in closed-door meetings, and countless phone calls with federal officials. It also meant regular private consultations on both budgetary and monetary decisions. It meant private conversations with Wall Street and banking executives. It meant emergency measures, including authorizing the spending of $700 billion in

taxpayer money in an attempt to create liquidity in financial markets—the Troubled Asset Relief Program, a.k.a. TARP.

And for certain members of Congress, it also meant trading stocks at critical times.

One of those who played a central role in governmental decisionmaking during the crisis was Congressman Spencer Bachus, then the ranking Republican on the House Financial Services Committee. (When Republicans retook control of the House of Representatives in 2010, Bachus became chairman.) It was the Financial Services Committee through which all bailout and other financial legislation had to move. When President George W. Bush discussed the passage of the Emergency Economic Stabilization Act in the midst of the crisis, he praised six members of Congress for their work on the issue, Bachus among them.[1] But beyond the formal hearings on the legislation, Bachus was regularly involved in private meetings and phone conversations. As he recounted later, he "received repeated Saturday or Sunday calls announcing intervention after intervention" by the government in the financial markets.[2] Henry Paulson, who was the Treasury secretary at the time, recounts in his memoir numerous closed-door meetings at which Bachus was a participant.[3]

As he was having those high-level discussions, however, he was also aggressively buying and selling stock options. For his efforts, Bachus netted tens of thousands of dollars in capital gains, while most Americans watched their portfolios plummet. A lawyer and a former state senator, Bachus has served in Congress since 1993. He is not a wealthy man. According to his financial disclosure forms, his net worth is less than $1 million. But he is an active stock trader. He is particularly active when it comes to trading options, which is a relatively inexpensive way to bet that a particular stock, or the broader market, will go up or down.

If you think a stock will fall from its current price, you can

buy an option to sell it at that current price, without spending the money to own the stock itself. If the price drops from, say, $4 to $2, you can buy it at $2 and immediately exercise your right to sell it at $4. If you bet wrong, you can let your option expire without ever buying the stock. Bachus has used this investment strategy repeatedly to supplement his salary. One year, for example, he earned as much from his options trading as he did from his congressional salary. Here's the rub: all too often his trades coincided with his congressional work.

From July 2008, when the first murmurs of the crisis were heard, to the dark days of November, with international markets in near free fall, Bachus engineered no less than forty options trades, betting that the market, a sector of the market, or an individual company would go up or down at critical times.

Financial markets were experiencing the greatest volatility on record.[4] Trillions of dollars in stock profits were being washed away. But for Bachus it was different. According to his financial disclosure statements, Bachus netted as much as $50,000 in capital gains by aggressively playing the market during this volatile period. And he netted tens of thousands more in early 2009, when financial reforms were put in place. What makes these results impressive is the fact that options trading is extremely risky. There is a rule of thumb in the financial industry that 75% of options are worthless when it comes time to redeem them, and that 80% of options traders lose money.

In a speech he gave shortly after the financial crisis abated, Bachus noted that the political class was looking at policy and making decisions on "how the markets were reacting."[5] Unfortunately, Bachus was also trading on that same information.

In the summer heat of 2008, as the crisis was getting started and before a broader panic set in, there were concerns about the housing market and the health of banks in particular. It was not

fully apparent that the entire financial system might be at risk. Some banks had failed, the investment house of Lehman Brothers had been battered but had not yet failed (it would finally go under on September 15), and government-backed Fannie Mae and Freddie Mac were in serious financial trouble. Bachus's Financial Services Committee consulted regularly with federal officials and was considering a series of legislative steps to deal with these problems.

Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) are congressionally chartered corporations whose original purpose was to pump cash into the nation's mortgage market. By 2007, the two had $83.2 billion in assets—but they were also carrying about $5.2 trillion in debt and guarantees. In short, they were leveraged at a ratio of about 65 to 1, and were hardly sustainable as the housing market tumbled.[6] Both were deeply in trouble and effectively insolvent. If they went down, many feared that Fannie and Freddie might bring the entire financial system down with them, since it would mean widespread foreclosures on countless homes. To head off disaster, congressional leaders and administration officials conferred frequently. According to Henry Paulson's memoir, for example, a private meeting took place on September 4 in the Russell Senate Office Building, with Paulson, Senators Chris Dodd and Richard Shelby, and Congressman Bachus in attendance. During the meeting they discussed how to proceed with legislation to rescue Fannie and Freddie. There had also been congressional hearings and consultations in July and August.[7]

As Bachus and his committee wrestled with these issues, the congressman was aggressively buying options.[8] Back on July 14, he bought "puts"—that is, options to sell—representing the entire financial sector of the stock market, in the form of a sector SPDR fund. This is an index fund that tracks the S&P 500 cor-

porations as divided into nine categories: consumer discretionary, consumer staples, utilities, technology, and so on. Bachus was betting that the financial sector fund would fall—in other words, the combined stock prices of financial services firms in the S&P 500 would go down. (This is what is called selling short.) He started small, buying $4,500 worth and cashing in the next day, making close to $1,500 in capital gains.

Ironically, on July 24, Bachus wrote to the Securities and Exchange Commission requesting that it extend an emergency order intended to curb naked short selling. Some analysts were blaming the high volatility of the crisis on speculators who made short-term bets on stock prices by shorting them. A "naked short" refers to short-selling a stock without first borrowing it, or ensuring the ability to borrow it. This is highly risky for the seller, and it greatly increases the potential amount of short selling, since anyone can do it, whether or not he can afford it, and whether or not the stock being shorted is even available. Bachus himself was not guilty of naked short selling; he was always careful to put in play small amounts of money that he could afford to lose. But naked short sellers are really just an extreme version of all short sellers, and he was actively engaged in betting on the markets to fall.

Bachus was neck-deep in crucial financial decision-making at the highest levels. A few weeks later, he sent a letter to the Financial Accounting Standards Board, an independent private-sector organization, expressing concerns that proposed accounting changes might put at risk $10.5 trillion worth of securitized assets. Bachus wanted to see an end to mark-to-market accounting, in which an asset or liability is priced based on the current market value, and instead allow financial institutions and others to price liabilities based on the value when they are acquired.[9] His position was cer-

tainly defensible, and it shows he was properly active and concerned with the state of financial markets. But he was not exactly disinterested in those markets.

Bachus kept trading. On August 15 and August 22, he bought more than $11,000 worth of SPDR sector option contracts. A few days later, he pocketed more than $5,000 in capital gains because he "guessed" right.

On the evening of September 18, at 7 P.M., Bachus received another private briefing for congressional leaders by Hank Paulson and Federal Reserve Bank Chairman Ben Bernanke about the current state of the economy. They sat around a long table in the office of Nancy Pelosi, then the Speaker of the House. These briefings were secretive. Often, cell phones and Blackberrys had to be surrendered outside the room to avoid leaks.[10]

What Bachus and his colleagues heard behind closed doors was stunning. As Paulson recounts, "Ben [Bernanke] emphasized how the financial crisis could spill into the real economy. As stocks dropped perhaps a further 20 percent, General Motors would go bankrupt, and unemployment would rise . . . if we did nothing." The members of Congress around the table were, in Paulson's words, "ashen-faced."

Bernanke continued, "It is a matter of days before there is a meltdown in the global financial system." Bachus was among those who spoke. According to Paulson, he suggested recapitalizing the banks by buying shares.[11]

The meeting broke up. *The next day*, September 19, Congressman Bachus bought contract options on Proshares Ultra-Short QQQ, an index fund that seeks results that are 200% of the inverse of the Nasdaq 100 index. In other words, he was shorting the market. It was an inexpensive way to bet that the market would fall. He bought options for $7,846 on a day when the Dow Jones Industrial

Average opened at 8,604. A few days later, on September 23, after the market had indeed fallen, he sold the options for over $13,000 and nearly doubled his money.

He continued in this vein, making short-term bets lasting between a day and a week, benefiting on 100-point swings. Meanwhile, the Treasury Department had worked with congressional leaders (including Bachus) to cobble together the $700 billion TARP rescue plan. The plan was publicly announced on September 22. Bachus made another options buy on Proshares Ultra on the day of the announcement. The congressman nearly doubled his money again, bringing in an additional $2,081 in capital gains.

On September 23, the House voted against the bailout as proposed by the Treasury Department. Amendments and revisions were offered. Bachus would later be criticized by his Republican colleagues for waffling on the bill: at first he was for it, then against it, then for it again. As the bill was recast and modified, Bachus's Financial Services Committee continued with private consultations. It was not until October 3 that the revised $700 billion bailout plan passed in the House and was signed into law by President Bush. At the signing ceremony in the Rose Garden of the White House, President Bush praised Bachus's work.

The bill gave the Treasury Department the power to purchase the toxic debt on banks' balance sheets. Paulson and others remained extremely concerned about the financial situation. Bachus was well aware of where things stood, but was apparently confident that the federal bailout would do the trick. He continued trading options, this time buying shares in an index fund known as Powershares QQQ, which tracks one hundred of the largest nonfinancial companies on the Nasdaq exchange. He bought into the fund on more than ten occasions in October, and he purchased options on the S&P 500 index six times. These were "calls"—that is, bets

that the market would rise. Not all of Bachus's trades made money. These were still bets, and sometimes he bet wrong.

On October 14, the federal government tapped into the $700 billion provided by the Emergency Economic Stabilization Act. The government took equity positions in banks that chose to participate. *The next day*, Bachus bought more SPDR option contracts and netted a quick $3,400. On October 21, the Federal Reserve announced it would spend $540 billion to purchase short-term debt from money market mutual funds. *The next day*, Bachus bought more than $5,000 worth of options in Market Vectors TRN. Thanks to his purchase of this call, he more than doubled his money.

Bachus was not just buying options on broad market funds or a sector of the economy. He also bought options on specific companies. On September 8, Hank Paulson received a disturbing private phone call from General Electric CEO Jeffrey Immelt. GE was having trouble selling its bonds, Immelt quietly told him.[12] Just two days later, Bachus shorted General Electric options. He did so *four times* in a single day, according to his financial statement from Fidelity, and more than doubled his money.[13] Indeed, between September 10 and 15, Bachus shorted GE a total of twelve times. Nine of those trades were profitable—a high batting average for such a risky game. Is there absolute proof that Paulson told Bachus about Immelt's phone call? No. Are Bachus's trades suspicious? You bet. Why, of all companies, did he choose to short GE at this time?

This was not the only instance when Bachus took leveraged stock options that were intertwined with his government work. Back in 1997, he aggressively purchased eleven put options on United Airlines, betting on the stock to fall. At the time, Bachus was on the House Transportation and Infrastructure Committee, which set policy toward the airlines. That same year, Bachus also

took short positions in Microsoft. The Department of Justice was in the midst of its antitrust case against the company. Bachus purchased two puts just days before the Justice Department filed a complaint demanding a $1-million-per-day fine against Microsoft for its violation of a consent decree. Is there proof that he knew about the complaint? No. But the larger pattern is suspicious. In the middle of the antitrust hearings he placed more bets that Microsoft stock would fall. On the Microsoft transactions he netted up to $20,000 in capital gains, according to his financial disclosure form.

Bachus has been able to use his above-average success with option trades to yield a nice supplemental income. In 2007, the congressman undertook several dozen risky short-term put and call options on a variety of companies. He was betting that he would know whether a company's price would go up or down. These included companies like Apple as well as obscure Chinese Internet advertising companies like Focus Media. Bachus had impeccable timing. In over two dozen cases, representing more than two-thirds of all the trades he made, he guessed correctly.

In the case of Focus Media, for example, he held the investment for only two weeks, and sold it on the same day that the company's stock price surged following its announcement that it would acquire a competitor. Again, there is no proof that he knew of the acquisition in advance. But it is highly unlikely that his two-thirds success rate in those 2007 trades could have been based on public information alone. If so, he should have quit Congress and become a professional investor. All told, in 2007 Bachus was able to supplement his $165,200 congressional salary with $160,000 in profits from aggressive put and call options on a variety of stocks.[14]

A spokesman for Baucus, Jeff Emerson, claims that this presented no difficulty. "There is no conflict of interest," he says.

"He asked the Ethics Committee if he could do this, and they said there's no problem." As a matter of law, that answer is accurate and complete. Only Congress's own Ethics Committee can decide whether to condone this kind of stock trading.

Here's the heart of the scandal—the fact that the Ethics Committee deems this acceptable. Welcome to the outrageous arrogance of crony capitalism in Washington. Not only are members of Congress able to act on information that is not available to the rest of us, but they are able to put their own fortunes at risk when they ought to be concerned only with the public interest. If you bet on a particular sector of the economy to fall over the course of a few days or weeks, how can you be sure that your subsequent decisions are not influenced by that bet?

Congressman Bachus was not the only one actively trading stocks while setting policy during the financial crisis. But he was particularly aggressive with options; others merely cashed out of positions that were just about to worsen. Sometimes knowing inside information can mean protecting your assets while the rest of America goes over a financial cliff.

On Tuesday, September 16, 2008, when Henry Paulson and Fed Chairman Ben Bernanke held another of their terrifying closed-door meetings with congressional leaders (two days before the "ashen-faced" meeting), the stock market had dipped only a few percentage points, and most people assumed that the financial crisis was a disruption that would have just a limited effect on the broader economy. But what Paulson and Bernanke told lawmakers on September 16 made it clear that the public's perception was wrong. Paulson, in his memoir, explains that during the meeting he outlined that the federal government was going to bail out the insurance giant AIG and that the markets were in deep trouble.

"There was an almost surreal quality to the meeting," he recounts. "The stunned lawmakers looked at us as if not quite believing what they were hearing."[15]

The next day, Congressman Jim Moran, Democrat of Virginia, a member of the Appropriations Committee, dumped his shares in *ninety* different companies.[16] Moran is a former mayor and city councilman of Alexandria, Virginia. Earlier in his political career he had faced legal charges for casting a vote on the Alexandria City Council that helped a developer friend win a bid for a lucrative plot of land. Moran pleaded no contest to a misdemeanor charge and resigned. It did not stop his career. He was elected mayor in 1985, and to Congress shortly after. (It's interesting to note that legal standards in Virginia are apparently higher than those of the U.S. Congress. Had Moran cast that same vote in Congress, there would be no cause for any charges!)

September 17, 2008, was by far Moran's most active trading day of the year. He dumped shares in Goldman Sachs, General Dynamics, Franklin Resources, Flowserve Corporation, Ecolabs, Edison International, Electronic Arts, DirecTV, Conoco, Procter & Gamble, AT&T, Apple, CVS, Cisco, Chubb, and a dozen more companies. *Moran's timing was impeccable.* He didn't profit very much from these trades, but he avoided the larger losses that the general public would face in a matter of weeks. Moran and his wife actually eked out a net capital gain on these trades.

Moran was just one of many. At least ten U.S. senators, including John Kerry, Sheldon Whitehouse, and Dick Durbin, traded stock or mutual funds related to the financial industry the following day. Representative Shelley Capito is a Republican from West Virginia who sits with Congressman Bachus on the House Financial Services Committee. She and her husband dumped between $100,000 and $250,000 in Citigroup stock the day after the

briefing. According to her financial disclosures, she and her husband somehow managed to accrue capital gains from Citigroup stock transactions made throughout the crisis, as much as $50,000 worth.[17]

Senator Dick Durbin, the Democratic whip and chairman of the Subcommittee on Financial Services and General Government of the Senate Appropriations Committee, attended that September 16 briefing with Paulson and Bernanke. He sold off $73,715 in stock funds the next day. Following the next terrifying closed-door briefing, on September 18, he dumped another $42,000 in stock.[18] By doing so, Durbin joined some colleagues in saving themselves from the sizable losses that less connected investors would experience. The stock market collapsed shortly after these congressional trades. By October 3, just seventeen days after the September 18 meeting, the market had dropped more than 9%. A month later, it had plummeted over 22%. Preventing a catastrophic loss can be just as important as making a big gain.

Senator Durbin did not just sell stocks based on his inside knowledge. Like Bachus, he was looking for opportunities to invest. Though he sold many of his holdings, he also bought tens of thousands of dollars' worth of Berkshire Hathaway, the holding company run by the legendary investor Warren Buffett. Durbin bought shares on September 19 and 22—more than $60,000 worth. His timing was nearly perfect. *The next day*, September 23, it was announced that Berkshire Hathaway was buying part of Goldman Sachs, which would yield a 10% guaranteed dividend for Berkshire investors like Durbin. The deal had been discussed behind closed doors for days before Buffett announced it publicly. Durbin's spokesman insists that the senator "didn't use any information from that closed-door gathering to counsel his trades the following day." Yet it is almost certain that Durbin, as chairman of a crucial subcommittee, knew about the Goldman Sachs deal.

When the House Financial Services Committee was crafting legislation for the TARP bailout of banks in the fall of 2008, eight members of the committee were actively and aggressively trading bank stocks. So too were members of the Senate Finance Committee. As the Treasury Department was conferring over which banks would get the bailout money, Senator John Kerry started buying Citigroup stock. The markets might have been down and in turmoil, but Kerry was buying the troubled company. Lots of it. He purchased up to $550,000 in Citigroup stock in early and mid-October. He also bought up to $350,000 in Bank of America shares. *Days later*, on October 28, it was announced that Citigroup was getting $25 billion from the TARP Capital Purchase Program and another $25 billion from the Targeted Investment Program. On November 4, it was announced that Citi would be provided additional loan guarantees that could total $277 billion, from the Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation.[19]

Members of Congress are privy to all sorts of inside information about pending government actions. Some of it comes from their actual actions—that is, passing legislation. Some of it comes as a result of their position of power. Legislators are told things by regulators or bureaucrats in private because they ask about them. While a committee's public hearings are generally about stagecraft, very frank and detailed conversations often take place behind closed doors. The most valuable information is revealed in private meetings, phone calls, and correspondence. If members of Congress buy and trade stock based on that information, or if they pass that information along to a campaign contributor or their own financial advisers, they are not considered guilty of any wrongdoing. Yes, this is an outrageous standard. But remember, they write their own rules.

Consider for a moment the fact that the political class regu-

larly trades stock in government-backed entities like Fannie Mae and Freddie Mac while *at the same time* determining the fate of those very entities.

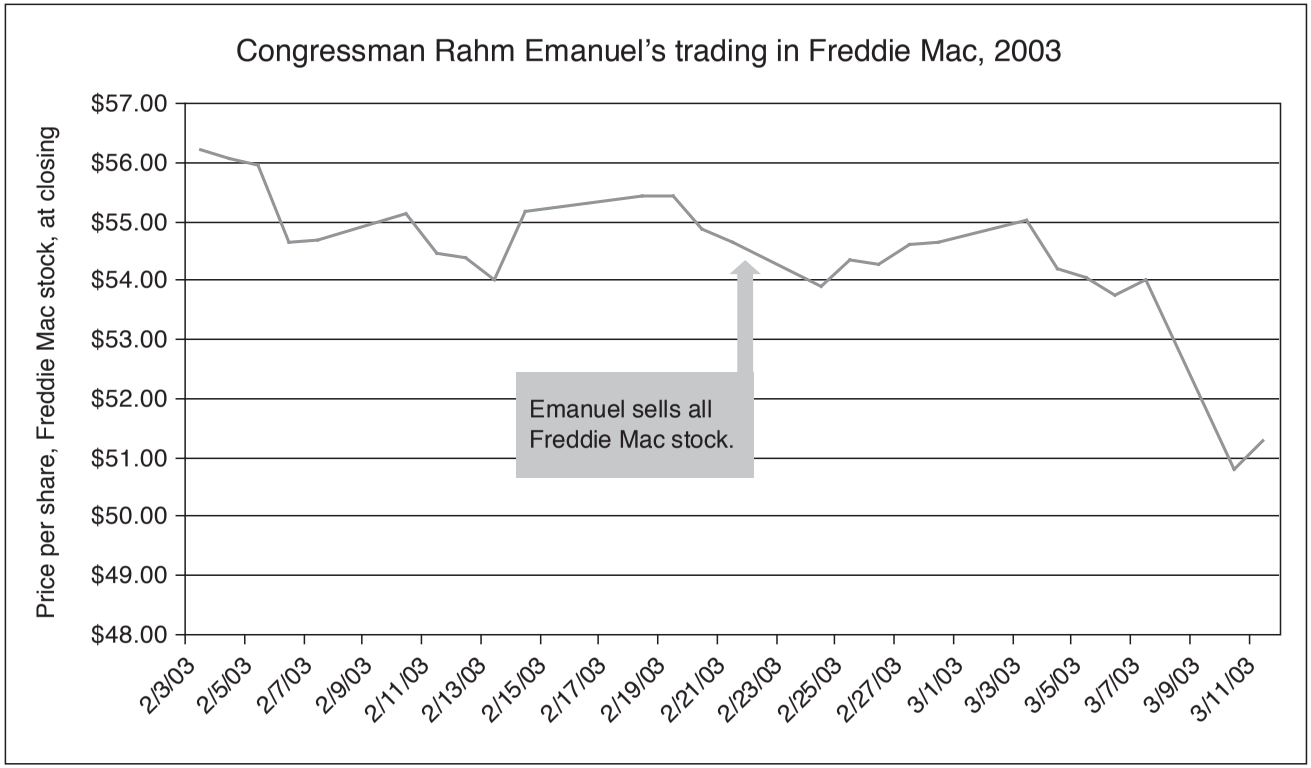
Fannie and Freddie were chartered by Congress, and both have implied government guarantees. For many years, these entities were exempt from the nation's financial disclosure regulations—and politicians traded shares in these companies. Indeed, Fannie and Freddie were even exempt from insider trading rules. And in this murky world, Senate and House members invested with one hand while they exercised oversight with the other.

In February 2003, Rahm Emanuel was a newly elected member of Congress from Chicago. He had a seat on the House Financial Services Committee's Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, which had direct supervision over Fannie and Freddie. Emanuel had previously served on the Freddie Mac board—he'd been appointed by President Clinton in 2000—so he was very familiar with its inner workings. On February 21, Emanuel suddenly sold off all of his Freddie Mac stock, up to $250,000 worth.[20] He did so *just days* before a nearly 10% drop in the share price. It was not until the late spring that the public learned in full what was going on at Freddie Mac: there was a criminal investigation of its senior executives, and its earnings had been inflated and would need to be restated to the tune of billions of dollars. (The Freddie Mac accounting scandal was actually larger than that of Enron.)

Were a board member or employee with intimate knowledge of a corporation to dump all of his shares right before an announcement of bad news and a plunge in the stock price, it would at least warrant a look by the SEC. But when a member of Congress does the same thing, he gets a free pass.

The profitability and stock price of Fannie and Freddie have been closely tied to the politics of Washington. On Election

WE KNOW WHAT'S HAPPENING BEFORE YOU DO



Day 2004, when exit polls initially—and wrongly, as it turned out—suggested that John Kerry would win the presidency, Fannie Mae stock markedly rose. When it became clear on November 3 that President Bush had been reelected, Fannie stock opened down and fell sharply for the day, while financial stocks gained overall.[21] The reason is simple: George W. Bush was seen as a likely proponent of reforming the government-backed financial giant, whereas Senator Kerry was an opponent of such reforms.

There is nothing wrong or unusual about that stock movement, nor anything surprising about the positions taken by Bush and Kerry on the issue. But were those positions influenced by self-interest? For years, Kerry had been an advocate for expanding Fannie Mae's mission, not reforming it.[22] He was generally opposed to removing any government guarantees, tightening lending standards, or greater regulatory oversight by Congress. As Kerry was resisting legislative efforts to impose additional regulatory restrictions on the financial giant, he and his wife were quietly selling off their extensive Fannie Mae holdings throughout early 2005.[23] Indeed, over a six-month period they dumped around $1 million in Fannie Mae stock. (Again, only ranges were disclosed, not actual figures.) Furthermore, the Kerrys were trading their shares at the same time that the company was telling all of its employees that they could not trade the stock until the new earning results were made public.[24] The Kerrys, who had traded Fannie Mae shares for years, dumped the stock before it suffered serious declines. They actually managed to post capital gains on the stock of up to $250,000 on those transactions.[25] How many other Fannie Mae investors could claim that, in what was a bad time for the stock?

Members of Congress sometimes pay lip service to avoiding potential conflicts of interest. Indeed—and ironically—in 2009,

when the federal government was passing out hundreds of billions of dollars in TARP funds to private financial institutions, Speaker of the House Nancy Pelosi argued that "when there's been a thought of conflict of interest" between a member's financial holdings and government bailouts, then that member "should divest."[26]

But there is simply no evidence that Pelosi, or any other member, did so. And there is no evidence of any member of Congress recusing himself when it came to voting on matters that would directly benefit him.

They bet on their own games. They bet on failure. Is there any solid evidence that their political decisions were tied to these bets?

For that, you have to look at some very narrow, tailored bets. Sometimes legislators receive big financial favors from specific companies—and then they work to help those firms.