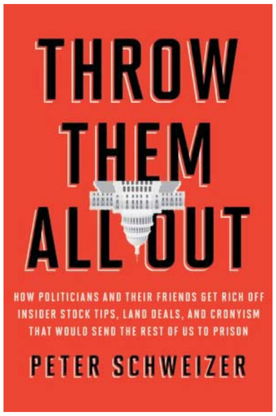

THROW THEM ALL OUT

How Politicians and Their Friends Get Rich Off Insider Stock Tips, Land Deals, and Cronyism That Would Send the Rest of Us to Prison

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General Overview:
Politicians have turned politics into a business. They are increasingly becoming entrepreneurs who turn access to privileged information into great personal wealth. This has attracted the attention of well-connected financiers and corporate leaders who collude with the self-designated "permanent political class" to put together deals which are too good to be true.

In practical terms, Washington politicians have figured out a way to extract wealth from working-class Americans based solely on their proximity to power and their access to insider information. Crony capitalism isn't really a new phenomena but in recent times, it has become so excessive it today threatens the health and sustainability of America's entire economic system. Why? Simply because politicians – who don't produce any goods or services – are now year after year drawing huge amounts of wealth away from those who are productive.

"Crony capitalism is not new, but it has become a dominant force in Washington. The amount of money to be made is much larger. And the opportunities have become more frequent. In fact, it is now threatening the health and integrity of our entire economic system. "Crony capitalism" is a term that used to be applied almost exclusively to developing countries that were rife with corruption. Now the label can be applied to many sectors of our economy. It is an important part of the reason we face the economic crisis that we do."

Part 1 – Crony Capitalism

Career politicians and their friends have become highly adept in recent times at using what they learn and do in Washington to line their own pockets. They are generating a huge amount of wealth for themselves by manipulating the "invisible hand" of the markets and claiming they are doing this in the name of "public service" The new government rich have made politics into a business and are in effect practicing an insidious form of crony capitalism.

So how does crony capitalism work and how do these political entrepreneurs make outrageous money above their publicly disclosed salaries? Crony capitalism takes several forms:

- Politicians sit on various Congressional committees which have access to confidential information which has not been disclosed to the market as a whole. They are then able to make personal investment decisions based on what they know is coming soon. They can buy and sell various types of investments on the strength of that information without falling foul of the insider trading regulations which apply to corporate officers and others. Politicians, for example, are able to invest in the stock of companies which they know will soon be awarded government contracts or other assistance before that information is disseminated to the broader markets. And this is just the tip of the iceberg. Many Washington insiders buy stock in companies whose share prices will move appreciably on the strength of pending legislative changes.

  For example, Senator John Kerry has been in office since 1984 and is a well-known advocate of health care reform. He serves as a member of the Health Subcommittee of the Senate Finance Committee. In 2009 while Obamacare was being pushed through Congress, Senator Kerry and his wife bought more than $1 million of stock in Teva Pharmaceuticals at around $50. Once Obamacare was approved, the stock surged to $62 a share and Kerry sold down his shareholding pocketing a sizable capital gain. Senator Kerry only owned the stock for a few short weeks.
  "We despise professional athletes who bet on their own games. Why don't we feel the same way about politicians who bet on the outcome of legislation? The stakes are surely higher?"

- Politicians are also in a position where they can initiate or sponsor legislation which can add billions to a company's turnover or send them into bankruptcy. That power is of huge value to lobbyists and others who will pay handsomely for access to lawmakers. These payments are not generally in the form of blatant bribes but usually come as sizable contributions to reelection funds or other party fundraising.

  When the $700 billion Troubled Asset Relief Program (TARP) was working its way through Congress in the summer and fall of 2008, many members of Congress were involved in closed-door meetings about how TARP would work. They then went out and traded on that inside information. Congressman Spencer Bachus, the ranking Republican on the House Financial Services Committee was among them. In 2008, Bachus was able to supplement his $165,200 congressional salary with $160,000 in profits he made from aggressive put and call options on a variety of stocks. He was receiving confidential information about various companies in order to consider the TARP legislation and then went out and used that information for his own personal investments. He even asked the Ethics Committee if there was any problem in doing this and they gave him the green light to do so. As a matter of law, only Congress's own ethics committee can decide whether or not a conflict-of-interest exists as politicians buy and sell stocks on the basis of information which is not available to the broader markets.
  "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?"

- Parties who are looking to curry favor with politicians also give them favorable deals on an ongoing basis. For example, many times politicians are able to get in on the hot IPOs which everyone else gets locked out of. In early 2008, Speaker of the House Nancy Pelosi and her husband made three purchases of stock in Visa which had been privately held up until that time. They purchased between $1 million and $5 million of shares at $44 a share. Upon listing, shares of Visa rose to $65 a share generating a 50% profit on their investment within weeks. Pelosi and her husband have been involved in at least ten lucrative IPOs during her congressional career and almost all of these have been hot IPOs which are inaccessible to ordinary Americans. Many other prominent politicians also get in on the best IPOs.

  Nancy Pelosi also actively champions the prospects of the companies she invests in. After purchasing $100,000 of stock in natural gas developer Clean Energy Fuels, Pelosi aggressively pushed for tax benefits which would favor natural gas use. *"In 2008, Clean Energy Fuels also backed California Proposition 10, a ballot initiative that would require the state to float a $5 billion bond offering to subsidize the purchase of "alternative fuel" vehicles. Clean Energy Fuels donated at least $3.2 million to the ballot campaign. Nancy Pelosi endorsed the initiative. In corporate America this would be a clear conflict of interest. Persuading a corporation to spend money on an initiative that you as an executive would personally profit from would raise huge questions. And if you were a middle-level employee in the executive branch of government, such a conflict of interest would trigger an investigation. Trying to help companies in which you have a large financial stake become more profitable through congressional legislation is the very definition of conflict of interest. But Pelosi tried to turn what was a vice for most everyone else into a virtue. "I'm investing in something I believe in," she told Meet the Press host Tom Brokaw. "I believe in natural gas as a clean, cheap alternative to fossil fuel." But, of course, she was also investing in something she could make more profitable by changing government policy. When Brokaw asked her that very question, she responded, "That's the marketplace.""*

- Another way members of Congress can make outlandish amounts is they buy up land they know the government will need to purchase in the not too distant future and then sell that land back to the government for a healthy profit. Former Speaker Dennis Halbert elevated this money-making approach to an art form. In 2002, he purchased a 195-acre farm in Kendall County, Illinois just a few months before Illinois announced it would build the Prairie Parkway just 2.4 miles away. Halbert also inserted a $207 million earmark into the federal highway bill to get construction started on the Prairie Parkway sooner rather than later. A little more than a year later, Halbert sold his land parcel for a 140% profit.

  "Members of Congress have used federal earmarks to enhance the value of their own real estate holdings in several ways: by extending a light rail mass transit line near their property, by expanding an airport, or by cleaning up a nearby shoreline. Federal funds have been used to build roads, beautify land, and upgrade neighborhoods near commercial and residential real estate owned by legislators, substantially increasing values and the net worth of our elected officials, courtesy of taxpayer money. Not only is this legal—by the bizarre standards of the Permanent Political Class—it's also deemed "ethical." Congressional ethics rules simply say that as long as a member can demonstrate that at least one other person will benefit from an earmark, that earmark is in the "public interest." Try out that ethical standard at your job and see how it works for you."

  Senate Majority Leader Harry Reid of Nevada is well known for sponsoring a $18 million earmark to build a bridge over the Colorado River to connect Laughlin, Nevada with Bullhead City, Arizona. Probably less well known is the fact Reid owns 160 acres of land nearby which will substantially appreciate in value if the project goes ahead – but that's just a coincidence according to Senator Reid's office.

"Leveraging your power for a land deal is one of the best paths to honest graft. It's difficult to determine the actual market price of most properties, so disclosure statements can be murky. And when an earmarked project improves the value of the property, it can be hard to calculate just how much that new road, transit stop, or beautification added to it. But there can be little doubt that the political class is the only group of people in America who can get away with using taxpayer money to increase the value of their real estate, while declaring they are doing it in the public's interest."

Part 2 – Capitalist Cronies

While the opportunity for politicians to enrich themselves on the strength of the confidential information they deal in every day is pervasive, there is also a broader and more subtle type of crony capitalism at work in Washington. Politicians are surrounded every day by wealthy friends and potential donors who aspire to make helpful political connections. This opens up some enormous room for ethical dilemmas to arise.

"The game of funneling taxpayer money to friends has exploded to astonishing levels in recent years. Now that annual federal outlays exceed $3 trillion, there are extraordinary opportunities to get a piece of the action. Government checks routinely find their way to very wealthy Americans. Convincing the public that billionaires need the money can, needless to say, be tricky. But if a government check somehow serves the "public interest," it can become part of a larger program and might escape scrutiny."

Some of the more obvious examples of this phenomena in action:

- The Department of Energy has run several stimulus programs for alternative energy projects in recent years. Of the $20.5 billion in loans which were granted as part of the 1705 Loan Guarantee program and 1603 Grant program, $16.4 billion went to companies either run by or primarily owned by financial backers of President Barack Obama's successful presidential election campaign. *"The grant and guaranteed loan recipients were early backers of Obama, before he ran for President, people who continued to give to his campaigns and exclusively to the Democratic Party in the years leading up to 2008. Their political largesse is probably the best investment they ever made in alternative energy. It brought them returns many times over."* For the record, President Obama insisted the loans and grants were made strictly on merit but the fact 80% of the funding went to Obama backers is staggering. Even the Government Accountability Office has been highly critical of the way these loans and grants have been allocated by the Department of Energy and the lack of transparency involved. Put another way, for every $1 raised for Obama's 2008 campaign, Obama's backers have received $24,783 in federal dollars. *"Imagine for a minute that you are a corporate executive and you start using your company's assets to "invest" in projects that in turn benefit you directly. What would happen? You would be risking possible criminal charges for the misuse of those assets. But if it's taxpayer money? Suddenly it becomes legal. Even acceptable. And for the billionaire who is looking to get a big return on his investment, there are few returns that can be higher than those resulting from campaign contributions."*
- Warren Buffett was prominent in encouraging Congress to pass the $700 billion TARP rescue plan. President Obama has described him as one of his "economic advisors." Buffett is highly regarded in political circles. The impressive financial resources of Berkshire Hathaway also meant Warren Buffett was able to make some astute investments when cash-strapped businesses faced pressure as the financial market collapsed. Buffett invested $5 billion into Goldman Sachs on favorable terms and then bought a $3 billion stake in General Electric. Berkshire also had substantial investments in Wells Fargo and U.S. Bancorp which would be impacted by the passage of the TARP package. So overall, it made perfect sense for Warren Buffett to state publicly his support of the proposal.

With the passage of the Emergency Economic Stabilization Act, the Treasury Department suddenly had $700 billion to lend financial institutions. Even more interesting was the fact Treasury could pick winners and losers. So how did Buffett do? In all, Berkshire Hathaway firms received $95 billion of the bailout money as well as $130 billion in federal guarantees for their debt. Or put differently, TARP-assisted companies constituted 30% of Berkshire's publicly disclosed stock portfolio and Warren Buffett ended up being one of the top beneficiaries of the banking bailout he had so vigorously championed. Buffett also suggested to Treasury Secretary Henry Paulson the concept of a public-private partnership to address the financial crisis on a long-term basis. The proposal was eventually picked up and put into action by Tom Geither, Paulson's successor. Berkshire Hathaway by mid-2011 would show a profit of $1.2 billion on its investment in General Electric and $3.7 billion on its bailout investment in Goldman Sachs. Berkshire also bought more bank stocks while the public-private proposal was under consideration which turned out to be superior investments.

"Again, to be clear, even though Buffet was the one who proposed the public-private partnership, there is absolutely nothing illegal about lobbying for a policy while investing in the potential winners if that policy is adopted. But consider this: had Buffet been pushing a private investment house to make an acquisition that would benefit certain stocks while quietly buying shares in those same stocks, he would possibly have been investigated for insider trading. Indeed, this is what his lieutenant David Sokol was accused of doing, landing him in legal hot water. Sokol apparently bought shares in Lubrizol, a chemical company, and then encouraged his employer, Berkshire Hathaway, to buy a large stake in the company, thereby driving up the price of the stock. All Buffett did differently was use the federal government instead of a private company to boost the prices of certain stocks. This, of course, is why crony capitalism is so attractive to financiers. First, it's legal. Moreover, it is often more remunerative than the illegal private-sector version might be. Because government officials are dealing with other people's money, they are less likely to drive a hard bargain than a private firm would."

- Many ex-politicians – including Dan Quayle, Al Gore and Madeline Albright – have launched their own hedge funds after leaving politics even though they have no background in finance. They then provide "political intelligence" to other investment funds for a fee, based on private conversations with Washington insiders about the direction of various legislative initiatives. Studies have show these funds with "political connections" subsequently generate a better rate of return on investments than their peers.
- The Deputy Defense Secretary William J. Lynn held a private briefing with Wall Street analysts in October 2010 to outline the Pentagon's future cost-cutting plans. The stocks of the Big Five defense contractors – Lockheed Martin, General Dynamics, Raytheon, Northrop Grumman and Boeing – all rose appreciably after that meeting. It was never disclosed who attended the meeting and who was excluded but firsthand information about the Pentagon's future plans was certainly a valuable item many smaller contractors would have loved to have access to.
- When the Obama administration made the decision to tap into the nation's strategic petroleum reserve in the summer of 2011, there was a suspicious spike in trading of oil companies shortly before the release of the drawdown. *"Human nature being human nature, such actions are not unique to the Obama administration. Traders, speculators, and investors seek out friends in both political parties. And politicians, political appointees, and bureaucrats see the value in helping out wealthy friends and contributors in the hope that the favor will be returned when they need it. But what has changed in recent years is the amount of money involved, and the power of the federal government to move markets and make people very rich."*

- One investor who worked very hard to profit from the economic stimulus bill passed in 2009 was George Soros, possibly the most visible investor in the world after Warren Buffett. Soros has made billions through currency speculation which is, in essence, a financial bet for or against a government policy. Soros is well-known for having poured money into the reelection funds of prominent politicians and to the Democratic Party and was a major financial backer of President Obama's successful 2008 presidential campaign. Soros regularly met with senior White House officials while the economic stimulus package was being fleshed out. He then went out and invested heavily in companies which would benefit directly from that stimulus package. *"To be clear, it is not necessarily the case that Soros had specific insider tips about any government grants. You might argue that any smart investor would have guessed that economic stimulus funds would be used to promote infrastructure improvements, green energy, and certain high-tech ventures. Yet the list of specific investment decisions by Soros is closely aligned with the list of grant recipients. How did these investments perform for Soros? It is very difficult to tell. He is not required to disclose the price he paid or the price at which he sold his shares. We don't know the dates of the transactions, only that they occurred during a particular three-month period. What we do know is that his investment decisions aligned remarkably closely with government grants and transfers. It would appear that one of the world's smartest investors chose a strategy based on political decisions—whether he knew about the decisions in advance or just guessed extremely well."*

What all of this means is political access has become the key to outstanding financial success. The way to get ahead nowadays is for companies to use their political connections to try and tilt the marketplace's level playing field to one's favor. Lobbying for handouts is now the new and improved way to get ahead.

"America's financiers have learned their lesson: profits are better in Washington, among insiders, than on the open market. Far from being the purveyors of pure free market capitalism, as we imagine, they are all too often riding in the wake of government money. Wouldn't it be better if they focused exclusively on financial and business matters? Crony capitalism favors the politically active, and the manipulative. It does not favor one party over the other. It does not care about policy. It just knows how to make money off any policy—your tax dollars, leveraged to the rich."

Part 3 – How to Stop Crony Capitalism

At its heart, crony capitalism is a large and rather obvious example of conflict-of-interest in action. The conventional approach has been to require politicians to put their investment activities into the hands of blind trusts which they neither influence nor know what's going on but this is a sham as well. Despite all the window dressing, these trusts are neither blind nor completely independent. Invariably, they are run by friends as trustees and privileged information finds its way to those trustees.

While judges, investment advisors, journalists and corporate executives have a bevy of financial regulations they must comply with when it comes to conflicts-of-interest, Congress does not. Why? The answer is simple: The U.S. Constitution gives authority to the House and Senate individually to "determine the rules of its proceedings, punish its members for disorderly behavior , and, with the concurrence of two thirds, expel a member." For all practical intents and purposes, this makes the members of Congress an untouchable political class. They are exempt from the laws they define for everybody else and therefore members of Congress have seized the opportunity to take advantage of some of the more obvious and more lucrative opportunities that come along. Self regulation has become a free for all and a scramble to accumulate a sizable personal nest egg while in public service.

Even beyond the more obvious conflicts-of-interest which are involved, Washington politicians are becoming highly adept at extortion. They threaten businesses, individuals and entire industries with harmful legislation which then gets withdrawn when campaign contributions are forthcoming. These are termed “juicer bills” or “milker bills”, so-named after their ability to “milk” campaign contributions and personal investment favors from businesses and industries. These are powerful weapons which politicians have no trouble using.

The founders anticipated the problems a permanent political class would impose on America. As James Madison stated in Federalist No. 57: *"I will add, as a fifth circumstance in the situation of the House of Representatives, restraining them from oppressive measures, that they can make no law which will not have its full operation on themselves and their friends, as well as on the great mass of society. This has always been deemed one of the strongest bonds by which human policy can connect the rulers and the people together. It creates between them that communion of interests and sympathy of sentiments, of which few governments have furnished examples; but without which every government degenerates into tyranny."*

The permanent political class are busy trying to convince us only they are capable of “running the country” or “managing the economy.” Therefore, their logic goes, America should be prepared for them to profit on the taxpayer’s dime. That’s the price of freedom, and a little bit of crony capitalism won’t matter in the long run. The problem with that train of thought is the concept and ideal America is supposed to be a nation ruled by laws, not by men. The notion that all are equal before the law and that laws should apply equally to everyone just don’t come into the equation. Simply put, the conflict-of-interest and insider trading laws which Congress applies to itself are inadequate.

Another variation of crony capitalism arises when retired politicians accept seats on the boards of directors of large corporations. A 2002 study showed more than 50% of Fortune 1000 companies have people with “government service experience” on their boards – predominantly Washington veterans who know the people at the executive and legislative levels of the government and who can provide helpful introductions and access. Numerous studies have also shown companies with board members who have affiliations to the party currently in power in Washington outperform the S&P 500 by a reasonable margin and this pattern has existed for quite some time. *“It's no coincidence that the realm of crony capitalism is populated by billionaire financiers and large corporations. As the economist Will Wilkinson puts it, "The more power the government has to pick winners and losers, the more power rich people will have relative to poor people." And crony capitalism is the ultimate system of wealth redistribution: poor and middle-class taxpayers subsidize the superrich. Call it trickle-up economics.”*

Another variation of crony capitalism comes about when the family of members of Congress get employed by companies to be their lobbyists. It was shown in 2009 that one-third of the United States Senate had family members who were registered as lobbyists or who worked for firms which were registered as lobbyists. Neither the lawmakers nor the lobbyists are under any legal obligation to disclose those family ties. *“The rule of law, and the notion that no one is above the law, is fundamental to a healthy democracy. If we accept crony capitalism with a shrug and an eye roll, we might as well accept a world of bribery and out-and-out vote buying. Crony capitalism has a corrosive effect on our politics, our economy, and our character. And we don't have to accept it. It's one thing to say that our country was founded on the Constitution—as in "back then." It is another thing entirely to grasp that the Constitution is a living contract, rooted in legal soil that makes it wrong for politicians to serve themselves and their cronies. It is high time we did some weeding.”*

The only practical way to break the cycle of crony capitalism is to put robust systems in place which will require politicians to abide by the same rules as everyone else. Specifically:

- The United States must create a legal code which makes trading on nonpublic government information illegal. This is now in place in Europe and it makes logical sense.
- Members of Congress should be required to publicly disclose all stock transactions above a threshold of say $5,000 within two days. This will make it easier to identify those situations where insider trading has taken place.
- Members of Congress should not be allowed to trade stock in companies which are overseen by their committees. There should be a blanket restriction on politicians buying and selling stocks where their decisions will potentially have an influence on future stock prices.
- Whistleblower laws should apply to Congress. If staffers see financial irregularities, they should be able to report them without fear of retaliation.
- "Sweetheart"deals on initial public offerings (IPOs) should also be disallowed. Unless an IPO goes through a public auction where anyone can openly bid for shares, members of Congress should not be able to participate in "special-friends" IPOs or anything of that nature.
- An urgent revision and update of conflict-of-interest laws is needed in the United States. While restricting individual stock trades for members of Congress who are serving on various committees is a good start, the situation where mutual funds are being used as the investment vehicle also needs to be included. Conflict-of-interest restrictions should also be applied even-handedly to senior White House officials and political appointees as well. Anyone who is in a position of influence to steer taxpayer money to a company they have an equity stake in should come under the reach of enhanced conflict-of-interest regulations.
- Earmarks where a member of Congress will receive a direct or indirect financial benefit should be disallowed, period. Under no circumstances should taxpayer money ever be used to boost the market value of properties owned by members of Congress This is an absolute no-brainer.
- The family members of legislators should not be allowed to become lobbyists.
- Campaign contributions should not be permitted whenever Congress is in session. Twenty-eight states have already placed restrictions on politicians receiving campaign contributions while the state legislature is in session and this commonsense idea should be applied at federal level as well. The aim here is to make it harder for politicians to extort money from businesses and this is an approach which works.
- The federal government needs to get out of offering grants and extending taxpayer-backed loans altogether. This has been a process which has been shrouded in secrecy – there's no clear criteria for getting these kinds of things and the decision making process has not been very transparent. This means loans and grants are a potential breeding ground for corruption, favoritism and cronyism. Furthermore, regulators shouldn't be trying to pick winners and losers. That's what the marketplace does best. The government should get out of the loans and grants business for good.

"The problems we face today are not the result of the individual failings of a few leaders. What we face is a system that is compromised by the perception that U.S. public policy is a marketable commodity. It's time to fix it. Let's relegate the Government Rich to the ashbin of history. If you want to get rich, do it the legitimate way. Go out and produce a useful good or service that you have a right to sell."

– Peter Schweizer

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