Financial Fraud Law Report

AN A.S. PRATT & SONS PUBLICATION

OCTOBER 2013

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POSTMASTER: Send address changes to the *Financial Fraud Law Report*, LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974. *ISBN: 978-0-76987-816-4*

Insider Trading in Mutual Funds: Do Traditional Theories Apply?

JAY BARIS, KELLEY HOWES, AND DANIEL NATHAN

The U.S. Court of Appeals for the Seventh Circuit recently reversed and remanded summary judgment granted to the Securities and Exchange Commission in a case alleging that a mutual fund's chief compliance officer improperly redeemed fund shares while in possession of material non-public information. The authors of this article discuss the case and its implications.

A federal court of appeals recently held out the possibility that insider trading prohibitions — at least under the classic theory — do not apply to mutual fund redemptions.

The U.S. Court of Appeals for the Seventh Circuit reversed and remanded summary judgment granted to the Securities and Exchange Commission ("SEC") in a case alleging that a mutual fund's chief compliance officer ("CCO") improperly redeemed fund shares while in possession of material non-public information. The appellate court directed the district court to address the novel issue of whether Section 10(b) of the Securities Exchange Act of 1934 applies to insider trading in mutual fund shares.

Whether traditional insider trading theories apply to mutual fund redemptions is mostly uncharted territory. In remanding the case for further consideration, the court said that insider trading approaches "fashioned in

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Published by Matthew Bender & Company, Inc. in the October 2013 issue of *Financial Fraud Law Report*. Copyright © 2013 Reed Elsevier Properties SA.

other areas may not be appropriate analytical models in the mutual fund context."

FACTS

The case involves redemptions by the CCO of the Heartland Short Duration Fund (the "Fund") in October 2000, at a time when illiquid securities in the Fund were under pricing pressure. The CCO, who also served as chief compliance officer of the Fund's investment adviser and a member of the adviser's pricing committee, routinely attended meetings of the Fund's board of directors. As CCO, she was also responsible for implementing the investment adviser's insider trading policy, which prohibited employees from trading on non-public information about the Fund's holdings, as well as on non-public information about the Fund itself.

Rule 22c-1(a) under the Investment Company Act of 1940 requires open-end investment companies ("mutual funds") to sell, redeem, or repurchase their shares at a price that is based on the current net asset value ("NAV") of the fund next computed after receipt of an order. For purposes of calculating NAV, "value" is defined to be either the market value of a security for which market quotations are readily available, or fair value as determined in good faith by the board of directors.

No secondary market exists for mutual funds; the funds are their own markets. Moreover, mutual funds must disclose in their prospectuses how they price fund shares, including when they fair-value securities when market prices are not readily available. Generally, mutual funds must limit the amount of illiquid holdings to no more than 15 percent of their net assets.

In this case, the Fund invested primarily in medium- and lower-quality municipal bonds. As the court noted, municipal bonds trade less frequently than other types of securities, and are not subject to the same federal disclosure requirements as corporations. As a result, they are relatively difficult to price, and the Fund relied heavily on a third-party pricing service that specialized in this type of security.

The trades at issue followed a period of market turmoil and substantial net redemptions in the Fund, which increased the percentage of illiquid securities held by the Fund. During this period, the Fund experienced difficulty

selling municipal bonds in its portfolio at their carrying price because many of the bonds had defaulted or were on watch for possible default, thus calling into question whether the securities' valuation reflected their fair value.

Although the pricing committee questioned whether valuations received from a third-party pricing service were accurate, it determined that it did not have "sufficient information to justify an override of any specific security." To generate emergency liquidity and reduce the percentage of non-performing bonds in the Fund's portfolio, the investment adviser arranged for a state securities fund to purchase a package of non-performing municipal bonds from the Fund at prices below those at which the bonds were carried in the Fund's portfolio, subject to the ability to "put" those bonds back to the Fund after two years at a guaranteed 20 percent return. While that transaction provided the Fund some breathing room, the third-party pricing service at about the same time told the Fund that it expected to adjust valuations of certain portfolio securities downward. On the day the Fund publicly announced the transaction with the state fund, the Fund's NAV dropped by approximately two percent.

Several days later, the CCO placed an order to redeem all of her holdings in the Fund. About a week later, the Fund's board and the pricing committee met to discuss the ongoing challenge of determining fair values for the Fund's holdings and the relative illiquidity of the market for certain bonds held by the Fund. Subsequently, the pricing committee, meeting without the CCO, applied across-the-board "haircuts" on bonds held in the Fund, despite concerns that the "haircuts" might be inconsistent with the CCO's instructions to fair-value those securities. As a result of these haircuts, the Fund's NAV dropped by 44 percent.

The district court granted summary judgment for the SEC on insider trading charges against the CCO — itself a highly unusual event — finding that there were no genuine issues of fact that the CCO possessed material information or that she had acted with scienter.

APPLICATION OF INSIDER TRADING LAWS

The circuit court identified the three elements of insider trading that constitute a violation of Section 10(b) and Rule 10b-5. Did the CCO:

1. Make a material misrepresentation or a material omission as to which she had a duty to speak, or use a fraudulent device;
2. With scienter;
3. In connection with the purchase or sale of securities?

Under the traditional theory of insider trading, a corporate insider violates Section 10(b) when she trades in the securities issued by her employer on the basis of material, non-public information. An insider in possession of material non-public information has a duty to disclose the information to its counterparty or to abstain from trading. Under the misappropriation theory, a "corporate outsider" violates Section 10(b) when she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information.

The court dispensed with the traditional insider trading theory fairly quickly, based on two significant points:

- "Mutual fund shares are traded very differently than other securities, with less opportunity for unfair gain based on non-public information." There is no secondary market in mutual fund shares: the fund itself issues and redeems them. As a result, "there is less reason for concern about unfair informational disparity between trading parties." If a mutual fund insider has gained access to material non-public information, then the fund itself would also be in possession of that information and therefore cannot be deceived by the trader. Thus, the SEC brings very few insider trading cases involving trading in mutual fund shares.
- A mutual fund's NAV is derived from the value of the underlying securities held in the fund's portfolio, not based on information about the fund itself, and therefore non-public information about the internal operations of a mutual fund is less likely to be material.

Perhaps based on the same reasoning recited by the circuit court, the SEC dropped the classical theory of insider trading on appeal, and argued instead that the CCO's conduct fit under the misappropriation theory of insider trading. But the SEC did not raise the misappropriation theory in the district court, and thus the defendant did not have an opportunity to refute that theory. Con-

sequently, the Court of Appeals remanded the case to the lower court to decide whether to apply the misappropriation theory. In so doing, however, the court appeared skeptical of applying the misappropriation theory in the context of mutual fund redemptions. For example, the court suggested that the district court should ask the SEC to explain why the CCO is an "outsider" for the purposes of the misappropriation theory, "given the investment adviser's deeply entwined role as sponsor and external manager of the fund."

MATERIALITY

Under prevailing case law, a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" whether to purchase or sell a security, and if there is "a substantial likelihood that the disclosure of [that] fact could have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[1]

The court agreed with the district court that certain information in the CCO's possession, *standing alone*, was material as a matter of law. The court found, however, that the lower court did not weigh the significance of the non-public information in the context of "considerable publicly available information regarding the Fund's poor performance." For example:

- The two percent decline in the Fund's NAV in late September 2000 attracted negative news coverage that "touched upon many of the categories of information that the district court found to be material as a matter of law."
- In late September, Morningstar published an article regarding the departure of the prior co-portfolio manager and the Fund's NAV decline.
- The Fund's prospectus and semi-annual report dated June 2000, included information concerning the Fund's problems with net redemptions and declining net assets.
- The Fund disclosed that illiquid holdings could represent up to 15 percent of its net assets, and at no time did the Fund's illiquid holdings exceed 11 percent.

The court said that whether the non-public information that the CCO possessed was material must be analyzed in light of the information publicly available: "[W]e think an assessment of the marginal impact that negative non-public information would have on an already highly pessimistic public forecast is 'peculiarly' one for the trier of fact."

SCIENTER

The court also disagreed with the district court's finding as a matter of law that the CCO acted with scienter. The court noted that the case is unusual because the defendant was charged with insider trading for a sale that took place *after* a series of price declines. The court suggested that the question is whether she knew or recklessly disregarded the possibility that Fund shares remained overpriced despite price declines that took place prior to her sale. The court said, "insiders are permitted to make rational investment choices based on information available in the market; [Section] 10(b) certainly does not require an insider to go down with the company ship when the public knows just as well that it is sinking." Thus, the question to be determined on remand is whether the public knew "just as well" that this particular ship was, in fact, sinking.

OBSERVATIONS

This case represents an unusual legal question: can mutual fund insiders violate traditional theories of insider trading? Mutual fund advisers, underwriters, investors, and their counsel will watch this case with great interest.

The case also provides some lessons for mutual funds, their officers, and their service providers:

- Mutual funds should remember the importance of the underlying obligation to fair-value portfolio securities, particularly in times of market distress and turmoil. Indeed, as recent enforcement activity has shown, this is when the obligation — and board oversight of that obligation — is the most significant.
- On occasion, mutual fund officers and directors, and their service pro-

viders, may possess material non-public information involving mutual fund shares. This information may involve portfolio securities, corporate actions, tax issues or dividends, among other things, and could give them an unfair advantage if they act on the information before it becomes public. The officers and directors may improperly benefit from this information if they realize a profit or avoid a loss by trading on that information. While trading on this information may not necessarily violate Section 10(b), it may violate their fiduciary duty to the fund. Mutual funds should consider whether their codes of ethics adequately address this possibility.

- The SEC has made it clear that it intends to hold gatekeepers to a higher standard, and this CCO's position as an attorney and compliance officer is a significant factor in considering whether she had the requisite scienter.
- A key consideration in any insider-trading case is whether the non-public information is material. This question may turn on the level of public information that was available to shareholders. Mutual funds, their service providers and their boards should consider not only their own disclosure obligations, but also other information available to the public when considering whether their risk disclosure is adequate.

NOTE

[1] *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988).