



# Financial Fraud Law Report

**AN A.S. PRATT & SONS PUBLICATION**

**OCTOBER 2013**

**HEADNOTE: FINANCIAL FRAUD AROUND THE GLOBE, AND IN CYBERSPACE**

Steven A. Meyerowitz

**SPOTLIGHT ON SOUTHEAST ASIA**

Andrew M. Levine, Christopher K. Tahbaz, Bruce E. Yannett, Philip Rohlik, and Xia Li

**WHAT IS THE FUTURE OF BITCOIN? THE ONLINE CURRENCY FACES REGULATORY SCRUTINY AND CONCERNS ABOUT FRAUD**

H. David Kotz

**INSIDER TRADING IN MUTUAL FUNDS: DO TRADITIONAL THEORIES APPLY?**

Jay Baris, Kelley Howes, and Daniel Nathan

**PCAOB PROPOSES NEW AUDITING STANDARDS RELATING TO THE AUDIT REPORT AND AUDITOR RESPONSIBILITIES REGARDING OTHER INFORMATION IN ANNUAL REPORTS**

Todd E. Freier, Jonathan A. Koff, and William M. Libit

**SEC ADOPTS SWEEPING CHANGES TO BROKER-DEALER FINANCIAL RESPONSIBILITY, REPORTING AND AUDIT RULES**

Hoyt Stastney

**SEC ELIMINATES THE BAN ON GENERAL SOLICITATION, AND DISQUALIFIES PARTICIPATION BY "BAD ACTORS," IN CERTAIN PRIVATE SECURITIES OFFERINGS**

Lily J. Lu and Theresa Nguyen

**WHY FINANCIAL INSTITUTIONS SHOULD THINK ABOUT ANTITRUST LENIENCY**

Wendy Huang Waszmer, James M. Griffin, and Grace Rodriguez

**CIRCUIT COURT ADOPTS NARROW INTERPRETATION OF ANTI-RETALIATION PROVISION OF DODD-FRANK WHISTLEBLOWER RULES**

Jyotin Hamid, Mary Beth Hogan, Jonathan R. Tuttle, and Ada Fernandez Johnson

**POTENTIAL CIRCUIT SPLIT CREATES AN UNCERTAIN FUTURE FOR WHISTLEBLOWER PROTECTION OF INTERNAL REPORTING**

Gayle Argon, Greg Little, and Owen Pell

**COURT REJECTS CORPORATE PLEA AGREEMENTS FOR FAILING TO SUFFICIENTLY PROTECT THE PUBLIC INTEREST**

Reid J. Schar, Robert R. Stauffer, Tiffany M. Cartwright, and Eddie A. Jauregui

**WHY ATTORNEYS USE FORENSIC ACCOUNTANTS IN LITIGATION CASES**

Mark S. Warshavsky

## EDITOR-IN-CHIEF

**Steven A. Meyerowitz**

*President, Meyerowitz Communications Inc.*

## BOARD OF EDITORS

**Frank W. Abagnale**

Author, Lecturer, and Consultant  
Abagnale and Associates

**William J. Kelleher III**

Corporate Counsel  
People's United Bank

**Sareena Malik Sawhney**

Director  
Marks Paneth & Shron LLP

**Stephen L. Ascher**

Partner  
Jenner & Block LLP

**James M. Keneally**

Partner  
Kelley Drye & Warren LLP

**Mara V.J. Senn**

Partner  
Arnold & Porter LLP

**Thomas C. Bogle**

Partner  
Dechert LLP

**H. David Kotz**

Director  
Berkeley Research Group, LLC

**John R. Snyder**

Partner  
Bingham McCutchen LLP

**David J. Cook**

Partner  
Cook Collection Attorneys

**Richard H. Kravitz**

Founding Director  
Center for Socially  
Responsible Accounting

**Jennifer Taylor**

Partner  
McDermott Will & Emery LLP

**David A. Elliott**

Partner  
Burr & Forman LLP

**Frank C. Razzano**

Partner  
Pepper Hamilton LLP

**Bruce E. Yannett**

Partner  
Debevoise & Plimpton LLP

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by Matthew Bender & Company, Inc. Copyright 2013 Reed Elsevier Properties SA., used under license by Matthew Bender & Company, Inc. All rights reserved. No part of this journal may be reproduced in any form — by microfilm, xerography, or otherwise — or incorporated into any information retrieval system without the written permission of the copyright owner. For permission to photocopy or use material electronically from the *Financial Fraud Law Report*, please access [www.copyright.com](http://www.copyright.com) or contact the Copyright Clearance Center, Inc. (CCC), 222 Rosewood Drive, Danvers, MA 01923, 978-750-8400. CCC is a not-for-profit organization that provides licenses and registration for a variety of users. For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., PO Box 7080, Miller Place, NY 11764, [smeyerow@optonline.net](mailto:smeyerow@optonline.net), 631.331.3908 (phone) / 631.331.3664 (fax). Material for publication is welcomed — articles, decisions, or other items of interest. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.

POSTMASTER: Send address changes to the *Financial Fraud Law Report*, LexisNexis Matthew Bender, 121 Channon 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

---

Jay Baris is a partner at Morrison & Foerster LLP, and chair of the firm’s investment management practice. Kelley Howes serves as of counsel within the firm’s investment management practice. Daniel Nathan is a partner in the firm’s securities litigation, enforcement and white-collar defense group. The authors may be contacted at [jbaris@mofo.com](mailto:jbaris@mofo.com), [khowes@mofo.com](mailto:khowes@mofo.com), and [dnathan@mofo.com](mailto:dnathan@mofo.com), respectively.

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.”<sup>1</sup>

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

<sup>1</sup> *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988).