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Insider Trading in Mutual Funds

The Securities and Exchange Commission ("Commission" or "SEC") has recently attempted to establish a new form of insider trading: the use of nonpublic information about mutual fund portfolio holdings to engage in fund arbitrage. In a series of settled cases, the Commission has alleged that six mutual fund managers violated section 204A of the Investment Advisers Act of 1940 ("Advisers Act")[1] by selectively disclosing material, nonpublic information about their funds' portfolio holdings to fund arbitrageurs.[2] The Commission has asserted that arbitrageurs used the information to engage in insider trading to the detriment of other shareholders of the funds.[3] This Article argues that information about a fund's portfolio holdings is not, how-

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[1] 15 U.S.C. § 80b-4a (2000).

[2] *See* Banc One Inv. Advisors Corp., Investment Company Act Release No. 26,490, 83 SEC Docket 695, 84 SEC Docket 2404, 2004 WL 1472043 (June 29, 2004); Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874 (June 21, 2004); Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 82 SEC Docket 3178, 2004 WL 1124933 (May 20, 2004); Complaint, SEC v. PIMCO Advisors Fund Mgmt. L.L.C., 04 Civ. 3464 (VM) (S.D.N.Y. May 6, 2004); Putnam Inv. Mgmt., L.L.C. (Putnam II), Investment Company Act Release No. 26,412, 82 SEC Docket 2225, 2004 WL 865794 (Apr. 8, 2004); Alliance Capital Mgmt., L.P. (Alliance II), Investment Company Act Release No. 26,312A, 81 SEC Docket 3401, 2004 WL 67564 (Jan. 15, 2004) (amending Dec. 18, 2003 order); Alliance Capital Mgmt., L.P. (Alliance I), Investment Company Act Release No. 26,312, 81 SEC Docket 2800, 2003 WL 22988724; Putnam Inv. Mgmt., L.L.C. (Putnam I), Investment Company Act Release No. 26,255, 81 SEC Docket 1913, 2003 WL 22683975 (Nov. 13, 2003). The Commission also settled claims against one fund manager's CEO for aiding and abetting the manager's section 204A violation. *See* Harold J. Baxter, Exchange Act Release No. 50,681, Investment Company Act Release No. 26,656, 84 SEC Docket 340, 2004 WL 2609265, at *2, *5 (Nov. 17, 2004).

[3] *See, e.g.*, *Pilgrim Baxter*, 83 SEC Docket 363, 2004 WL 1379874 (through defendant, arbitrageurs were provided with nonpublic information about fund holdings that they used to facilitate fund arbitrage).

ever, inside information for purposes of insider trading and section 204A and that the SEC's selective disclosure cases would be summarily dismissed if actually litigated.

Insider trading assumes that there is "inside" information to which the market is not privy, but information about a fund's portfolio does not provide such inside information. When a trader has inside knowledge about an operating company's positive prospects that is not reflected in the company's share price, the trader can profit by buying the company's stock while the information is still nonpublic and then selling it for a profit after the information has been released and incorporated into the stock price.[4] In contrast, inside knowledge about the contents of a fund's portfolio by itself reveals nothing about what the value of the fund's shares will be in the future.

Mutual fund arbitrage depends on the availability of opportunities to purchase fund shares at a discount, which occurs only when the fund violates applicable pricing and sales rules. Mutual fund shares are not traded on a secondary market but are required to be sold only at their next computed per share net asset value.[5] If a fund undervalues its shares or sells shares at previously computed prices, in each case in violation of applicable rules, traders can buy shares at prices that understate their current value and sell them at a profit the next day when the pricing error is corrected. Access to information about a fund's portfolio holdings can facilitate such arbitrage, but it is not a necessary element for successful fund arbitrage and is never sufficient. If a fund complies with pricing and sales rules, fund arbitrage is not possible, regardless of how much information is selectively disclosed about the fund's portfolio.

These pricing and sales rules, as well as the mechanics of fund arbitrage and the use of fund portfolio information in arbitrage, are discussed in Part I of this Article. Part II argues that selective disclosure of the contents of a fund portfolio does not constitute the kind of misuse of material, nonpublic information that

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[4] *See* Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1431 (1967).

[5] For purposes of this Article, the term "mutual fund" does not include an exchange-traded fund. An exchange-traded fund is a mutual fund that permits the direct purchase and redemption of its shares only in very large aggregations. The shares of ETFs trade on exchanges, like stocks. *See generally* iShares, Inc., Investment Company Act Release No. 25,595, 67 Fed. Reg. 38,684 (June 5, 2002). *See also infra* text accompanying notes 100-13.

section 204A is intended to prevent but that selective disclosure of inside information about fund transactions or valuations (as opposed to portfolio holdings) may trigger section 204A liability. Part III contends that the SEC's new rules regarding funds' portfolio disclosure policies are as misguided as its selective disclosure prosecutions in that both the rules and prosecutions misunderstand the true source of the harm caused by arbitrage. Fund arbitrage is enabled not by selective disclosure of portfolio information but by funds' violations of applicable pricing and sales rules, and it is on these rules, not funds' portfolio disclosure practices and policies, that the Commission should focus its efforts.

I
Background

To understand the dynamics of insider trading in mutual fund shares, it is necessary to understand the rules under which mutual fund shares are priced and sold. Mutual fund prices are fixed, and the sale of fund shares is strictly regulated under the Investment Company Act of 1940,[6] the primary statute governing the operation and distribution of mutual funds.

A. Transactions in Mutual Fund Shares

Mutual funds act as intermediaries between investors and the securities markets. Investors purchase shares of a fund from the fund itself, and the fund generally invests the proceeds of these purchases in a diversified pool of securities. Fund shareholders own a pro rata interest in the fund and generally share the fund's investment returns and expenses in proportion to the size of their ownership interest. This sharing of expenses can create economies of scale in both the administration of the fund and the transaction costs incurred in investing the fund's assets in the securities markets. The mutual fund form thus enables investors to own an interest in a diversified pool of securities that can minimize transaction costs through the economies of scale generated by spreading costs over a large asset base.

Mutual funds also offer liquidity. A mutual fund is defined as an "open-end" investment company, which is a company that "is

[6] 15 U.S.C. §§ 80a-1 to 80a-64 (2000).

offering for sale or has outstanding any redeemable security."[7] A holder of a "redeemable security" is entitled "to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."[8] The fund must stand ready to redeem shares at their market value, or per share "net asset value" (NAV), and pay the redemption proceeds within seven days of tender of the shares.[9] Mutual fund shareholders are thus assured that they can sell their shares at their net asset value on short notice, a feature that is an important contributor to the enormous popularity of mutual funds.[10]

When calculating a fund's net asset value, its portfolio securities must be valued, if "market quotations are readily available," at their current market value.[11] If market quotations are not readily available, portfolio securities must be valued based on their "fair value as determined in good faith by the [fund's] board of directors."[12] Funds choose the time or times of day as of which they price their shares, but in practice, virtually all funds price their shares once a day as of 4:00 p.m. eastern standard time.[13] Fund shares must be sold by the funds and their distributors at their per share NAV, and there is no secondary market for fund shares.[14] This means that all fund sales and redemptions

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[7] 15 U.S.C. § 80a-5(a)(1).

[8] *Id.* § 80a-2(a)(32).

[9] *See id.* § 80a-22(e).

[10] Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328 (proposed Mar. 18, 2005) (to be codified at 17 C.F.R. pt. 270) ("[R]edemption right makes funds attractive to fund investors, most of whom are long-term investors, because it provides ready access to their money if they should need it."). Mutual fund assets exceed $8.1 trillion. *See* Investment Company Institute, *Trends in Mutual Fund Investing, December 2004*, Jan. 28, 2005, http://www.ici.org/stats/latest/trends_12_04.html.

[11] 17 C.F.R. § 270.2a-4(a)(1) (2005).

[12] *Id.*

[13] A small minority of funds price their shares more than once each day, *see, e.g.*, FIDELITY INVESTMENT, AVAILABLE PRODUCTS: FIDELITY SELECT PORTFOLIOS, http://personal.fidelity.com/products/funds/content/sector/products.shtml (last visited Oct. 30, 2005) (stating policy of calculating fund's NAV once every hour during the business day), and/or price their shares at times other than 4:00 p.m. For example, the Guinness Atkinson Asia Focus Fund and Guinness Atkinson China & Hong Kong Fund calculate their prices at 12:30 a.m. *See* Guinness Atkinson Funds, Prospectus, Apr. 30, 2005, at 20, http://www.gafunds.com/prospectus.pdf. These funds price their shares early in the morning to prevent pricing arbitrage, as discussed *infra* at text accompanying notes 23-28. For purposes of simplicity, this Article assumes that all funds price their shares at 4:00 p.m. eastern standard time, although this is not required.

[14] *But see* Ilana Polyak, *PSSST, Buddy, Wanna Hot Share in a Long-Closed Mu-*

occur at their per share NAV.

Finally, mutual funds are required to use forward pricing. This means that funds are required to execute purchases and redemptions at a price based on the fund's per share net asset value "which is next computed after receipt of . . . tender."[15] If a purchase or sale order is submitted at 4:01 p.m., it must be assigned the next day's 4:00 p.m. price. The Commission has prohibited funds from selling shares at previously calculated, or "backward," prices to protect fund shareholders from dilution of their interests. Before this prohibition was enacted, traders were permitted to purchase shares at backward prices, and when positive information about the fund's portfolio securities was released after the time as of which the fund was priced, these traders would profit at the expense of the other shareholders.[16] The Commission recently has brought a number of cases that allege that investors and brokers violated the forward pricing rule by assigning the fund's 4:00 p.m. price to orders that were received after 4:00 p.m.[17]

When funds sell and redeem their shares in accordance with the foregoing rules, traders generally cannot exploit inside information about the contents of a fund's portfolio to gain an advantage in trading shares of the fund. If fund shares are accurately priced at their current market value and trades occur only at forward ("next computed") prices, then inside information about the fund portfolio provides no additional insight into the true value of the fund. Inside information about an operating company can provide reliable insight into its future market price, but

tual Fund? Secondary Market – Ebay, too – Has Funds Otherwise Unavailable, INVESTMENT NEWS, Oct. 11, 1999, at 13 (describing black market in shares of mutual funds that are closed to new investors).

[15] 17 C.F.R. § 270.22c-1(a) (2005). The Commission has proposed to replace the phrase "which is next computed" with "established as of the next pricing time" to clarify that the relevant time is not the time the fund's pricing staff actually "computes" the value of the fund, which is completed after 4:00 p.m., but the time "as of which" the fund's value is computed. Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388, 70,391 n.26 (Dec. 17, 2003).

[16] *See* Markovitz, Exchange Act Release No. 48,588, Investment Company Act Release No. 26,201, 81 SEC Docket 450, 2003 WL 22258425, at *2 (Oct. 2, 2003) ("[T]he late trader obtains an advantage—at the expense of the other shareholders of the mutual fund—when he learns of information and is able to purchase (or sell) mutual fund shares at prices set *before* the information was available."). This practice is now known as "late trading," discussed *infra* Part I.B.

[17] *See, e.g.*, *id.*

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fund portfolio information by itself generally cannot provide reliable insight into the fund's future per share NAV. As discussed below, however, portfolio information can be useful to traders when fund prices are miscalculated or traders are permitted to purchase shares at backward prices.

B. The Mechanics of Fund Arbitrage

The SEC's mutual fund insider trading cases involve situations in which fund prices were mispriced and traders were permitted to purchase shares at backward prices. Such mispricing and backward pricing enable two kinds of fund arbitrage: pricing arbitrage, and late trading, the mechanics of which are briefly described below.[18]

Late trading occurs when funds permit backward pricing in violation of the forward pricing rule,[19] that is, they permit an investor to purchase fund shares after the time as of which the fund is priced.[20] Late trading enables the arbitrageur to base his decision on market events that occur after the time as of which the fund's price was calculated.[21] Companies in which funds invest often release market-moving information, such as earnings announcements, after the close of the New York Stock Exchange at 4:00 p.m.[22] If the post-4:00 p.m. information is positive, the resulting increase in the value of the company's stock will also increase the value of the fund's portfolio. The late trader purchases the fund's shares at the old 4:00 p.m. price, which is the

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[18] The mechanics of fund arbitrage are explained more fully in Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUSTON L. REV. (forthcoming 2006).

[19] *See supra* text accompanying notes 14-16; *Markovitz*, 81 SEC Docket 450, 2003 WL 22258425, at *2.

[20] *See Markovitz*, 81 SEC Docket 450, 2003 WL 22258425, at *2 ("'Late trading' refers to the practice of placing orders to buy or sell mutual fund shares after 4:00 p.m. ET, the time as of which mutual funds typically calculate their NAV, but receiving the price based on the prior NAV already determined as of 4:00 p.m.").

[21] *See id.* ("[T]he late trader obtains an advantage—at the expense of the other shareholders of the mutual fund—when he learns of information and is able to purchase (or sell) mutual fund shares at prices set *before* the information was available.").

[22] For example, on August 12, 2004, Hewlett-Packard reported lower-than-expected net income, and its stock fell 14%, driving down the price of other tech stocks and the NASDAQ Composite to its one-year low. Dell's stock declined $0.40/share. After the market closed, however, Dell announced a 29% increase in second-quarter profits. The next day, the NASDAQ rose and Dell gained $1.39/share, or 4.2%. *See* Tom Walker, *Oil Prices, Not Profits, Driving Stocks*, MILWAUKEE J. & SENTINEL, Aug. 14, 2004, at 10C, *available at* 2004 WLNR 47010666.

practical equivalent of buying them at a discount. The late trader sells the shares the next day and, assuming no subsequent changes in the fund's value, pockets a profit equal to the amount of the discount. Late traders typically have been hedge funds or other large institutional traders that have developed relationships with brokers who permit them to effect post-4:00 p.m. purchases.[23]

Pricing arbitrage involves the purchase of a fund's shares when the shares are mispriced in violation of fund pricing rules.[24] This may occur, for example, when a fund invests in securities traded on a foreign exchange that closes before the fund is priced at 4:00 p.m. If an event occurs after the foreign exchange closes that affects the value of the fund's portfolio ("arbitrage event"), market quotations for the fund's portfolio are not readily available,[25] and the fund accordingly must value its portfolio based on its "fair value as determined in good faith by the [fund's] board of directors."[26] If the fund fails to fairly value its portfolio and instead uses stale closing prices on the foreign exchange to calculate its net asset value as of 4:00 p.m., then its price will be inaccurate and in violation of the Investment Company Act.[27] If the arbitrage event reflects positively on the value of the fund's portfolio, the fund's price will be too low, and purchasers will buy the fund's shares at a discount.[28] If such purchasers sell their

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[23] *See, e.g.*, Banc of America Capital Mgmt., L.L.C., Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, 84 SEC Docket 2780, 2005 WL 310459, at *17 (Feb. 9, 2005) (broker permitted hedge fund to purchase fund shares after 4:00 p.m.).

[24] *See supra* text accompanying notes 10-13.

[25] *See* Letter from Douglas Scheidt, Assoc. Dir. and Chief Counsel, Div. of Inv. Mgmt., U.S. Sec. and Exch. Comm'n, to Craig S. Tyle, Gen. Counsel, Inv. Co. Inst., at Part I.C (Apr. 30, 2001), *available at* http://www.sec.gov/divisions/investment/ guidance/tyle043001.htm. ("If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund's NAV calculation, then the closing price for that security would not be considered a 'readily available' market quotation, and the fund must value the security pursuant to a fair value pricing methodology.").

[26] *Id.*

[27] *See supra* text accompanying notes 10–13.

[28] Pricing arbitrageurs "take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase." Letter from Douglas Scheidt to Craig S. Tyle, *supra* note 25, at n.7 ("Low trading volume of securities in some foreign markets raises issues as to the reliability of the market quotations and can trigger the requirement to fair value price those securities."). The identification of the differences between price and value is, of course, precisely the type of conduct in the marketplace that is normally rewarded, and some com-

shares the next day, assuming no subsequent changes in the fund's value, they will pocket a profit equal to the amount of the discount. Pricing arbitrageurs have included retail and institutional investors alike, as no special access to a fund-trading mechanism is needed.[29]

The late trader's and pricing arbitrageur's profits come directly from the pockets of the fund's other shareholders. Each form of fund arbitrage effectively entails purchasing an interest in a pool of securities at a discount, which dilutes the interests of the other shareholders in the amount of the discount. To illustrate, if a fund had a net asset value of $10, with one shareholder who holds the fund's one outstanding share, and the fund mispriced its portfolio and sold a second share to an arbitrageur for $5, the first shareholder's interest would be diluted. After the transaction, the fund will have a net asset value of $15 and two outstanding shares, each of which will be worth $7.50. The arbitrageur will have paid $5 for an interest worth $7.50. The first shareholder's share that was worth $10 is now worth $7.50. His $2.50 loss matches precisely the arbitrageur's $2.50 gain.

C. The Role of Portfolio Information in Fund Arbitrage

Fund arbitrageurs can benefit from knowing a fund's portfolio

mentators have taken this view of pricing arbitrage as well. *See, e.g.*, Frank Partnoy, *The Real Mutual Fund Problem*, SAN DIEGO UNION-TRIB., Dec. 5, 2003, at B-7 ("Late trading and market timing are neither new nor the result of a change in culture at funds. Instead, this 'arbitrage' activity—buying low and selling high—is, and long has been, a rational response to the once-a-day pricing rule."). "Mutual funds are not markets, however, but cooperative enterprises in which shareholders are not and should not be permitted to buy and sell shares at inaccurate prices." Bullard, *supra* note 18, at n.88.

[29] For example, dozens of members of the Boilermakers Union engaged in pricing arbitrage on a regular basis, with one member taking over $1 million in profits over a three-year period. *See* Administrative Complaint at Pts. II, V, VII, *Putnam II*, Investment Company Act Release No. 26,412, 82 SEC Docket 2225, 2004 WL 865794 (Apr. 8, 2004) (No. E-2003-061) (discussing that frequent trading in 401(k) funds by members of the Boilermakers Local Lodge No. 5 "was so prolific that the last hour of the trading day became known internally as boilermaker hour at Putnam's Norwood office"; 2.9% of plan participants accounted for "99% of the exchanges in International Voyager, 99% of the International Growth exchanges, and 98% of the money market exchanges"), *available at* http://www.sec.state.ma.us/ sct/ sctpdf/putnamcomplaint.pdf; *see also* Barry P. Barbash, Dir., Div. of Inv. Mgmt., Remarks at the 1997 ICI Securities Law Procedures Conference (Dec. 4 1997) (transcript available at http://www.sec.gov/news/speech/speecharchive/1997/ spch199.txt) ("fairly large numbers of investors" attempted to exploit arbitrage opportunities); Alan J. Wax, *Fund Pricing 'Fair,' But Late*, NEWSDAY, Oct. 31, 1997, at A69 (stating that T. Rowe Price Funds used fair valuation procedures).

holdings, but portfolio information often is not necessary and is never by itself sufficient for fund arbitrage to succeed. First, arbitrageurs can more accurately predict the effect that market-moving information will have on a fund's portfolio if they know what securities the portfolio holds. The late trader needs to know whether a fund holds the securities of companies that have released market-moving information after the markets have closed to determine whether the release of the information will affect the value of the portfolio.[30] For example, if Microsoft announces higher-than-expected earnings at 6:00 p.m., the late trader needs to know whether the fund owns Microsoft shares to determine whether purchasing the fund's shares at its 4:00 p.m. price would be a bargain.

Similarly, the pricing arbitrageur may need information about the contents of a fund's portfolio in order to determine whether the arbitrage event occurring after the close of foreign markets will affect the value of the portfolio. For example, if positive returns in the U.S. markets signal that Asian stock prices will open higher the next day, the pricing arbitrageur needs to know whether the fund owns Asian stocks to determine whether the fund's 4:00 p.m. price, which is based on the prior day's closing prices on the Asian exchanges, is too low. The arbitrageur also benefits from having more current portfolio information because the more current the information, the greater the arbitrageur's certainty that the price he pays for the fund's shares understates its market value.

Second, traders may use portfolio information to construct derivative positions that reduce their market risk.[31] When arbitrageurs purchase fund shares, they take the risk that after the purchase the value of the fund will fall, thereby saddling them with a loss upon selling the shares the next day. When Microsoft makes a positive earnings announcement at 6:00 p.m., a late trader can purchase shares of a fund that has a large position in

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[30] Although none of the SEC's selective disclosure cases have included allegations of late trading, its theory of the cases, and this Article's critique thereof, applies equally in the late trading context as in the pricing arbitrage context.

[31] *See* Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874 (June 21, 2004) (arbitrageurs used portfolio information to "create derivative securities baskets that allowed them to simulate short positions in the PBHG Funds and thereby create profitable hedging transactions through other financial institutions"); Peter Elkind, *The Secrets of Eddie Stern*, FORTUNE, Apr. 19, 2004, at 106.

Microsoft at the fund's 4:00 p.m. price, but the trader cannot sell those shares until 4:00 p.m. the next day. The trader is exposed to the market risk that Microsoft stock or other stocks in the fund's portfolio will decline in value the next day, which will cause the fund's NAV to decline from its previous day's 4:00 p.m. price, thereby leaving the trader with a loss. An arbitrageur can reduce or eliminate this market risk by taking a short position, as of 6:00 p.m., in a basket of securities that matches the fund's holdings, which will offset any decline in the portfolio's value after 6:00 p.m., thereby locking in the profit represented by the difference between the fund's 4:00 p.m. share price and its 6:00 p.m. value.

The typical arbitrage scenario involves a situation where fund shares are underpriced, but portfolio information also can be used to profit even when fund shares are overpriced. An arbitrageur can use portfolio information to generate profits when the fund's net asset value is inflated (i.e., adverse arbitrage events reflect negatively on the value of the fund's portfolio), or the market-moving information released after 4:00 p.m. is negative, by entering an order to purchase shares of the fund every day by 4:00 p.m. and constructing a derivative short position in the fund's portfolio securities. If there is an adverse arbitrage event or a post-4:00 p.m. release of negative information, the trader cancels the fund order and cashes out the now-profitable short position.[32] The arbitrageur can still profit if the arbitrage event or post-4:00 p.m. information has a positive effect on the portfolio by closing out the derivative position[33] and pocketing the gains realized upon selling the fund shares the next day.

Portfolio information is helpful, but by no means necessary, for fund arbitrageurs to ply their trade. For example, traders can successfully arbitrage stale-priced Asian stock funds by simply buying shares every day that the S&P 500 significantly rises, with only the knowledge that the fund invests in Asian stocks and without any special access to portfolio information, public or

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[32] *See, e.g.*, Powell, Exchange Act Release No. 51,017, Investment Company Act Release No. 26,722, 84 SEC Docket 2346, 2005 WL 53296, at *3 (Jan. 11, 2005) (late trader engaged in "next–day busting," i.e., canceling orders after 4:00 p.m. that had been submitted before 4:00 p.m.).

[33] As noted above, the arbitrageur might keep open a derivative position as a hedge against a decline in the value of the fund's portfolio between the time of the arbitrageur's purchase of fund shares and the time at which the arbitrageur sells the shares the next day. *See supra* text accompanying note 30.

nonpublic.[34] Even when portfolio information is helpful, the assistance it provides does not depend on its having been selectively disclosed. Publicly available information about a fund's quarterly portfolio holdings, for example, is no less helpful to arbitrageurs than selectively disclosed quarterly portfolio information. In practice, however, arbitrageurs may benefit by access to portfolio information that is provided more frequently (e.g., monthly) or that is more current information (e.g., thirty rather than sixty days old) than information that is publicly available. Such special access to portfolio information can be helpful, however, when the amount of the discount at which the arbitrageur purchases the fund's shares is small, and the added certainty provided by access to recent portfolio holdings may be decisive in an arbitrageur's decision as to whether the trade will be profitable. Special portfolio access makes it easier to determine when profitable arbitrage opportunities are available.

Although fund portfolio information can be helpful, it is never sufficient. Successful fund arbitrage depends critically on the opportunity to purchase fund shares at a backward price (late trading) or a stale price (pricing arbitrage). If neither opportunity exists, access to fund portfolio information provides no useful information to the fund arbitrageur. Neither access to nor disclosure of fund portfolio information plays any role in the existence of either arbitrage opportunity.

II

Insider Trading on Mutual Fund Portfolio Information

The Commission has used enforcement and regulatory measures to address the selective disclosure of portfolio information to fund arbitrageurs. As noted above, the Commission has brought a number of enforcement actions on the ground that the selective disclosure of portfolio information violated section 204A of the Investment Advisers Act.[35] Section 204A generally requires that investment advisers implement procedures that are

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[34] *See* William N. Goetzmann, Zoran Ivkovich & Geert Rouwenhorst, *Day Trading International Mutual Funds: Evidence and Policy Solutions*, 10–11 (Yale Sch. of Mgmt., Working Paper No. ICF-00-03, 2000), *available at* http://ssrn.com/abstract=217168 (discussing that the strategy of buying stale-priced global equity fund when the performance of the S&P 500 index was positive generated substantially higher returns at lower risk).

[35] 15 U.S.C. § 80b-4a (2000).

designed to prevent the misuse of material, nonpublic information by the adviser and its affiliates. The Commission also adopted new disclosure rules regarding the disclosure of funds' policies and procedures relating to the disclosure of funds' portfolio information, which are discussed in Part III.

A. Background

There is a certain irony to the portfolio disclosure cases in that funds are actually *required* to make their portfolio holdings publicly available. At the time of the conduct underlying the alleged insider trading, funds were required to file with the Commission and send to shareholders semiannual reports that included a list of the funds' portfolio holdings.[36] This list had to be made public within sixty days of the end of the fund's reporting period, which means that in most cases the information was about sixty days' stale when it became public. Most funds chose to make their portfolio information public more frequently than required, with a majority disclosing their portfolios quarterly and a substantial percentage disclosing monthly.[37] The Commission recently increased the frequency with which funds are required to disclose their portfolios from semiannually to quarterly.[38] There are no

[36] *See id.* § 80a-29(b)(2) (requiring that semiannual reports be filed with the Commission); *id.* § 80a-29(e) (requiring delivery of semiannual report to shareholders that includes a balance sheet and a list of portfolio securities owned as of the date of the balance sheet); 17 C.F.R. § 270.30b2-1 (2005) (requiring filing of semiannual report within ten days of transmission to shareholders); *id.* § 270.30e-1 (requiring delivery of semiannual report to shareholders within sixty days of end of reporting period).

[37] *See* Scott Cooley, *The Case for Better Portfolio Disclosure*, MORNINGSTAR ONLINE, Feb. 6, 2003, *available at* http://news.morningstar.com/doc/article/0,1,86497,00.html?_QSBPA=Y (stating that more than 70% of funds currently provide monthly or quarterly portfolio disclosure to Morningstar); Tom Lauricella & Aaron Lucchetti, *Silence is Golden to Mutual-Fund Industry*, WALL ST. J., July 31, 2002, at C1 (stating that roughly 200 fund firms and seventeen of the twenty largest funds provide quarterly or monthly holdings updates to investors); INV. CO. INST., SURVEY OF FUND GROUPS' PORTFOLIO DISCLOSURE POLICIES SUMMARY OF RESULTS (2001), *available at* http://www.ici.org/statements/cmltr/01_sec_port_disclos_surv.html (42% of fund groups surveyed disclose portfolio holdings more frequently than semiannually).

[38] *See* 17 C.F.R. § 270.30b1-5 (requiring funds to file a quarterly report on Form N-Q within sixty days of the end of the first and third fiscal quarters); SEC Form N-Q, *available at* http://www.sec.gov/about/forms/formn-q.pdf (last visited Nov. 14, 2005) (form used for reporting quarterly portfolio holdings); S'holder Reports & Quarterly Portfolio Disclosure of Registered Mgmt. Inv. Cos., Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,244 (Mar. 9, 2004) (requiring quarterly disclosure of portfolio holdings on Form N-Q for fiscal quarters ending after July 9,

allegations in the SEC's selective disclosure cases that fund managers selectively disclosed nonpublic portfolio information more frequently than monthly, which is the same frequency with which many funds have disclosed their portfolios publicly.[39]

Further, it has been generally understood and accepted that funds may disclose their portfolio holdings on a selective basis to preferred investors or consultants.[40] For example, financial plan-

2004). The Commission also permitted funds to deliver a summary schedule of portfolio information to shareholders, provided that the complete schedule was filed with the Commission and was provided to shareholders upon request. *Id.* In addition, section 13(f) of the Exchange Act and Rule 13f-1 thereunder require fund managers that exercise investment discretion over $100 million or more in certain equity securities to report on Form 13F the holdings of the accounts that they manage, including the mutual funds. *See* 15 U.S.C. § 78m(f) (2000); 17 C.F.R. § 240.13f-1 (2005).

[39] *See, e.g.*, Banc One Inv. Advisors Corp., Investment Company Act Release No. 26,490, 83 SEC Docket 695, 84 SEC Docket 2404, 2004 WL 1472043 (June 29, 2004) (access to monthly portfolios about five days after the end of the month); *Alliance II*, Investment Company Act Release No. 26,312A, 81 SEC Docket 3401, 2004 WL 67564 (Jan. 15, 2004) (one example of disclosure of one-day stale portfolio holdings); Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874 (June 21, 2004) (thirty-day stale monthly portfolios disclosed). There are no allegations in any cases that portfolio information was updated more frequently than monthly, which is consistent with the practice of many funds to provide Morningstar and other third-party information providers with nonpublic portfolio information on a monthly basis, *see* Cooley, *supra* note 37, and in some cases, there is little or no discussion of the staleness or frequency of the disclosure, *see, e.g.*, Complaint, *supra* note 2 (no discussion of frequency or staleness); *Putnam I*, Investment Company Act Release No. 26,255, 81 SEC Docket 1913, 2003 WL 22683975 (Nov. 13, 2003) (same); Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 82 SEC Docket 3178, 2004 WL 1124933 (May 20, 2004) (monthly portfolios disclosed with no discussion of staleness). This arguably is not significant in the *Putnam* case because *Putnam* involved trading only by insiders who apparently had real-time access to portfolio holdings as a matter of course and there were no allegations of selective disclosure. In some exceptional cases, mutual funds have provided daily, current, public access to their portfolios. For example, the Community Intelligence Fund and the OpenFund made their portfolios and trades publicly available on an almost real-time basis. *See* Bruce W. Fraser, *Are "Naked" Funds Worth the Wait?*, CNBC.COM, Apr. 20, 2000. Both funds closed in 2001. *See* Justin Wiser, *A Jungle Out There: Community Intelligence Fund Latest Internet Victim*, CBSMARKETWATCH.COM, Aug. 27, 2001, http://cbs.marketwatch.com/news/story.asp?guid=%7B70D6ABB8%2D13B3%2D46F3%2DB4BE%2DAE35371FDDBB%7D&siteid=mktw; Craig Tolliver, *Tech, Japan Funds Collapse in July: Stock Funds Leak $500 Million in Latest Week*, CBSMARKETWATCH.COM, Aug. 2, 2001, http://cbs.marketwatch.com/news/story.asp?guid=%7B1E93FDFC%2DF80C%2D4BD3%2DAF8C%2D6EEDB238183F%7D&siteid=mktw.

[40] Such differential treatment of shareholders regarding the disclosure of fund portfolio holdings was partly responsible for prompting consumer, professional, and employee groups to petition the Commission to require more frequent disclosure of fund portfolios. *See, e.g.*, Rulemaking Petition from the Int'l Bhd. of Teamsters

ners and pension consultants with a large amount of client assets invested in a fund may obtain a list of the fund's portfolio holdings upon request to assist their evaluation of the fund.[41] The Commission has found that "[m]ost funds regularly provide portfolio information to service providers, such as custodians, administrators, securities lending agents, pricing services, and rating agencies."[42] More than thirty percent of funds responding to an SEC survey "appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares."[43] To date, the Commission has not described the nature of these "advantageous decisions" other than in the context of the kind of fund arbitrage activities discussed above.

The risks historically associated with portfolio disclosure, however, have not included the risk of exploitation by arbitrageurs.[44] One common concern has been that traders could use portfolio holdings to track which securities a fund is buying or selling and trade ahead of, or "front run," the fund's trades.[45] When a fund

(Jan. 18, 2001), *available at* http://www.funddemocracy.com/Teamsters%20Petition.htm; Rulemaking Petition from the AFL-CIO (Dec. 20, 2000), *available at* http://www.funddemocracy.com/AFL-CIO%20Petition.htm; Rulemaking Petition from the Nat'l Ass'n of Investors Corp. (Oct. 9, 2000), *available at* http://www.funddemocracy.com/NAIC%20Petition.pdf; Rulemaking Petition from the Consumer Fed'n of Am., et al. (Aug. 8, 2000), *available at* http://www.funddemocracy.com/Consumer%20Petition.pdf; Rulemaking Petition from the Fin. Planning Ass'n (June 28, 2000), *available at* http://www.funddemocracy.com/fpapetition.pdf; Rulemaking Petition from Fund Democracy, L.L.C. (June 28, 2000), *available at* http://www.funddemocracy.com/ Holdings%20Petition.pdf.

41 This is based on discussions between the author and financial planners and other financial services professionals.

42 *See, e.g.*, *Mutual Funds: Trading Practices and Abuses that Harm Investors, Hearing Before the Subcomm. on Financial Management, the Budget, and International Security, S. Comm. on Governmental Affairs*, 108th Cong. 20 (2003) (statement of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission), *available at* http://hsgac.senate.gov/ _files/110303cutler.pdf.

43 *Id.*

44 Letter from Craig S. Tyle, Gen. Counsel, Inv. Co. Inst., to Paul F. Roye, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n (July 17, 2001), http://www.ici.org/ statements/cmltr/2001/01_sec_port_disclose_ltr.html; *see* Russ Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, 7 PERSP. 1, 5-6 (2001), *available at* http://www.ici.org/stats/res/per07-03.pdf.

45 Letter from Craig S. Tyle to Paul F. Roye, *supra* note 44; Wermers, *supra* note 44, at 1; *see, e.g.*, Gintel Asset Mgmt., Inc., Exchange Act Release No. 46,798, Investment Company Act Release No. 25,798, 2002 WL 31499839, at *1 (Nov. 8, 2002) (finding that personal trading in securities held by fund was misuse of information under section 204A); Alliance Capital Mgmt., L.P., 64 SEC Docket 1207, 1997 WL 206129, at *1 (Apr. 28, 1997) (stating that portfolio manager traded in securities

is building a position in a stock, its purchases may cause the price of the stock to rise; when it is liquidating a position, this effect is reversed. A trader with advance knowledge of a fund's plans to buy or sell a stock may herself buy or short the stock in anticipation of the effect of the fund's trading on the stock's price. Such front-running itself can cause the stock's price to rise or fall ahead of the fund's purchases or sales, respectively, thereby increasing the fund's transaction costs.[46] Although there is general agreement that front-running is a real risk, there is substantial disagreement about the point at which portfolio disclosure is frequent or current enough to make it a material risk.[47] Thus, the risks of fund portfolio disclosure historically have been associated with traders using the information to trade securities held by the fund,[48] not securities issued by the fund, as occurs in the case

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bought and sold by funds, including two that he managed); Honour, Investment Company Act Release No. 21,385, 60 SEC Docket 1053, 1995 WL 579523, at *1 (Sept. 29, 1995) (same). *See generally*, Knight Sec. L.P., Exchange Act Release No. 50,867, 84 SEC Docket 1417, 2004 WL 2913488 (Dec. 16, 2004) (settling charges against broker-dealer that used information about client trades to increase proprietary trading profits); Ann Davis, *Client Comes First? On Wall Street, It Isn't Always So*, WALL ST. J., Dec. 16, 2004, at A1 (discussing *Knight Securities*); Susan Pulliam, *SEC Probes Firms That Gather Data on Who Owns What Shares*, WALL ST. J., Dec. 8, 2004, at A1 (discussing disclosure of confidential trading data by securities custodians).

[46] This presumably was not a problem for the Community Intelligence Fund or the OpenFund, *see supra* text accompanying note 39, because their stock positions were too small for their trading to affect the stock price.

[47] *Compare* Wermers, *supra* note 44, *with* S'holder Reports & Quarterly Portfolio Disclosure of Registered Mgmt. Inv. Cos., Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,244 (Mar. 9, 2004).

[48] Another concern is that traders may use fund portfolio information to mimic a fund manager's portfolio and thereby "expropriate the results of proprietary research and strategies that fund shareholders pay for." *See* Letter from Craig S. Tyle to Paul F. Roye, *supra* note 44, at Part II.A.2. It is not clear how this harms the fund independent of the front-running that it may entail, however, because to the extent that other traders purchase securities after the fund has purchased them, the value of the securities should rise, thereby benefiting the fund. Indeed, the Commission has brought a number of enforcement actions against persons who purchased a company's stock before publicly endorsing the company in the hope that such "expropriation" *would occur* and their holdings would increase in value. *See, e.g.*, SEC v. Park, Litigation Release No. 16,399, 2000 WL 4014, at *1 (Jan. 5, 2000) (charging Internet-based service with recommending stocks without disclosing that the owner traded in the same stocks prior to making the recommendation), *settled*, Litigation Release No. 16,925, 2001 WL 224981 (Mar. 8, 2001); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (finding that failing to disclose purchases of stocks immediately prior to recommending them to clients, known as "scalping," operated as a fraud upon clients under the antifraud provisions of Advisers Act); HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 54 (1966) (arguing that investors are not harmed by scalping); Schotland, *supra* note 4, at 1458–69

of fund arbitrage.

B. Applicability of Section 204A to Selectively Disclosed Portfolio Information

The Commission has charged a number of fund managers with violating section 204A of the Advisers Act,[49] which requires that investment advisers:

> [E]stablish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of [the Advisers Act, Exchange Act, or rules under either] of material, nonpublic information by such investment adviser or any person associated with such investment adviser.[50]

The Commission generally has asserted that the fund managers misused nonpublic information about fund portfolio holdings by selectively disclosing that information to fund arbitrageurs.[51] Typically, fund managers provided hedge funds with a list of fund portfolio holdings on a monthly basis without also disclosing that information to the public at large.[52]

This Article argues that the selective disclosure of portfolio information to arbitrageurs did not in fact violate section 204A. The selective disclosure of fund portfolio information to fund arbitrageurs is not the kind of misuse of material, nonpublic information that section 204A was intended to prevent.[53] Fund

(countering Manne's argument that scalping does not harm investors). Interestingly, one of the newsletters at issue in *Capital Gains* reported on changes in mutual funds' portfolios. *See* SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 608 (2d Cir. 1962), *rev'd and remanded*, 375 U.S. 180 (1963).

[49] *See* 15 U.S.C. § 80b-4a (2000).

[50] *Id.* A parallel provision imposed similar requirements on broker-dealers. *See id.* § 78o(f); *see also* NYSE, Inc., Rule 342.21 (2004), *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_11&manual=/nyse/nyse_rules/nyse-rules/ (requiring members to establish procedures "reasonably designed to identify trades that may violate the provisions of the Securities Exchange Act of 1934, the rules under that act or the rules of the Exchange prohibiting insider trading and manipulative and deceptive devices").

[51] *See, e.g.*, Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874 (June 21, 2004) (finding that an investment adviser violated section 204A by failing to implement procedures to prevent the disclosure of nonpublic information about fund holdings that arbitrageurs used to facilitate fund arbitrage).

[52] *See supra* note 38.

[53] *Contra* DONALD C. LANGEVOORT, 18A INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 12:20 (Supp. 2004) ("SEC investigations indicated that advisory personnel were using their knowledge of the make-up of the fund's

portfolio information is neither material nor nonpublic in the sense that these terms are used in section 204A, and other provisions of section 204A's enacting legislation are inconsistent with the view that section 204A applies to the disclosure of fund portfolio information to fund arbitrageurs. No regulator has ever brought a case against anyone for engaging in the kind of insider trading in mutual fund shares that the Commission asserts section 204A's policies and procedures must be designed to prevent.

Section 204A is part of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA),[54] which was enacted in the wake of a series of high-profile insider trading cases against Dennis Levine, Ivan Boesky, other Wall Street insiders, and Drexel Burnham Lambert, Inc.[55] None of these cases involved trading shares of mutual funds or obtaining access to funds' current holdings. The cases involved insider trading on material, nonpublic information that related to the true value, as opposed to the current market value, of securities issued by operating companies.[56] All of the SEC's prescandal section 204A cases similarly involved the misuse of nonpublic, market-sensi-

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portfolio to make more profitable 'timing' trades for their own accounts, or passing on this sensitive information to favored hedge funds and others. This would be a fairly straightforward violation under the misappropriation theory.")

[54] Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, § 3(b)(2), 102 Stat. 4677 (codified as amended at 15 U.S.C. § 80b-4a (2000)). The ITSFEA was signed into law by President Ronald Reagan on November 19, 1988. *See generally* Barbara Bader Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALB. L. REV. 893 (1988); Michael J. Chmiel, *The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action*, 1990 U. ILL. L. REV. 645 (1990); Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465 (1990); Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989).

[55] *See generally* H.R. REP. NO. 100-910, at 7, 11–14 (1998), *as reprinted in* 1988 U.S.C.C.A.N. 6043, 6044, 6048-51 (citing the *Levine*, *Boesky*, and *Drexel* cases and stating that the ITSFEA "represents the response of this Committee to a series of revelations over the last two years concerning serious episodes of abusive and illegal practices on Wall Street."); U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION: EFFORTS TO DETECT, INVESTIGATE, AND DETER INSIDER TRADING (1988), *available at* http://161.203.16.4/t2pbat16/136893.pdf; LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION, § 9-B-9, at n.765 (3d ed. 2004); Aldave, *supra* note 54, at 914–15; Chmiel, *supra* note 54, at 658; Kaswell, *supra* note 54, at 145-46. Congress was not satisfied with reforms adopted only four years earlier in the Insider Trading Sanctions Act of 1984. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (2000)). *See generally* LOSS & SELIGMAN, *supra*, § 9-B-9.

[56] *See generally* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. Rev. 1, 9 (1980) (discussing survey of insider trading cases during period

tive information about operating companies that could be used to trade profitably in the companies' shares or, in one case, information about client trades used in connection with trades in the same securities.[57] None of these cases involved the misuse of nonpublic information about a fund's portfolio holdings. These prescandal cases properly reflect Congress' intent that section 204A engender adequate supervision of investment adviser personnel who had "access to confidential, market-sensitive information" about securities where the prices of the relevant securities were sensitive to the "confidential, market-sensitive information."[58]

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from 1966 to 1980 involving traders who traded on inside information about, for example, projected earnings, proposed mergers, and forthcoming tender offers).

[57] *See* SEC v. Davis, Litigation Release No. 18,322, 81 SEC Docket 2952, 2003 WL 23303550 (Sep. 4, 2003) (settling charges against investment advisers that received material nonpublic information about the U.S. Treasury's decision to cease issuance of the 30-year bond); Gintel Asset Mgmt., Inc., Exchange Act Release No. 46,798, Investment Company Act Release No. 25,798, 2002 WL 31499839 (Nov. 8, 2002) (settling charges against investment adviser that traded on inside information about purchases and sales in client accounts); DePrince, Race & Zollo, Inc., Investment Advisers Act Release No. 2035, 77 SEC Docket 2532, 2002 WL 1286223 (June 12, 2002) (settling charges against investment adviser that did not have procedures designed to address its portfolio manager's access to inside information as a director of a company held in the manager's portfolios); Wyser-Pratte, Exchange Act Release No. 44,283, 74 SEC Docket 2073, 2001 WL 487946 (May 9, 2001) (settling charges against investment adviser that did not have procedures designed to address its access to material nonpublic information obtained through frequent contacts with executives of companies involved in merger and takeover negotiations); Gabelli & Co., Exchange Act Release No. 35,057, 58 SEC Docket 443, 1994 WL 684627 (Dec. 8, 1994) (settling charges against investment adviser that did not have adequate procedures designed to address adviser's CEO's access to inside information as a director of a company–the securities of which were traded in the investment adviser's portfolios). Three cases have generally alleged a failure to adopt procedures designed to prevent the misuse of material, nonpublic information without identifying any specific, related conduct. *See* Sharp, Exchange Act Release No. 35,215, 58 SEC Docket 1547, 1995 WL 15885, at *4 (Jan. 11, 1995); Van Den Berg Baker, Investment Advisers Act Release No. 1414, 56 SEC Docket 1828, 1994 WL 192455, at *5 (May 12, 1994); Lynn Elgert, Inc., Investment Advisers Act Release No. 1339, 52 SEC Docket 1614, 1992 WL 252172, at *3 (Sep. 21, 1992).

[58] H.R. REP. NO. 100-910, at 21, *as reprinted in* 1988 U.S.C.C.A.N. 6043, 6058 ("[Section 204A] will promote more rigorous supervision of associated persons of broker-dealers and investment advisers who have access to confidential, market-sensitive information. As a result, they will help to combat market abuses that constitute the misuse of material, nonpublic information."); *see* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (stating that an insider's duty "arises only in 'those situations which are essentially extraordinary in nature and which are *reasonably certain to have a substantial effect on the market price of the security if* [*the extraordinary situation is*] *disclosed*'" (quoting Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965) (emphasis added)); Selective Disclo-

In contrast, mutual funds' prices are not sensitive to the public availability of information about their portfolio holdings. Fund prices cannot (legally) understate or overstate the true value of their holdings, regardless of whether they are publicly disclosed.[59] Mutual fund shares are not traded in a secondary market in which new information might affect the price of the security.[60] A fund's share price is fixed, which means that there can be no inside information that, if publicly disclosed, would affect the fund's price.[61]

The mutual fund scandal does not involve trading on "material, nonpublic information" as Congress used that term in section 204A. Information is "material" if there is a "substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security."[62] In traditional insider trading cases, reasonable investors attach importance to the inside information because it relates to the issuer's true value but is not reflected in the market price of the issuer's securities.[63]

sure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 24, 2000) [hereinafter *Selective Disclosure and Insider Trading Adopting Release*] (explaining the need to regulate selective disclosure of material, nonpublic information by operating companies: "Issuer selective disclosure bears a close resemblance in this regard to ordinary 'tipping' and insider trading. In both cases, a privileged few gain an informational edge—and the ability to use that edge to profit—from their superior access to corporate insiders, rather than from their skill, acumen, or diligence").

59 *See supra* text accompanying notes 11-14.

60 *See supra* Part I.A.

61 *See supra* Part I.A; Select Sector SPDR Trust, SEC No-Action Letter, 1999 WL 285555, at *20 (May 6, 1999) ("The distinction drawn by Congress between open-end and closed-end funds [in exempting only open-end funds from section 16 reporting requirements, *see infra* notes 106-107] may be based on the view that the ability to exploit inside information is, at least in part, a function of the discrepancies that may exist between market price and NAV. An insider of an open-end fund generally would not be able to exploit inside information by buying or selling shares of the fund on the basis of an anticipated change in the shares' value because an open-end fund is required to price its shares, and effect redemptions and sales of its shares, at NAV." (footnote omitted)).

62 17 C.F.R. § 230.405 (2005) (defining the term "material"); *see* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (stating that material information creates a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"); *Tex. Gulf Sulphur Co.*, 401 F.2d at 850 (reasoning that materiality turns on whether the information "would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold").

63 *See, e.g.*, SEC v. Yun, 327 F.3d 1263, 1267-68 (11th Cir. 2003) (defendant traded on basis of company's negative earnings forecasts prior to negative earnings an-

Fund portfolio information reveals nothing about a fund's true value; that information is already captured in the fund's NAV if the fund's NAV has been calculated in compliance with applicable rules. Access to fund portfolio information can be helpful to arbitrageurs, but it is neither a necessary nor sufficient element of successful arbitrage.[64]

Fund portfolio information is not material because there is no "substantial likelihood that the disclosure of [the information] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[65] Fund portfolio information is only useful to the pricing arbitrageur who has gleaned from publicly available information that the fund has mispriced its shares or to the late trader who has determined from publicly available information that the value of the fund's portfolio securities has changed since the fund was priced. There is no likelihood, much less a substantial one, that fund portfolio information would have any affect on a reasonable investor's opinion regarding the value of a mutual fund unless one assumes that the reasonable investor is an arbitrageur. Even for the fund arbitrageur, fund portfolio information does not "significantly" alter the total mix of information made available. Although there may be instances in which an arbitrageur's investment decision might be tipped one way or the other based on access to fund portfolio information, in this case it would be "principally the skill of the [arbitrageur] that leads to the profit, not simply his access to an insider."[66] Information about fund portfolio holdings simply is not "material" information in the sense intended in section 204A.

Nor is portfolio information "nonpublic" in the sense that Congress used that term in section 204A. In the classic insider

nouncement that preceded a forty percent decline in value of company's stock). *See generally* LANGEVOORT, *supra* note 53, § 5:2 ("Economic theory teaches that price of exchange-listed and other widely traded securities typically reflects a consensus among investors about its fair value based on all available information. A shorthand definition of materiality for insider trading purposes, therefore, is any information the disclosure of which would be likely to result in a substantial change in the price of the security.").

[64] *See supra* Part I.C.

[65] *TSC Indus.*, 426 U.S. at 449.

[66] LANGEVOORT, *supra* note 53, § 5:3 ("For this reason, investment analysts can properly elicit bits of information from company insiders and piece them together in a mosaic that can lead to an investment decision, so long as the pieces of information are not, standing alone, material. In that case, it is principally the skill of the analyst that leads to the profit, not simply his access to an insider.")

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trading context, whether the inside information is nonpublic is critical. Public disclosure of the information would eliminate the insider's informational advantage because the information would soon be reflected in the price of the relevant security.[67] In the fund arbitrage context, however, whether the information is publicly available makes little difference. If a fund's price is stale or the fund permits late trading, the arbitrage opportunity is essentially the same regardless of whether portfolio information is selectively or publicly disclosed. The only adverse consequence to the arbitrageur of public disclosure is that this might increase the number of arbitrageurs exploiting the stale price or late trading opportunity, which might dilute potential arbitrage gains.[68]

Courts and commentators have often argued that insider trading should be prohibited based on the unfairness of permitting privileged investors to trade on information to which all investors do not have equal access.[69] This unfairness is eliminated by public disclosure. But public disclosure of mutual fund holdings has no effect on the availability or size of the fund arbitrage opportunity. Regardless of whether portfolio information is selectively or publicly disclosed, the stale price remains stale, and the late trade is still profitable. The unfairness created by funds using stale prices or permitting late trades is the same whether a select

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67 *See* Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1502–03 (1999) ("[D]isclosing the formerly non-public information largely eliminates any windfall profit to be gained; once the market processes the material information, the insider's ability to exploit that information subsequently is greatly diminished.").

68 A hedge fund manager once stated to the author that his firm had ceased its pricing arbitrage activities because so many investors were engaged in fund arbitrage that the firm's profit margins had declined.

69 *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) ("The only regulatory objective is that access to material information be enjoyed equally . . . ."); Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907, 912 (1961) (citing "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing"). *Contra* Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (rejecting equal access standard for insider trading liability). *See generally* LOSS & SELIGMAN, *supra* note 55, § 9-B-1(a)(i); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 880–82 (1983) (discussing "fair play" conception of purpose of insider trading prohibition); Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L. J. 353, 359-60 (1988) (same); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1047–48 (1990) (same); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980) (same). Technically, the other party to a transaction in fund shares is the fund itself, which always has superior access to information about its own portfolio.

few, or the investing public at large, are able to fully exploit the arbitrage opportunity.

Indeed, investors in funds that use stale prices arguably should prefer, if there is going to be some disclosure of portfolio holdings, that it be selective rather than public. Public disclosure simply increases the likelihood that arbitrageurs will prey on the fund because it makes it easier to determine when profitable arbitrage opportunities are available. At least in some cases, selective, rather than public, disclosure of portfolio holdings may limit arbitrage to a smaller number of favored traders and result in less total dilution of non-trading shareholders' interests.[70]

The inapplicability of the ITSFEA to fund arbitrage is further illustrated by some of its key provisions. For example, the ITSFEA increased maximum penalties for persons and their control persons convicted of insider trading based on the amount of "profit gained or loss avoided as a result of such [violations]."[71] The ITSFEA defines the terms "profit gained" or "loss avoided" as the "difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information."[72] This conception of "profit gained" or "loss avoided" is inapplicable to mutual funds because the release of nonpublic information about a mutual fund's portfolio holdings does not and legally cannot have any affect on the price of the fund's shares.[73]

The ITSFEA also granted a cause of action to contemporane-

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[70] This could be viewed as consistent with the efforts of many of the defendants in the frequent trading and selective disclosure cases to permit some, but not all, arbitrageurs to engage in frequent trading. *See, e.g.*, Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874, at *3 (June 21, 2004) (finding that fund manager suspended trading by all market timers except those related to two entities). It is likely, however, that as the number of arbitrageurs increases, the arbitrageurs shift from being professional traders with large accounts to retail investors with small accounts. *See supra* note 67 and accompanying text. Thus, as the number of arbitrageurs increases, the average amount each arbitrageur invests may decline, such that the aggregate dilution remains unaffected.

[71] Insider Trading and Securities Fund Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, § 3(a)(2), 102 Stat. 4677, 4678 (codified at 15 U.S.C. § 78u-1(a)(2)-(3) (2000)).

[72] *Id.* § 3(a)(2), 102 Stat. at 4679 (codified at 15 U.S.C. § 78u-1(f) (2000)). *See generally* LOSS & SELIGMAN, *supra* note 55, § 9-B-9.

[73] The ITSFEA also used the concept of the "profit gained or loss avoided" by the trader as the measure of damages for claims brought by contemporaneous traders. *See supra* text accompanying notes 70-72.

ous traders in insider trading cases.[74] The ITSFEA amended section 20A of the Exchange Act to provide that any person who purchases or sells securities while in possession of material, nonpublic information shall be liable to "any person who, *contemporaneously with the purchase or sale of securities* that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class."[75] This cause of action would not apply in the context of fund arbitrage because the harm is not done to persons who sell shares contemporaneously with the arbitrageur's purchase, or who purchase shares contemporaneously with the arbitrageur's sale. Purchasing and selling shareholders do not purchase from or sell to other investors; they only purchase from and sell to the fund itself.[76] The persons who are harmed by the arbitrageur's purchase are holders, not purchasers or sellers, whose holdings are diluted by the arbitrage.[77] Holders do not have a cause of action under the

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[74] This provision was intended to overturn *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), in which the Second Circuit denied recovery to the plaintiffs because the trader-defendant's duty was owed not to the plaintiffs but to a third party. *See* H.R. REP. NO. 100-910, at 26 (1988), *as reprinted in* 1988 U.S.C.C.A.N. 6043, 6063. *See generally* Aldave, *supra* note 54, at 914–15; Chmiel, *supra* note 54, at 660–61.

[75] ITSFEA, § 5, 102 Stat. at 4680 (codified at 15 U.S.C. § 78t-1(a) (2000)) (emphasis added).

[76] *See supra* text accompanying note 14.

[77] The Securities Litigation Uniform Standards Act of 1988 (SLUSA) provided that securities class actions alleging wrongdoing "in connection with the purchase or sale" of a security shall be removable to federal court. *See* Pub. L. No. 105-353, § 101, 112 Stat. 3227, 3227-28, 3230 (codified at 15 U.S.C. §§ 77p, 78bb(f) (2000)). A number of courts have addressed the question of whether stale-pricing claims brought by shareholders who held shares at the time that frequent trading occurred satisfied SLUSA's "in connection with the purchase or sale" requirement. *See, e.g.*, *In re* Alger, Columbia, Janus, MFS, One Group, & Putnam Mutual Fund Litig., 320 F. Supp. 2d 352 (D. Md. 2004) (discussing but declining to rule on removal issue); Bradfisch v. Templeton Funds, Inc., 319 F. Supp. 2d 897, 901 (S.D. Ill. 2004) (rejecting SLUSA removal on ground that complaint alleged dilution of ownership interests and voting rights); Meyer v. Putnam Int'l Voyager Fund, 220 F.R.D. 127, 128-29 (D. Mass. 2004) (rejecting SLUSA removal on ground that claim that defendants violated their fiduciary duty was exclusively derivative and therefore excluded from SLUSA removal, and allegations related to holders, not purchasers or sellers); Potter v. Janus Inv. Fund, No. 03-CV-0692-DRH, 2004 WL 1173201, at *2–*3 (S.D. Ill. Feb. 12, 2004) (same); Vogeler v. Columbia Acorn Trust, No. 03-CV-0843-DRH, 2004 WL 1234135, at *2 (S.D. Ill. Feb. 12, 2004) (same); Kircher v. Putnam Funds Trust, No. 03-CV-0691-DRH, 2004 U.S. Dist. LEXIS 10327, at *7-*9 (S.D. Ill. Jan. 27, 2004) (same); Dudley v. Putnam Inv. Funds, No. 03-CV-853-GPM, at 3 (S.D. Ill. Jan. 27, 2004) (same) (on file with author); Nekritz v. Canary Capital Partners, L.L.C., No. 03-5081(DRD), 2004 WL 1462035, at *4 (D.N.J. Jan. 12, 2004) (expres-

federal securities laws based on insider trading.[78]

Finally, the ITSFEA generally authorized additional sanctions against any person who has violated the Exchange Act or its rules by engaging in securities transactions while in possession of material, nonpublic information or by communicating such information "in connection with, a transaction on or *through the facilities of a national securities exchange* or from or through a broker or dealer, and which *is not part of a public offering by an issuer* of securities other than standardized options."[79] Like the provisions discussed immediately above, this provision also would not apply to mutual funds because they are not traded on an exchange[80] and are, technically, always sold as "part of a public offering by an issuer."[81]

An additional problem with the selective disclosure cases is that no one has ever been charged with the kind of substantive violation insider trading that the settling investment advisers failed to prevent. Insider trading occurs when a person trades securities on the basis of material, nonpublic information about the securities that the trader knows was disclosed in breach of a duty owed to the source of the information.[82] Thus, if an arbitrageur knows that the nonpublic fund portfolio information was

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sing view that frequent trading satisfied SLUSA's "in connection with" requirement but declining to rule on removal); *see also* Miller v. Nationwide Life Ins. Co., No. Civ. A. 03-1236, 2003 WL 22466236, at *6 (E.D. La. Oct. 29, 2003) (finding breach of contract based on fund's instituting short term trading fees is subject to SLUSA); Rahul Bhargava, Ann Bose & David A. Dubofsky, *Exploiting International Stock Market Correlations with Open-End International Mutual Funds*, 25 J. BUS. FIN. & ACCT. 765, 771 (1998).

[78] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975).

[79] ITSFEA, Pub. L. No. 100-704, § 3(a)(2), 102 Stat. 4677 (codified at 15 U.S.C. § 78u-1(a)(1) (2000)) (emphasis added). The ITSFEA similarly expanded controlling-person liability for such violations provided the Commission could prove, among other things, that the controlling person violated section 204A or section 15(f) of the Exchange Act. *Id.* § 3(a)(2) (codified at 15 U.S.C. § 78u-1(b) (2000)).

[80] This provision would apply to exchange traded funds, which are mutual funds that are traded on exchange. *See generally supra* note 5.

[81] Mutual fund shares are sold and redeemed by their issuer and are continuously "in registration." *See* 15 U.S.C. § 77e (2000) (generally requiring issuers of securities to sell shares only off of a current prospectus).

[82] *See* U.S. v. O'Hagan, 521 U.S. 642, 647 (1997) (actionable insider trading occurs when a person misappropriates information obtained in breach of a duty owed to the source of the information); Dirks v. SEC, 463 U.S. 646, 660 (1983) (stating that actionable insider trading by tippee occurs when the tippee knows the traded-on information was obtained in breach of tipper's duty to the source of the information). *See generally* Joel Seligman, *A Mature Synthesis:* O'Hagan *Resolves Insider Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1 (1998).

disclosed in breach of the fund manager's duty to the fund, the arbitrageur would be guilty of insider trading, but no case against any arbitrageur has ever been brought.[83] The fact that the Commission has never charged a fund arbitrageur with insider trading suggests that it is unsure whether a court would agree that the fund manager's disclosure of the fund's portfolio violated its duty to the fund. This failure further undermines the SEC's position that fund managers violated section 204A by failing to implement procedures to prevent the use of portfolio information for the purpose of fund arbitrage.[84]

Finally, the SEC's mutual fund insider trading cases contradict its historical position that "trading in mutual fund shares posed little risk of abuse, because those shares are priced at net asset value daily."[85] Under both the Investment Company and Ad-

[83] The Commission has charged some traders who were also insiders (portfolio managers) with respect to the fund's manager with violating the antifraud provisions of the Advisers Act, which parallel Rule 10b-5. *See, e.g.*, Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874, at *3 (June 21, 2004); Jury Trial Demanded, SEC v. Scott, No. 03-12082-EFH (D. Mass. Oct. 28, 2003), *available at* http://www.sec.gov/litigation/ complaints/ comp18428.htm. There is no indication, however, as to whether the Commission would have found a violation in the absence of the insider's preexisting fiduciary duty as an investment adviser to the fund. *See* Jury Trial Demanded, *supra*. In some cases, firms were charged with violating the Advisers Act's antifraud provisions, which might be interpreted as being based on a kind of tipper liability. *See* Banc One Inv. Advisors Corp., Investment Company Act Release No. 26,490, 83 SEC Docket 695, 84 SEC Docket 2404, 2004 WL 1472043 (June 29, 2004); *Pilgrim Baxter*, 83 SEC Docket 363, 2004 WL 1379874, at *5; Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 82 SEC Docket 3178, 2004 WL 1124933, at *3, *11 (May 20, 2004).

[84] The Commission and private litigants do have some recourse, however. Late traders can be prosecuted for violating the forward pricing rule. *See, e.g.*, Markovitz, Exchange Act Release No. 48,588, Investment Company Act Release No. 26,201, 81 SEC Docket 450, 2003 WL 22258425, at *4 (Oct. 2, 2003). But liability of pricing arbitrageurs may be limited to civil claims based on, for example, the common law cause of action for overpayments. *See* Wanda Ellen Wakefield, Annotation, *Recovery by Bank of Money Paid Out to Customer by Mistake*, 10 A.L.R.4th 524 (1981).

[85] Investment Adviser Codes of Ethics, Investment Company Act Release No. 26,337, 69 Fed. Reg. 4040 (Jan. 27, 2004) [hereinafter Codes of Ethics Proposing Release] (citing Prevention of Certain Unlawful Activities with Respect to Registered Investment Companies, Investment Company Act Release No. 11,421, 45 Fed. Reg. 73,915 (Nov. 7, 1980)) (adopting Rule 17j-1 and stating that mutual fund shares "present very little opportunity for the type of improper trading that [Rule 17j-1] is intended to cover"). In contrast, section 17(j) of the Investment Company Act and Rule 17j-1 are intended to address the use of fund portfolio information for front-running. *See* Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and Their Investment Advisers and Principal Underwriters, Securities Act Release No. 7212, Investment Company Act Re-

viser Acts, the Commission has adopted rules requiring that fund managers and other investment advisers keep records of their employees' securities transactions for the purpose of detecting and deterring trading that may harm funds and other advis ory clients.[86] In SEC Rule 17j-1, which requires the reporting of personal securities transactions by personnel of mutual fund affiliates, the Commission expressly excluded transactions in mutual fund shares[87] because "shares of open-end funds would appear to present little opportunity for the type of improper trading that Rule 17j-1 is intended to cover."[88] For the same reason, the Commission excluded transactions in mutual fund shares from Rule 204-2, which requires that investment advisers keep records of certain employees' securities transactions.[89] The Commission took the same position when it adopted Regulation FD, which generally prohibits the selective disclosure by issuers of material, nonpublic information, but which expressly excludes mutual funds from its coverage.[90] The Commission excluded mutual funds from Regulation FD because they:

> [A]re continually offering their securities to the public . . . and are not permitted to sell, redeem, or repurchase their securities except at a price based on their securities' net asset value. . . . [W]e believe that Regulation FD would offer little additional protection to investors in these types of investment companies and therefore they should be excluded from its cov-

lease No. 21,341, 60 Fed. Reg. 47,844 (Sept. 14, 1995) [hereinafter Personal Investment Activities Proposing Release]. Like Rule 17j-1, Rule 204-2 under the Advisers Act previously excluded mutual fund shares from reporting requirements for certain investment advisory personnel. *See* 17 C.F.R. § 275.204-2(a)(12)(i)(B) (2005).

86 *See generally* Personal Investment Activities Proposing Release, 60 Fed. Reg. at 47,849.

87 *See* 17 C.F.R. § 270.17j-1(a)(4), (d) (2005).

88 Personal Investment Activities Proposing Release, 60 Fed. Reg. at 47,851.

89 *See* 17 C.F.R. § 275.204-2(a)(12)(i)(B), (13)(i)(B) (2005) (excluding mutual fund shares from reporting requirements for investment advisers); Personal Investment Activities Proposing Release, 60 Fed. Reg. at 47,851; Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and their Investment Advisers and Principal Underwriters, Securities Act Release No. 7728, Investment Company Act Release No. 23,958, 64 Fed. Reg. 46,821 (Aug. 27, 1999) (adopting release amending Rule 204-2 to exclude transactions in fund shares for the same reason it excluded such transactions from Rule 17j-1).

90 *See* 17 C.F.R. § 243.101(b) (2005) (defining "issuer" generally to exclude mutual funds under Regulation FD's selective disclosure rule); *see also* Selective Disclosure and Insider Trading Adopting Release, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 57,719 (Aug. 24, 2000).

erage . . . .[91]

After a quarter-century of maintaining publicly that insider trading on mutual funds does not pose a threat to funds, the Commission has changed its position by instituting proceedings against funds for failing to prevent the disclosure of portfolio information used to facilitate fund arbitrage. The Commission provided no direct or indirect warning of this policy shift; for example, the amendments to rules requiring investment advisers' employees to report trades in mutual fund shares were adopted after the conduct on which the selective disclosure cases have been based occurred.[92] When the Commission proposed in 2002 to require funds to disclose their portfolios more frequently, it nowhere mentioned the issue of whether more frequent disclosure might facilitate fund arbitrage,[93] yet it now argues that investment advisers should have known to limit the disclosure of fund portfolio information to prevent such arbitrage.

C. Insider Trading on Other Selectively Disclosed Fund Information

The foregoing analysis should not be read to suggest that there is no fund-related information that could ever qualify as material, nonpublic information for the purposes of section 204A. As dis-

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[91] Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590, 72,597 (Dec. 28, 1999) [hereinafter Selective Disclosure and Insider Trading Proposing Release].

[92] *See* Investment Advisor Codes of Ethics, 17 C.F.R. § 275.204A-1(a)(3), (b), (e)(9), (e)(10) (2005) (requiring record of holdings and transactions in funds advised by the adviser or by a control affiliate of the adviser); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26,492, 69 Fed. Reg. 41,696 (July 9, 2004) [hereinafter Codes of Ethics Adopting Release]; Codes of Ethics Proposing Release, Investment Company Act Release No. 26,337, 69 Fed. Reg. 4040 (Jan. 27, 2004); *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (extending Rule 204A-1 compliance date to February 1, 2006). The Commission did not make a conforming amendment to Rule 17j-1 because in section 17(j) of the Investment Company Act, Congress authorized the Commission to prohibit only "fraud or deceptive practices in connection with the purchase or sale of 'any security held or to be acquired'" by a fund and not the purchase or sale of securities *issued* by the fund. Codes of Ethics Proposing Release, 69 Fed. Reg. 4040. Notwithstanding the SEC's view that Congress wrote section 17(j) so as *not* to authorize it to require reporting on mutual fund share transactions, the Commission decided that it had the authority "to close [this] regulatory gap" by requiring such reporting under Rule 204A-1." *Id.*

[93] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8164, Investment Company Act Release No. 25,870, 68 Fed. Reg. 160 (Jan. 2, 2003).

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cussed above, a fund manager's failure to adopt policies and procedures designed to prevent the disclosure of material, nonpublic portfolio information could trigger section 204A liability to the extent that the portfolio information could be used by traders to front-run fund transactions.[94] The fund industry has argued that fund portfolio information provided monthly or even quarterly could enable a trader to identify patterns of purchases and sales and use that information to front-run a fund's transactions.[95] This contention is suspect, as none of the SEC's selective disclosure cases included allegations that arbitrageurs were exploiting their special access to fund portfolio information to front-run fund trades, even though the portfolio information was provided, according to the fund industry, frequently enough to permit profitable front-running.[96] If arbitrageurs could have used such access to front-run fund trades profitably, they probably would not have ignored this profit opportunity.

A section 204A misuse of material, nonpublic information is more likely to occur when a fund manager selectively discloses information about the fund's transactions (as opposed to its portfolio holdings), and the information is used to front-run the fund's trades.[97] Recent reports of front-running on the basis of confidential information about trading activities suggest that this may become a significant focus for the section 204A policies and procedures of funds whose trades may have a material effect on market prices.[98] Indeed, one of the SEC's recent mutual fund

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[94] *Alliance II*, Investment Company Act Release No. 26,312A, 81 SEC Docket 3401, 2004 WL 67564 (Jan. 15, 2004). Although the inside information relates to market activity rather than company operations, it still shares some of the characteristics of traditional notions of insider trading. Publicizing the insider information would have a direct effect on the price at which the relevant securities were traded by moving them toward a price that more accurately reflects (or anticipates) actual demand and supply. *See generally* LANGEVOORT, *supra* note 53, § 11:7 (discussing insider trading liability for front-running). This dynamic also occurs in traditional insider trading but not in late trading or pricing arbitrage because future prices of mutual funds are set independent of the demand for fund shares. *See supra* text accompanying notes 10-13.

[95] *See supra* note 44.

[96] *See supra* note 39.

[97] *See supra* text accompanying notes 45-48.

[98] *See, e.g.*, Complaint at 1, SEC v. Furino, No. 05-1259 (E.D.N.Y. Mar. 9, 2005) (alleging floor broker was compensated by day trader for providing confidential, real-time information about customers' orders), *available at* http://www.sec.gov/litigation/complaints/comp19126.pdf; *see also* Kate Kelly & Deborah Solomon, *SEC Preps 'Best-Price' Overhaul*, WALL ST. J., Nov. 22, 2004, at C1 (expressing fund manager's concerns that trade-through rule mandating that orders be executed at

cases charged two portfolio managers with violating the antifraud provisions of the Advisers Act by trading fund shares while in possession of confidential information about, *inter alia*, the fund's transactions,[99] and the fund managers' related section 204A violation was based, in part, on the selective disclosure of the fund's transactions.[100] The portfolio managers did not use this information to front-run fund trades, however, but rather to decide whether to invest in the fund.[101] Basing insider trading charges on the failure to protect against the use of transaction information to trade in fund shares (rather than to front-run fund portfolio transactions) is problematic because, like portfolio information, transaction information provides no additional insight into the future value of the fund. Access to transaction information facilitates the identification of arbitrage opportunities in the same way that access to portfolio information can be used for this purpose. Thus, selective disclosure of fund transaction information to persons who are using it to front-run fund transactions probably would support a section 204A case, whereas disclosure to persons who trade only in fund shares might not.

When might a section 204A violation occur in connection with trading in securities issued by the fund rather than securities held by the fund? Section 204A should support such a claim when the fund manager fails to have policies and procedures designed to prevent the release of nonpublic information about the fund's portfolio security *valuations*. If a fund used a flawed methodology in pricing its securities that resulted in undervalued shares in violation of fund pricing rules and information about the use of that methodology was leaked to a trader, the trader could use the information to identify pricing arbitrage opportunities. In this case, the information relates directly to the validity of the fund's price, just as inside information about an operating company's

the best price may reveal large trades and adversely affect execution); Kara Scannell, Aaron Lucchetti & Susanne Craig, *'Squawk Box' Figure is Aiding Federal Probe*, WALL ST. J., Mar. 14, 2005, at C1 (describing investigation of traders using access to confidential communications among Wall Street firms to front-run trades by mutual funds and other institutional investors).

99 *See* Jury Trial Demanded, SEC v. Scott, No. 03-12082-EFH, ¶¶ 2, 15, 19, 34-41 (D. Mass. Oct. 28, 2003) (also alleging trading while in possession of information about fund portfolio holdings and valuations), *available at* http://www.sec.gov/ litigation/complaints/comp18428.htm.

100 *See Putnam I*, Investment Company Act Release No. 26,255 , 81 SEC Docket 1913, 2003 WL 22683975 (Nov. 13, 2003).

101 Jury Trial Demanded, *supra* note 99, ¶¶ 19, 20, 25, 26.

prospects relates to whether the company's stock price accurately reflects its true value. The valuation information tells the trader that the current day's price will not be accurate, and the next day's price probably will be higher, just as inside information about a company's positive prospects tells the trader that the company's stock's current market price understates its value, and the price will rise when the information is made public.

The Commission also has based two section 204A cases in part on the selective disclosure of valuations.[102] In recent SEC rulemaking releases discussing appropriate section 204 policies and procedures, however, the Commission has not mentioned the need to protect against the misuse of valuation information; rather, it has only discussed the misuse of portfolio holding and transaction information.[103] Yet it is the misuse of valuation information that poses the greatest risk of arbitrage losses. The Commission previously has brought cases involving insider trading based on inside knowledge of the mispricing of a mutual fund, and these cases probably would be best argued on the theory that the insiders had access to inside information about valuations.[104]

[102] *See Putnam I*, 81 SEC Docket 1913, 2003 WL 22683975; Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 2004 WL 1379874 (June 21, 2004).

[103] *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300, 22,305-07 (Apr. 23, 2004) [hereinafter Market Timing Adopting Release]. Nor does the SEC's discussion of funds' compliance procedures relating to the protection of nonpublic fund information mention valuations. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,719 (Dec. 24, 2003) [hereinafter Compliance Programs Adopting Release]. One might even argue that the selective disclosure of portfolio information by itself could be subject to section 204A to the extent that it could be used to determine whether the fund was mispriced, but this information probably is not material because it is only indirectly related to fund pricing. *See supra* text accompanying notes 61–63.

[104] These cases do not involve fund arbitrage; instead, they are situations in which insiders had inflated the value of the fund in order to conceal losses. *See, e.g.*, Demand for Jury Trial, SEC v. Heartland Advisors, Inc., No. 03-C-1427 (E.D. Wisc., Dec. 11, 2003), *available at* http://www.sec.gov/litigation/complaints/ comp18505.htm (charging fund manager and its executives with mispricing violations). In 1994, the Commission sued the directors of a money market fund and employees of the fund's sub-adviser in connection with the mispricing of a money market fund. *See* Backlund, Securities Act Release No. 7626, Investment Company Act Release No. 23,639, 68 SEC Docket 2663, 1999 WL 8164 (Jan. 11, 1999) (charging directors with mispricing fund); Vanucci, Securities Act Release No. 7625, Investment Company Act Release No. 23,638, 68 SEC Docket 2661, 1999 WL 81620 (Jan. 11, 1999) (charging sub-adviser's employees with mispricing fund). Some shareholders in the fund sued other shareholders who redeemed their shares before the fund's price was cor-

Some have suggested that insider trading could result from knowing that a fund held a stock about which negative news had been released.[105] Assuming that the information about the portfolio company is public, knowing that the fund had bought or sold that company's stock could not benefit a trader because the negative information would be incorporated in the fund's 4:00 p.m. price. If the company information was nonpublic, a trader presumably could use a mutual fund as an indirect vehicle through which to engage in insider trading in the company's shares. In some cases, a fund may have invested enough of its assets in a single company's stock to provide a profitable vehicle for an insider to use the fund to trade on inside information about the company.[106] In this scenario, section 204A might require the fund manager of a concentrated fund to adopt procedures that either prevent selective disclosure to portfolio company insiders or prohibit such insiders from investing in the fund.

It is ironic that a fund manager might be liable under section 204A for selectively disclosing its portfolio to a company insider when the insider was expressly exempted from reporting transactions in the fund's shares under section 16(a) of the Exchange Act,[107] which generally requires company insiders to report their transactions in company securities for the purpose of deterring insider trading.[108] One might argue that no trader would ever follow this insider trading strategy because it would be less profitable than buying the stock directly, as the trader's investment would be spread across the fund's entire portfolio and her profit accordingly diluted, but this strategy would have the advantage of legally evading section 16(a)'s reporting requirements.

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rected on the ground that they had possession of material, nonpublic information about the fund's mispricing. Robert McGough, *SEC Probes Insider Trading At Money Fund*, WALL ST. J., Oct. 24, 1994, at C1.

105 *See, e.g.*, Christopher Oster, *Forcing Managers to Reveal Fund Stakes*, WALL ST. J., Aug. 2, 2004, at R1.

106 Microsoft stock is one of the most widely held stocks in equity mutual funds, with some fund portfolios holding more than ten percent of their assets in the stock. *See* Ian McDonald, *How Plan May Affect Investors*, WSJ.COM, July 21, 2004.

107 *See* 15 U.S.C. § 78*l*(g)(2)(B) (2000) (exempting securities issued by registered investment companies from registration under section 12 of the Exchange Act); *id.* § 78p(a) (requiring reporting by certain persons of beneficial ownership in securities registered under section 12 of the Exchange Act); 17 C.F.R. § 240.16(a)(5)(ii) (2005) (excluding interests in portfolio securities held by registered investment companies from interests deemed to confer beneficial ownership for purposes of section 16).

108 *See generally* LOSS & SELIGMAN, *supra* note 55, § 6-E-1.

Although this Article focuses on insider trading of mutual funds, it is relevant to consider briefly insider trading in exchange-traded funds (ETFs). Exchange-traded funds technically are mutual funds because they are open-end funds that issue redeemable securities,[109] but unlike conventional mutual funds, their shares are traded in the secondary market. This secondary market trading creates interesting new possibilities for insider trading in ETF shares. While ETF shares trade in the secondary market like other stocks, the funds themselves sell and redeem their shares only in large aggregations ("creation units").[110] An ETF's market price typically tracks its per share NAV closely because arbitrage activity provides a kind of disciplining mechanism.[111] For example, if an ETF's market price falls below its per share NAV, arbitrageurs buy shares with the knowledge that once they have accumulated enough shares to form a creation unit, the fund must redeem the creation unit at the higher per share NAV. This kind of fund arbitrage, ironically, benefits shareholders by providing a liquid, exchange-traded pool of securities that does not trade at a discount to its net asset value.[112] There are situations, however, in which nonpublic information about an ETF's internal operations could be used to anticipate changes in its market price,[113] and trading on such information could constitute insider trading.[114] An ETF manager's failure to

[109] *See* 15 U.S.C. § 80a-5(a)(1).

[110] *See supra* note 5.

[111] Exchange-traded funds may trade at market prices that deviate from their per share NAVs, however. *See generally* Memorandum from Fund Democracy, L.L.C. in Support of Hearing Request (May 4, 2000) (arguing that ETFs should be required to disclose discrepancies between trading and market prices), http://www.funddemocracy.com/Supporting%20Memo.pdf.

[112] In contrast, closed-end funds, which are investment companies that trade in the secondary market but do not offer redeemable securities, *see* 15 U.S.C. § 80a-5(a)(1)-(2), often trade at substantial discounts to their per share NAV, *see generally* Matthew I. Spiegel, *Closed-End Fund Discounts in a Rational Agent Economy* (Feb. 5, 1999), http://som.yale.edu/~spiegel/closedend/cef.pdf.

[113] For example, in 1994, Malaysia WEBS, an ETF that invests in stocks traded on the Kuala Lumpur Exchange, traded at substantial discounts to its NAV, *see* Premium/Discount for Malaysia WEBS (May 4, 2004), http://www.funddemocracy.com/MalaysiaGraph.pdf, and these discounts were affected, in part, by internal decisions regarding the exchange rate used by the fund, *see* Prospectus, WEBS Index Fund, Inc. (supp. Feb. 17, 1999), http://www.sec.gov/ Archives/edgar/data/930667/0000940400-99-000052.txt (using exchange rate other than the rate established by the Malaysian government).

[114] Transactions in exchange-traded funds, unlike transactions in other mutual funds, are subject to reporting under section 16 of the Exchange Act. *See* 15 U.S.C. § 78*l*(b) (requiring companies with securities traded on an exchange to register

protect against such misuse accordingly could violate section 204A.

Each of the foregoing mutual fund insider trading scenarios presents a stronger case under section 204A than the SEC's selective portfolio disclosure cases, but courts still might deem none of them to constitute the kind of "misuse" that section 204A was intended to address. To violate section 204A, the investment adviser must have failed to protect against the kinds of "misuse" that the section was intended to prevent. If this misuse must involve traditional insider trading, as argued above,[115] the Commission would have to persuade a court that the various scenarios described above involve insider trading. The scope of conduct deemed to constitute insider trading has been largely defined by the courts under section 10(b) of the Exchange Act and Rule 10b-5 thereunder,[116] and courts in recent years have been reluctant to expand established private causes of action under the federal securities laws.[117] Courts therefore may reject

under section 12 of the Exchange Act); *id.* § 78p(a) (requiring reporting by certain persons of beneficial ownership in securities registered under section 12 of the Exchange Act). The SEC staff has stated that it would not recommend that the Commission institute an enforcement action if a section 16 beneficial owner of shares of an ETF did not file reports under section 16 provided that the market price of the fund did not deviate materially from its NAV. *See* Select Sector SPDR Trust, SEC No-Action Letter, 1999 WL 285555, at *20 (May 6, 1999).

115 *See supra* text accompanying notes 59-69.

116 *See* LOSS & SELIGMAN, *supra* note 55, § 9-B-3 (regarding evolution of substantive law under section 10(b) and Rule 10b-5: "That law, of course, is federal: the 'federal common law' of which Judge Friendly and others have spoken as forming a penumbra around every federal statute. In theory the courts are merely construing a statute and rule. But when the statute and rule are, like § 10(b) and Rule 10b-5, virtually as vague as the Due Process Clause, the law is surely as much judge made as is the classic common law of the states." (footnote omitted)); Seligman, *supra* note 82, at 2 (claiming that there is no evidence that Congress was thinking about trading by insiders in enacting section 10(b) and that "[i]t has . . . been up to the courts to decide precisely which persons should" be subject to insider trading liability).

117 After an initial period of expansive interpretation of causes of action under the federal securities laws, the Supreme Court entered on a substantial narrowing of its earlier jurisprudence, and recent cases generally have not disturbed this second stage opposition to an expansive creation or expansion of such private rights. *See* E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571, 1579-84 (2004) (describing different stages in the Supreme Court's positions on private rights of action under the federal securities laws). There have been exceptions, however, such as the late-stage decisions in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), and *United States v. O'Hagan*, 521 U.S. 642 (1997), which expanded private rights of action, the latter specifically with respect to the law of insider trading. *Id.* at 1583.

expanding the definition of insider trading to include purchases and redemptions of mutual fund shares based on inside information about the funds.[118]

Courts also may be particularly leery of imposing duties to adopt procedures that the Commission historically has suggested were unnecessary[119] and lack a clear source of law, especially where the Commission has declined to bring charges either against the insider traders/arbitrageurs themselves or fund managers for aiding and abetting funds' violations of express statutory mandates such as the fair value pricing. While the Commission has brought a number of cases against funds for permitting late trading,[120] it has never taken action against a fund for permitting pricing arbitrage (i.e., using stale prices). Late trading and stale pricing violate express, specific, statutory duties, in contrast with the implied, general obligation the Commission argues is imposed by section 204A that fund managers must prevent selective disclosure of fund portfolio information that may be used to facilitate insider trading in mutual fund shares.

III

Disclosure of Portfolio Disclosure Policies

The SEC's new rules regarding funds' portfolio disclosure policies[121] follow the same misguided logic as the SEC's selective dis-

118 *See* Monetta Fin. Servs., Inc. v. SEC, 390 F.3d 952, 955-57 (7th Cir. 2004) (finding that the fund president did not violate duty to disclose allocations of IPOs to fund directors, which was material information, because he was not aware that disclosure was required, that the SEC had not adopted a rule requiring such disclosure, and that the allocations were not inequitable). *But see* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200 (1963) (stating that adviser's failure to disclose material information is fraud under Advisers Act, regardless of whether "elements of technical common-law fraud—particularly intent—[have been] established").

119 *See supra* text accompanying notes 85-93.

120 *See, e.g.*, Markovitz, Exchange Act Release No. 48,588, Investment Company Act Release No. 26,201, 81 SEC Docket 450, 2003 WL 22258425 (Oct. 2, 2003).

121 In Codes of Ethics Adopting Release, Investment Company Act Release No. 26,492, 69 Fed. Reg. 41,696 (July 9, 2004), the Commission adopted Advisers Act Rule 204A and amended Advisers Act Rule 204-2 and Investment Company Act Rule 17j-1. *See* 17 C.F.R. § 275.204A-1 (2005) (adopting new rule requiring registered investment advisers to adopt a code of ethics that includes, *inter alia*, provisions regarding the reporting by certain persons of personal securities holdings and transactions, including securities issued by certain affiliated mutual funds); *id.* § 275.204-2(a)(12)(i)–(iii), (a)(13)(i)–(iii), (e)(1) (amending recordkeeping rule to require maintenance of a copy of the code of ethics and records relating to holdings and transactions, pursuant to Rule 204A-1); *id.* § 270.17j-1(a)(1)(i), (a)(2)(i), (a)(11), (d)(1), (d)(2)(iv)–(v) (amending requirements regarding contemporaneity

closure cases: that regulating portfolio disclosure policies provides an effective means of combating fund arbitrage. As discussed above, selective portfolio disclosure is at most only incidentally related to fund arbitrage, which is, in fact, enabled primarily by late trading opportunities and stale prices.

Previously, funds were not required to disclose their portfolio disclosure policies, and their policies were not substantively regulated.[122] Funds are now required to provide in their Statements of Additional Information (SAI), which is a part of a fund's registration statement,[123] a detailed description of the fund's policies and procedures regarding the disclosure of portfolio holdings.[124] The disclosure must include, *inter alia*, the terms under which portfolio information is selectively disclosed[125] and the process for determining whether such selective disclosure is

of personal holdings and transactions reports and expanding category of persons subject to reporting requirements). In Market Timing Adopting Release, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 23, 2004), the Commission revised Form N-1A, the registration statement for mutual funds. *See* Form N-1A, Item 4(d), *available at* http://www.sec.gov/about/forms (requiring prospectus to state that the fund's portfolio disclosure policy is described in its Statement of Additional Information and on its website); *id.* at Item 11(f) (setting forth requirements for disclosure of fund portfolio disclosure policies, *see infra* note 126). In Compliance Programs Adopting Release, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, (Dec. 24, 2003), the Commission adopted Rule 38a-1. *See* 17 C.F.R. § 270.38a-1 (2005) (requiring that mutual fund boards adopt "policies and procedures reasonably designed to prevent" violations of the federal securities laws, including policies and procedures that address disclosure of fund portfolio, trading strategy, and transaction information and transactions by fund personnel in fund shares based on such information).

122 For example, when the Commission issued its proposal to require more frequent disclosure of fund portfolio information in December 2002, it did not mention the potential harm caused by selective disclosure, much less the issue of what information should be required to be disclosed about selective disclosure. *See supra* text accompanying note 93.

123 The mutual fund registration statement includes three parts: Part A: The Prospectus; Part B: Statement of Additional Information (SAI), and Part C: Other Information (e.g., exhibits). The prospectus must be provided to investors at or before the completion of a fund purchase. *See* 17 C.F.R. § 230.134b (2005). The SAI must be provided only upon the request of the investor. *See* Form N-1A, *supra* note 121, at Item 1(b)(1), Instruction 3.

124 *See* Form N-1A, *supra* note 121, at Item 4(d).

125 Funds are not required to disclose selective disclosure arrangements to the extent that the fund's portfolio is disclosed on its website. *See* Market Timing Adopting Release, 69 Fed. Reg. at 22,307. The Commission stated that filing the information with Commission would not be sufficient for this purpose. *Id.* In contrast, the Commission took the position in adopting Regulation FD that disclosure of company information on a Web site would not by itself qualify as "public disclosure" for purposes of the rule. Selective Disclosure and Insider Trading Adopting Release, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Invest-

in the best interests of fund shareholders.[126]

The Commission also required that fund advisers' compliance procedures include provisions designed to prevent access to material, nonpublic information about client holdings and transactions, and implied that these procedures must satisfy certain substantive standards. New Rule 38a-1 under the Investment Company Act generally requires fund advisers to adopt codes of ethics and specifically requires that the codes include or incorporate by reference procedures designed to prevent access to material, nonpublic information about client holdings and transactions.[127] The Commission also amended the investment

ment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,723-24 (Aug. 24, 2000).

[126] Specifically, the SAI must disclose:

> How the policies and procedures apply to disclosure to different categories of persons, including individual investors, institutional investors, intermediaries that distribute the fund's shares, third-party service providers, rating and ranking organizations, and affiliated persons of the fund.
>
> Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information.
>
> The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed.
>
> Any policies and procedures with respect to the receipt of compensation or other consideration by the fund, its investment adviser, or any other party in connection with the disclosure of information about portfolio securities.
>
> The individuals or categories of individuals who may authorize disclosure of the fund's portfolio securities.
>
> The procedures that the fund uses to ensure that disclosure of information about portfolio securities is in the best interests of fund shareholders, including procedures to address conflicts between the interests of fund shareholders, on the one hand, and those of the fund's investment adviser; principal underwriter; or any affiliated person of the fund, its investment adviser, or its principal underwriter, on the other.
>
> And the manner in which the board of directors exercises oversight of disclosure of the fund's portfolio securities.

Market Timing Adopting Release, 69 Fed. Reg. at 22,306 (footnotes omitted); *see* Form N-1A, *supra* note 121, at Item 11(f)(1).

[127] 17 C.F.R. § 270.38a-1 (2005). As originally proposed, Rule 204A-1 would have required investment advisers to adopt codes of ethics that included provisions designed to prevent access to material, nonpublic information about client holdings and transactions, *see* Codes of Ethics Proposing Release, Investment Company Act Release No. 26,337, 69 Fed. Reg. 4040, 4041 (Jan. 27, 2004) (noting that proposed Rule 204A-1(a)(3) required codes of ethics to "include provisions reasonably designed to prevent access to material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions, unless those individuals need the information to perform their duties"), but the Commission ulti-

adviser recordkeeping rule to require certain employees of the adviser to report trades in securities, including trades in mutual fund shares.[128] Previously, transactions in mutual fund shares were expressly excluded from the reporting requirements under the Advisers Act because the Commission did not believe that mutual funds presented opportunities for insider trading.[129]

Finally, the Commission also promulgated substantive standards for portfolio disclosure policies. In the release adopting Rule 38a-1, the Commission states that "[d]ivulging nonpublic portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality, including a duty not to trade on the nonpublic information."[130] This expansive dictum will effectively force funds that provide any portfolio disclosure beyond that required by law to do so only pursuant to a confidentiality agreement and a "legitimate business purpose" in both cases subject to the SEC's satisfaction. The Commission identifies no authority for this standard other than the exemption from Regulation FD's general prohibition against selective disclosure for disclosure to persons who have agreed to maintain confidentiality.[131] Regulation FD hardly supports the SEC's position, however, as it is intended to address only classic insider trading based on material, nonpublic information about securities "such as advance warnings of earnings results" that affect their true value,[132] a concern that does not apply in the mutual fund context;[133] and it specifically excludes mutual funds from its coverage.[134]

In effect, the Commission has created a new substantive legal duty under which funds may disclose their portfolios selectively

mately decided only to remind advisers that such provisions already would be required under section 204A and that fund advisers' compliance procedures, as required under Rule 38a-1 under the Investment Company Act, should incorporate the adviser's policies and procedures under section 204A, *see* Compliance Programs Adopting Release, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,717-18 (Dec. 24, 2003).

128 *See* 17 C.F.R. § 275.204-2(a)(12)(i)–(iii), (13)(i)–(iii), (e)(1) (2005).

129 *See supra* text accompanying note 89.

130 Market Timing Adopting Release, 69 Fed. Reg. at 22,306.

131 *See id.* at n.42.

132 Selective Disclosure and Insider Trading Adopting Release, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,716.

133 *See supra* text accompanying notes 59-61.

134 *See supra* text accompanying notes 90–91.

only pursuant to a confidentiality agreement and only when there is a legitimate business purpose. The SEC's inspection staff presumably will be the arbiter as to what constitutes a legitimate business purpose. Any inadequacy in funds' policies relating to these substantive requirements will likely bring heightened regulatory scrutiny, and any deviation from the policies may constitute a disclosure violation.[135]

These disclosure requirements seem particularly inappropriate to the extent that the concern is the use of fund information for purposes of fund arbitrage. As discussed above, fund portfolio information is not material to arbitrageurs, and its usefulness does not turn on whether it is nonpublic.[136] In fact, to the extent that the new disclosure requirements cause funds that use stale prices or permit late trading to publicly disclose portfolio holdings that otherwise would have been only selectively disclosed, non-arbitrageur shareholders may be worse off because the potential harm from fund arbitrage could increase as a result.[137] In contrast, while arbitrageurs generally prefer more frequent disclosure of portfolio information, they generally will be indifferent to whether the information is publicly available. The harm that results from the use of the portfolio information arises from the fund's stale price or the opportunity to enter a late trade, not from the selectiveness of the disclosure of the information.[138]

The SEC's new disclosure policy creates a contradiction. Before quarterly disclosure of fund portfolios was required, a fund manager who selectively disclosed portfolio information on a quarterly basis risked violating section 204A. Now that quarterly disclosure is required, that section 204A liability risk has disappeared, despite the fact that the potential for fund arbitrage is, if anything, greater than before. The same abuse (fund arbi-

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[135] *See* 15 U.S.C. § 80a-33(b) (2000) (generally prohibiting, in fund filings, the making of any untrue statements of material fact or the omitting of any fact necessary to prevent other statements from being materially misleading).

[136] *See supra* text accompanying notes 62-68.

[137] *See supra* text accompanying note 70. If funds continue to use stale prices, the more frequent disclosure of portfolio holdings recently required by the Commission probably will increase shareholders' arbitrage losses in those funds.

[138] *Contra* Allan Sloan, *Where's the Outrage?*, WASH. POST, Nov. 11, 2003, at E03 ("Let's think for a minute about many of the transactions that regulators have described. Well-connected investors get real-time information about what's in mutual funds' portfolios, information that's not available to the public. Then these Connected Ones use that information to make profits. 'If it's material, nonpublic and they're trading on it to their advantage, it's insider trading,' says Stephen Cutler, director of enforcement at the Securities and Exchange Commission. Exactly so.").

trage) that funds are required to protect against by prohibiting selective disclosure of portfolio information will occur when portfolio information is publicly disseminated, yet under the SEC's position, the public dissemination insulates the fund manager from section 204A liability while increasing the potential harm to the fund. The mistaken position in this contradiction is not the requirement for more frequent disclosure but the belief that the disclosure of portfolio information to fund arbitrageurs violates section 204A.

The new disclosure requirements will be of little or no value to shareholders.[139] The Commission stated that they "are intended to provide greater transparency of fund practices with respect to the disclosure of the fund's portfolio holdings," but it offered no explanation as to how it expects investors to use this information to evaluate the fund.[140] The new disclosure requirements will impose additional costs on funds and further complicate fund disclosure without any clear countervailing benefit. Only investors who want to obtain more frequent and/or current portfolio disclosure are affected by such disclosure, and we can rely on them to ask for it. It will provide no additional protection to other shareholders. They are not interested in or benefited by evaluating disclosure policies to determine when other investors are being provided with portfolio information.

Conclusion

The Commission has recently settled a series of cases that attempt to establish a new form of insider trading: the use of nonpublic information about mutual fund portfolio holdings to engage in fund arbitrage. The cases alleged that fund managers violated rules requiring that they adopt procedures to prevent the misuse of material, nonpublic information about fund portfolio holdings. These rules were not intended to require such procedures, however, as fund arbitrage based on fund portfolio holdings does not constitute insider trading. The SEC's enforcement actions, if actually litigated, would be summarily dismissed.

Access to portfolio disclosure information can be helpful to

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139 *Contra* Market Timing Adopting Release, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300, 22,307 (Apr. 23, 2004) ("[W]e believe that investors have a *significant interest* in knowing how widely and with whom the fund shares its portfolio holdings information." (emphasis added)).

140 *See id.* at 22,305.

arbitrageurs, but it is not material for purposes of the federal securities laws. The fact that the information is nonpublic has no bearing on the value of the information to the fund arbitrageur. In fact, the public release of the information, if it affects the possibility of fund arbitrage at all, may result in greater, not lesser, harm. There may be, however, certain types of fund information that could be used for insider trading in mutual fund shares, such as information about how the funds are valued.

The SEC's new disclosure rules regarding the disclosure of portfolio disclosure policies, like its selective disclosure cases, misunderstand the true cause of fund arbitrage losses. Rather than focusing on the funds' disclosure of portfolio holdings, the Commission should direct its efforts toward detecting and deterring the violations of fund pricing and sales rules that are the direct cause of losses resulting from fund arbitrage.