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SELF-REGULATION OF INSIDER-TRADING IN MUTUAL FUNDS AND ADVISERS

*Tamar Frankel**

INTRODUCTION

Financial services providers such as investment advisers, investment managers, underwriters, and brokers produce or possess financial insider-information. Insider-information is inherent in their very services for a number of reasons. First, as part of their work financial services providers should glean as much information as they can about target investments, including nonpublic information. Second, financial servicers create a temporary or lasting effect on securities market prices by offering investment advice to a large number of followers or to large clients. Third, the performances of some financial servicers, such as mutual funds management and investment advice, may affect the securities prices markets in which they determine to trade or guarantee for their clients or for their institutions' trading. After all, at the end of 2012, mutual funds alone held over \$26 trillion in worldwide assets.¹

Thus, by definition, financial servicers either gain nonpublic information or create it. In fact, financial servicers are similar to legislators. Legislators, too, receive insider-information and may make decisions that enhance or reduce the profitability of enterprises and, consequently, the price of the enterprises' securities.²

It is not surprising that financial servicers and their personnel must grapple with a strong and continuous temptation to use insider-information for their own benefit or for the benefit of selected others, such as family members or friends. In contrast, the law that prohibits insider-trading often remains unenforced. The reason is that outside regulators face great difficulty and high costs in detecting and preventing the use of insider-information by those related to financial servicers' institutions. Therefore, the legal prohibition on insider trading is enforced after the fact or remains a dead letter. A legal prohibition in and by itself might deter violations. But in this case the prohibition is not very effective. The possibility of quick collections of large sums of money and the low risk of discovery may trump the prohibition.

And yet, throughout the years, there have been relatively few cases concerning insider-trading by regulated mutual funds and advisory service personnel. From 1980 to 2012, according to a LEXIS search, the U.S.

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1. See INV. CO. INST., 2013 INVESTMENT COMPANY FACTBOOK 25 (53d ed. 2013), available at http://www.icifactbook.org/pdf/2013_factbook.pdf.

2. See Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U.L. REV. 1105, 1106 (2011).

Securities and Exchange Commission (SEC) filed thirty-one enforcement actions under Rule 17j-1 of the Investment Company Act of 1940.³ Significantly, the most recent proceedings are dated from 2007,⁴ and none were found for the past five years before that date. Eight of the thirty-one proceedings involved violations of the substantive provision of Rule 17j-1, that is, the direct prohibition on certain fraudulent activities.⁵ Twelve of the proceedings involved violations of the individual companies' established codes of ethics (Codes of Ethics or Codes) requirements,⁶ including one case in which performing transactions in violation of a Code was deemed aiding and abetting a violation of the Code requirements.⁷ There was one insider-trading case against an investment company in 1990,⁸ one against an investment adviser and a portfolio manager in 1995,⁹ and another against an investment adviser in 1997.¹⁰

In 2012 the SEC alleged that a consulting firm and its manager obtained material nonpublic information and provided it to clients, who were "portfolio managers and analysts at prominent hedge funds and other nationally recognized investment advisors."¹¹ In 2011 the SEC claimed that an employee's trades followed the trades at his former employer's exchange-traded fund (ETF) desk.¹² When the SEC focused on insider-trading in the last four years, regulated mutual funds and their managers and employees took a back seat to corporations, hedge funds, investment banks, bank managers, and their employees.¹³

3. Result of LEXIS search performed Feb. 1, 2013, in "SEC Decisions, Orders & Releases."

4. Brod, Investment Advisers Act Release No. 2673, Investment Company Act Release No. 28,022, 91 SEC Docket 2377 (Oct. 24, 2007).

5. *E.g., id.*; Buchner, Investment Advisers Act Release No. 2282, Investment Company Act Release No. 26,580, 83 SEC Docket 1961 (Aug. 26, 2004); Speaker, Investment Company Act Release No. 22,461, Investment Advisers Act Release No. 1605, Exchange Act Release No. 38,161, 63 SEC Docket 1640 (Jan. 13, 1997).

6. *E.g.,* Van Wagoner, Investment Advisers Act Release No. 2281, Investment Company Act Release No. 26,579, 83 SEC Docket 1955 (Aug. 26, 2004); Putnam Inv. Mgmt., LLC, Investment Advisers Act Release No. 2192, Investment Company Act Release No. 26,255, 81 SEC Docket 1913 (Nov. 13, 2003); Gintel Asset Mgmt., Inc., Investment Advisers Act Release No. 2079, Investment Company Act Release No. 25,798, Exchange Act Release No. 46,798, 2002 WL 31499839 (Nov. 8, 2002) [hereinafter Gintel Release].

7. Gintel Release, *supra* note 6.

8. SEC v. Unifund SAL, 910 F.2d 1028 (2d Cir. 1990).

9. Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1494, Investment Company Act Release No. 21,113, 59 SEC Docket 1103 (June 6, 1995).

10. Alliance Capital Mgmt. L.P., Investment Advisers Act Release No. 1630, 64 SEC Docket 1207 (Apr. 28, 1997).

11. Complaint at 2, SEC v. Kinnucan, No. 12-CV-1230 (S.D.N.Y. Feb. 17, 2012), available at <http://www.sec.gov/litigation/complaints/2012/comp22261.pdf>.

12. Mindlin, Securities Act Release No. 9261, Exchange Act Release No. 65,372, Investment Advisers Act Release No. 3284, Investment Company Act Release No. 29,813, 101 SEC Docket 3911 (Sept. 21, 2011).

13. See *SEC Enforcement Actions: Insider Trading Cases*, SEC, <http://www.sec.gov/spotlight/insidertrading/cases.shtml> (last modified Oct. 25, 2013) (summarizing enforcement

Mutual funds are required to impose Codes of Ethics on many of their employees. Did this requirement make a difference? After all, similar Codes proliferate in many other financial and business corporations¹⁴ with fairly miserable results. In fact, the temptations facing employees and managers of many business corporations that published self-imposed Codes are relatively weaker than the temptations facing employees and managers of mutual funds. Yet as compared to mutual funds, these business companies have failed to prevent insider-trading!

I believe that regulated mutual funds are less prone to insider-trading than non-regulated funds and traders because their Codes of Ethics have introduced enforcement mechanisms and have influenced their culture. Regulated mutual funds' Codes of Ethics are accompanied by four features that may have helped reduce the zeal of temptation for insider-trading:

- (1) The Codes are far from voluntary. They are required by law.
- (2) The Codes contain both general principles and self-enforcement mechanisms.
- (3) Mutual funds depend not only on their performance but, like other financial services, are heavily dependent on investors' trust. The managers of regulated mutual funds recognize that a hint of unfair treatment can decimate their entire business and may result in "runs." Similar to banks, open-end funds must offer investors redemption within seven days of demand, with few exceptions.¹⁵ Mutual funds receive investors' demands, and in seven days investors must receive their money!¹⁶
- (4) The Investment Company Institute—the professional and trade organization of investment advisers that manage mutual funds—has supported the legally required provisions of the Code.

It may well be that these four conditions help increase the deterrent effect, reduce temptation within an organization, strengthen the prohibition on insider-trading, and—most importantly—establish a culture of compliance.

actions relating to hedge funds and similar organizations, rather than mutual funds, from late 2009 to present).

14. See, e.g., DELOITTE DEVELOPMENT LLC, CODE OF ETHICS & PROFESSIONAL CONDUCT (2013), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_about_ei_coe2013_06042013.pdf (accounting firm); U.S. BANK, CODE OF ETHICS AND BUSINESS CONDUCT (2013), available at <https://usbank.com/ht/docs/policies/coeHandbook.pdf> (bank); WHIRLPOOL CORP., CODE OF ETHICS (2006) available at <http://www.whirlpoolcorp.com/shared/content/responsibility/code-of-ethics.pdf> (manufacturing firm).

15. 15 U.S.C. § 80a-22(e) (2012) (general rule); 17 C.F.R. §§ 270.22e-1 to -3 (2013) (exceptions).

16. See 15 U.S.C. § 80a-22(e).

This Article concludes with two questions. First: what is not included in the Code of Ethics? And second: does it pay to internalize enforcement, and if so, to whom? The following is a discussion of each of these four components.

I. THE CODES OF ETHICS IMPOSED ON MUTUAL FUNDS HAVE BEEN INDUCED AND SUPPORTED BY LAW

A. INVESTMENT COMPANY ACT OF 1940¹⁷ (RULE 17J-1)¹⁸

Rule 17j-1 requires investment companies to establish Codes of Ethics.¹⁹ The Rule's requirement applies both to the investment company's investment adviser and principal underwriter.²⁰ The principal underwriter is very important to open-end investment companies because these companies issue redeemable securities.²¹ Investors may demand their money, not because they are dissatisfied with the performance of their funds but because they need the money.²² Yet, heavy demand may shrink the fund's portfolio and raise the cost of managing it.²³ The dependency of mutual funds on principal underwriters is the main reason for regulating their Codes of Ethics.²⁴

B. RULE 17J-1 PROVIDES DETAILED REQUIREMENTS REGARDING THE SUBSTANCE OF CODES OF ETHICS

Codes must contain specific self-enforcing provisions. These provisions must be implemented not only to punish violators but to *prevent* violations of the federal securities laws. The requirements include oversight of compliance by the investment adviser, principal underwriter, administrator, and transfer agent.²⁵ Under Rule 38a-1, the funds' boards of directors are required to approve the policies and procedures—the Codes—of the

17. *Id.* §§ 80a-1 to -64.

18. 17 C.F.R. § 270.17j-1.

19. *Id.*

20. *Id.* § 270.17j-1(c)(1)(i).

21. 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS* § 9.03[D], at 9-56 (2002) (noting investment companies' dependence on distribution of their securities); 15 U.S.C. § 80a-15(b) (requiring principal underwriter for registered open-end investment company to have written contract).

22. *See* Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328, 13,328 (Mar. 18, 2005) (noting that mutual funds' "redemption 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").

23. *See, e.g., Meyer v. Oppenheimer Mgmt. Corp.*, 895 F.2d 861, 865 (2d Cir. 1990) ("[A]n enormous and rapid shrinkage in asset size is potentially very damaging . . . Lower total assets would also result in a higher effective advisory charge to remaining shareholders because of the economies of scale of fund management.").

24. *See supra* note 21 and accompanying text.

25. 17 C.F.R. § 270.38a-1(a)(1).

investment adviser, principal underwriter, administrator, and transfer agent.²⁶ A few details are interesting:

1. The Code must subject “access persons” to reporting of their *personal securities transactions and holdings*.²⁷ An access person is a “supervised person who has access to nonpublic information regarding clients’ purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic.”²⁸ “A supervised person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds” is an access person as well.²⁹

Thus, access persons include “portfolio management personnel and, in some organizations, client service representatives who *communicate* investment advice to clients” (even if they did not prepare the advice).³⁰ “These employees [gain] information about investment recommendations whose effect may not yet be felt in the marketplace; [therefore], they may be in a position to take advantage of their inside knowledge.”³¹ “Administrative, technical, and clerical personnel may also be access persons if their functions or duties [require] access to nonpublic-information.”³²

There is no specific and fixed definition of the word “access” with respect to insider-information. Access is measured by the organizations’ controls and structures.³³ If an organization has a large number of employees with broad responsibilities, yet imposes on them few barriers to insider-information, the organization may have to consider a larger percentage of its staff to be access persons.³⁴ In contrast, if an organization keeps strict controls on sensitive information, it may be deemed to have fewer access persons.³⁵ Thus, the position of the employees is not the only consideration. The *internal controls* of the organization play a part in the definition of “access” as well. Rule 204A-1 provides a “presumption that, if the firm’s primary business is providing investment advice, then *all of its directors, officers and partners will also be access persons*.”³⁶ Therefore, in many

26. *Id.*

27. *Id.* § 270.17j-1(d).

28. Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, Investment Company Act Release No. 26,492, 69 Fed. Reg. 41,696, 41,698 (July 9, 2004) [hereinafter Investment Advisers Code of Ethics Release].

29. *Id.*; see also 17 C.F.R. § 270.17j-1(a)(1) (general definition); *id.* § 270.17j-1(a)(1)(i) (incorporating definition of “Advisory Person of a Fund or of a Fund’s investment adviser”); *id.* § 270.17j-1(a)(2) (defining “Advisory Person of a Fund or of a Fund’s investment adviser”).

30. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698 (emphasis added).

31. *Id.*

32. *Id.*

33. See *id.* (noting relationship between access and information barriers or controls).

34. *Id.*

35. *Id.*

36. *Id.* (emphasis added) (citing 17 C.F.R. § 275.204A-1(e)(1)(ii)).

advisory firms, directors, officers, and partners will be access persons as well.

2. The Code should impose on an adviser's access persons a requirement to periodically report their personal securities transactions and holdings.³⁷

The report should be forwarded to the adviser's chief compliance officer or other designated persons.³⁸ The adviser should review the reports to ensure that the adviser and the SEC examiner would be able to "identify improper trades or patterns of trading by access persons."³⁹ The reports are modeled largely on the requirements in Rule 17j-1.⁴⁰

3. Even though Rule 17j-1 contains no requirement to adopt many of the detailed, prophylactic measures common to many Codes, advisory firms usually include in their Codes many of the following elements:

a. Access persons must have prior written approval (or "pre-clearance") before they can place a personal securities transaction and may trade in securities only through particular brokers. These persons could be limited with respect to the number of brokerage accounts they may hold.⁴¹

b. Advisers should prepare "duplicate trade confirmations and account statements" and set forth procedures for assigning new securities analyses to employees. These employees' personal holdings should not present apparent conflicts of interest.⁴²

c. An advisory firm should maintain lists of the issuers of securities that the Advisory firm is analyzing or recommending for clients. Advisers are prohibited from "personal trading in securities of those issuers."⁴³ In addition, the firm must maintain "restricted lists" of issuers

37. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698.

38. *Id.*

39. *Id.*

40. *Id.*; 17 C.F.R. § 270.17j-1(d).

41. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698; INV. CO. INST., REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, at vii, 14-15, app. II at 4 (1994) [hereinafter REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING], available at http://www.ici.org/pdf/rpt_personal_investing.pdf.

42. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698; REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at vii, 45.

43. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698; REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, app. II at 4; FRANKEL & SCHWING, *supra* note 21, § 13.04, at 13-64 (citing INV. ADVISER ASS'N, STANDARDS OF PRACTICE (2010), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA_Standards_of_Practice/Standards_of_Practice_2010_final.pdf ("The parameters of an investment adviser's duty depend on the scope of the advisory relationship and generally include . . . the duty to respect the confidentiality of client information.")); CFA INST., CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT para. III.E.1-3 (2010), available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1> ("Members and Candidates must keep information about current, former, and prospective clients confidential unless: (1) The information concerns illegal activities on the part of the client or prospective client, (2) Disclosure is required by law, or (3) The client or prospective client permits disclosure of the information."); *Code of Ethics & Professional Responsibility*, CERTIFIED FIN. PLANNER BOARD OF STANDARDS,

about which the Advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers.”⁴⁴ The firm should impose “‘blackout periods’ when client securities trades are being placed” or recommended. Access persons may not personally engage in transactions in these securities.⁴⁵

d. Access persons must be reminded that investment opportunities should be offered to clients first, before the adviser or its employees may act on such opportunities.⁴⁶ The Adviser must have procedures to implement this directive.⁴⁷

4. The Code should prohibit “‘short-swing’ trading and market timing.”⁴⁸

5. The Code should require initial and annual holdings and quarterly transaction reports,⁴⁹ with three exceptions: “transactions effected pursuant to an automatic investment plan,”⁵⁰ “securities held in accounts over which the access person had no direct or indirect influence or control,”⁵¹ and a report that would “duplicate information contained in [broker] trade confirmations or account statements” provided that recordkeeping

<http://www.cfp.net/for-cfp-professionals/professional-standards-enforcement/standards-of-professional-conduct/code-of-ethics-professional-responsibility> (last visited Nov. 17, 2013) (“Protect the confidentiality of all client information. Confidentiality means ensuring that information is accessible only to those authorized to have access. A relationship of trust and confidence with the client can only be built upon the understanding that the client’s information will remain confidential.”); *Code of Ethics*, FIN. PLANNING ASS’N, <http://www.fpanet.org/AboutFPA/CodeofEthics/> (last visited Nov. 17, 2013) (“An FPA member shall not disclose any confidential client information without the specific consent of the client unless in response to proper legal process, to defend against charges of wrongdoing by the FPA member or in connection with a civil dispute between the FPA member and client.”); see *FINRA Manual: Contents*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=8849 (last visited Nov. 17, 2013) (FINRA Rule 2060, which has superseded NASD Rule 3120); cf. W. E. SELL, AGENCY § 136, at 123 (1975) (“An agent has a duty not to reveal or use any confidential information received from his principal for his own or another’s benefit.”) The term “confidential information” has been construed to include all information that the agent should be aware the principal would not want revealed, for example, a list of preferred customers or a manufacturing process. “Confidential information” does not include generally known information.); John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685 (2007).

44. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698.

45. *Id.*; see also REPORT ON THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at 36.

46. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,698.

47. *Id.*; see also REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at 27 (stating principle that client interests should come first).

48. Investment Advisers Code of Ethics Release, *supra* note 28; see also INV. CO. INST., *supra* note 41, at vii.

49. Investment Advisers Code of Ethics Release, *supra* note 28; 17 C.F.R. § 275.204A-1(b)(1)(ii)(A)–(B), (2) (2013).

50. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,699; see also 17 C.F.R. § 275.204A-1(b)(3)(ii).

51. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,699; see also 17 C.F.R. § 275.204A-1(b)(3)(i).

requirements are met.⁵² There is an additional exception if the advisory firm “has only one access person, so long as the firm maintains records of the holdings and transactions that Rule 204A-1 would otherwise require be reported.”⁵³

6. The Code “must require that access persons obtain the adviser’s approval before investing in an initial public offering (‘IPO’) or private placement.”⁵⁴ This issue is debated. Because “[m]ost individuals rarely have the opportunity to invest in these types of securities[,] an access person’s IPO or private placement purchase raises issues.”⁵⁵ To what extent does the employee “misappropriat[e] an investment opportunity that should first be offered to eligible clients”?⁵⁶ Or is a portfolio manager “receiving a personal benefit for directing client business or brokerage”?⁵⁷ Yet it seems that these actions should generally be prohibited. One signal is Rule 204A-1’s exception for advisory firms with only one access person.⁵⁸

C. THE CODES IMPOSE ENFORCEMENT MECHANISMS SUCH AS REPORTING VIOLATIONS AND EDUCATING EMPLOYEES

“[E]ach adviser’s code of ethics must require prompt internal reporting of any violations of the code. Violations must be reported to the adviser’s chief compliance officer.”⁵⁹ Further, “an adviser’s code of ethics must require the adviser to provide each supervised person with a copy of the code of ethics and any amendments.”⁶⁰ This requirement reduces the cost of government examiners.

Nonetheless, a Code of Ethics differs from a statute or regulation by offering more flexibility. Instead of requiring evidence in writing and a review by independent experts, the Codes may offer, for example, to include mechanisms that help the institutions enforce the Code rules. This flexibility allows for adjusting the rules to fit the particular functions, size, and culture of subject institutions. Advisers have more discretion to design their Codes and facilitate enforcement of the rules.

52. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,699; *see also* 17 C.F.R. § 275.204A-1(b)(3)(iii).

53. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,699; *see also* 17 C.F.R. § 275.204A-1(d).

54. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,700; *see also* REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at 32–34.

55. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,700.

56. *Id.*

57. *Id.*

58. *Id.* at 41,699; *cf.* 17 C.F.R. § 275.204A-1(d) (exempting a company with a single access person from the requirement of obtaining approval for investments in any security in an IPO or in a limited offering).

59. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,700; *see also* 17 C.F.R. § 275.204A-1(a)(4).

60. Investment Advisers Code of Ethics Release, *supra* note 28, at 41,700; *see also* 17 C.F.R. § 275.204A-1(a)(5).

It is interesting that the SEC did not prohibit insiders within advisory organizations from securities trading.⁶¹ After all, such a requirement would have made the issues and enforcement simpler.⁶² Yet it was recognized that a prohibition (like the prohibition on alcohol drinking) will be difficult, if not impossible, to enforce. People who deal with securities trading and management are engrossed in their activities. The assumption seems to have been that a total prohibition might lead to increased avoidance and costlier enforcement.

The sanctions for violating a Code of Ethics are crucial to its viability. Employers must enforce the rules and punish its violations. The SEC backs these sanctions with more severe ones, such as disqualification from engaging ever again in the service or trade.⁶³ Rule 17j-1 requires compliance procedures and practices to prevent Code violations.⁶⁴ These requirements apply only to registered investment companies and their advisers and principal underwriters.⁶⁵ Lawyers and compliance officers play a role in enforcing the law. While legal provisions may disqualify violators from continuing to practice,⁶⁶ they rarely impose termination of the violators' employment. In contrast, private enforcement by employers for violations of Codes of Ethics can involve reduced bonuses, demotion, and termination of employment, among other disciplinary actions. Thus, to this extent the employers' enforcement power is not only vested in them but provides more, alternative enforcement measures.

II. THE ROLE OF THE PRIVATE SECTOR IN STRENGTHENING THE LEGALLY REQUIRED PROVISIONS OF THE CODE

The requirement to establish a Code was negotiated with the Investment Company Institute, and that led to an agreement before Congress.⁶⁷ The

61. See REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at 19–25 (discussing Advisory Group's consideration of total ban on personal investing by portfolio managers).

62. See *id.* at 20 (noting that such a ban may be a "clear standard to follow" and "relatively easy to implement and administer and less burdensome and costly than the alternatives").

63. 15 U.S.C. §§ 80a-9(b), 80b-3(f) (2012).

64. 17 C.F.R. § 270.17j-1(c)(2)(i) (2013).

65. *Id.* (requiring "Fund, investment adviser and principal underwriter" to institute procedures to prevent violations of Code of Ethics); *Id.* § 270.17j-1(a)(5) (defining "Fund" as "an investment company registered under the Investment Company Act").

66. 15 U.S.C. §§ 80a-9(b), 80b-3(f).

67. *Investment Company Act Amendments of 1967: Hearings on H.R. 9510 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate & Foreign Commerce*, 90th Cong. 73 n.27 (1967) (statement of the SEC); see *id.* at 80, 84–85 (The SEC recommended changes to provisions of Senate Bill 1659, reflecting upon how both SEC staff and representatives of the Investment Company Institute had agreed "that the purposes intended by the proposed amendment would be more precisely delineated if the amendment prohibited insider trading in contravention of such rules as the Commission may adopt to define fraudulent, deceptive and manipulative practices and to prescribe means reasonably necessary to prevent such practices." The Investment Company Institute agreed that SEC would be authorized "to adopt rules with respect to minimum

Code's provisions are supported by private organizations. The Investment Company Institute—the professional/trade organization of investment advisers that manage mutual funds⁶⁸—has established a Code which is intended to prevent insider-trading and sets higher standards than the Code required by regulations.⁶⁹ Similarly, the Investment Adviser Association (the IAA) has established a Code prohibiting violations of general fiduciary duties (e.g., conflicts of interest and non-disclosure).⁷⁰ Membership in the IAA is not required, but membership requires endorsement of the standards.⁷¹

In sum, pressured by the public, the professional organizations, combined with a shadow of SEC enforcement and specific internal enforcement, may be able to increase the strength of enforcement by the management and reduce government enforcement.

III. WHAT IS NOT INCLUDED IN THE CODE OF ETHICS?

Just as interesting as the contents of Codes of Ethics is what is *not* included in the requirements concerning the Code. Open many books on Codes of Ethics and you will find at the outset a discussion of ethics.⁷² This requirement is missing here. The word “Ethics” appears in the title of the Code. Yet, there is no direct requirement to behave in an ethical way. This is not, in my opinion, an error. It is intentional.

The reason may have been spelled out in another examination of effective Codes of Ethics. The advice in that source is to avoid “positions that are generally held in society” such as: “obey the law.”⁷³ A Code is also a piece of literature. Its writing and expressions can be inspirational or deadly boring. Therefore, avoidance of well-trodden words is desirable. Highly generalized expressions do not lend help when applying the rules to everyday, specific activities. Highly detailed rules are mind-numbing, but also invite circumvention. Although precision can be understood, everyday work involves activities that do not necessarily fall into the precise

standards for codes of ethics governing insider trading by insiders of investment companies to prevent such practices, and the statute so specifies.”); *Hearings on S. 1659 Before the S. Comm. on Banking & Currency*, 90th Cong. (1967).

68. See REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, *supra* note 41, at 8 (noting industry support of adoption of section 17(j) of the Investment Company Act of 1940, authorizing SEC to require Codes of Ethics).

69. *Id.* app. I.

70. *IAA Standards of Practice*, INVESTMENT ADVISER ASS'N, <https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=StandardsPractice> (last visited Nov. 17, 2013).

71. See *Membership Criteria*, INVESTMENT ADVISER ASS'N, <https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=Criteria> (last visited Nov. 17, 2013) (stating that new member firms must endorse Standards of Practice).

72. See, e.g., MARTIN T. BIEGELMAN WITH DANIEL R. BIEGELMAN, *BUILDING A WORLD-CLASS COMPLIANCE PROGRAM* 1–23 (2008).

73. John C. Lere & Bruce R. Gaumnitz, *Changing Behavior by Improving Codes of Ethics*, AM. J. BUS., Fall 2007, at 7, 9.

language of Codes of Ethics. Therefore, something in-between is most desirable.

Have these materials decreased the prevalence of insider-trading? They have not. Have I assumed that the rate of insider-trading by advisory firms is related to their Codes of Ethics? I have not. Arguably, the reason for the lower use of insider-trading is that employees in these organizations are well rewarded. I reject this argument. People who deal with money are usually hungry for money. For such people there is never enough. For people who are envious of richer people, there are always those who have more.⁷⁴ Therefore, the explanation must be different for people who deal with money and make enormous returns for others but are not likely to use the easier path to financial success by insider-trading.

Codes of Ethics contribute to the low incidence of insider-trading for a number of reasons. In this Article I deal with just one contribution: culture. Culture is a social habit. Our culture requires us to wear clothes in public. A social habit is beneficial in that it leads to a “knee-jerk reaction” rather than to an evaluation of the pros and cons of a particular action.⁷⁵ Every society has leadership, from a family to a club, a school, or Congress. And in each such group there is a leader or a group of leaders, from fathers (or fathers and mothers) to teachers and party leaders. They are the ones who establish or induce others to follow a certain group-culture.

In a business organization, the leadership is usually endowed with rank signals to clarify and establish their position (although there are controlling persons who bear no title).⁷⁶ To some extent, Codes of Ethics help leaders in financial advisory services to establish a culture that prohibits insider-trading. It may be the culture that causes every access person to say: “We do not do this here!” Such a culture finds many reasons to justify the prohibition, such as the support of the law; the approval of the professional and the leadership of business organizations; public reputation; trust, loyalty, and devotion of investors and employees; significant profits; and the satisfaction of controlling much money and affecting the social welfare. If violations by insider-trading threaten the strength of all these factors, then insider-trading is a danger to be prevented. And the best way to prevent it is to make clear to the rank and file as well as co-management that such an action will not be tolerated.

When these benefits to high-ranking leadership exist, there is a good chance that insider-trading can be reigned-in, if not eradicated entirely. The Codes of Ethics in the financial advisory area may demonstrate this.

74. TAMAR FRANKEL, TRUST AND HONESTY 88-91 (2005).

75. *Id.* at 190.

76. *Id.* at 193-94 (role of leaders in culture).

CONCLUSION

As money managers serve more investors, pool more securities, and combine their securities-pools with other pools, investors and outside regulators are less able to uncover, let alone control, the activities of these money managers. Many financial services can be carried out without detection; many wrongful actions can be justified as good business practices and efficient services. The danger to the financial system from wrongful activities can be devastating. Societies cannot afford to wait until the harm of such activities is done.

Codes of Ethics are focused on prevention rather than punishment. Compliance Officers and top management can more easily detect possible violations and uproot them. Effective compliance might be practiced within the institutions in the shadow of the law. Mutual funds and advisers' Codes of Ethics and their enforcement offer one fairly effective model.