

Second Circuit: Investment Advisory Client Did Not Become a Member of a Section 13(d) “Group” With the Advisor Simply By Delegating Discretionary Investment Authority to the Advisor

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On May 20, 2020, the Second Circuit held that a client of an investment advisor did not become “a member of a Section 13(d) group with his investment advisor and the advisor’s other clients merely because he and the other clients had delegated discretionary investment authority to the advisor and the advisor had purchased for the client’s account shares of the same issuer that was the subject of the advisor’s Schedule 13D filing.” *Rubenstein v. Int’l Value Advisers*, 2020 WL 2549507 (2d Cir. 2020) (Parker, C.J.). The court concluded that the client was therefore “not obligated to disgorge his short-swing profits” under Section 16(b) of the Exchange Act of 1934.

The Second Circuit explained that “Section 16(b) . . . imposes strict liability on certain insiders of an issuer, requiring them to disgorge to the issuer any profits they realize from short-swing trading in the issuer’s securities.”^[1] “In addition to requiring individual statutory insiders to disgorge short-swing profits, the [Exchange] Act provides for ‘group’ liability” pursuant to Section 13(d). “A Section 13(d) group is formed ‘[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer.’” *Id.* (quoting 17 C.F.R. § 240.13d-5(b)(1)). “The group is then deemed to have acquired beneficial ownership of all equity securities of that issuer beneficially owned by any group members. If the group’s collective holdings exceed 10% of any class of the issuer’s outstanding equity securities, then each group member is subject to the short-swing profit rule.”

In the case before the court, an investment advisor and two of its managing members had reported that “they beneficially owned, through their voting and investment power over their advisee-clients, more than 10% of [a company’s] outstanding common stock” and “filed Schedule 13Ds with the SEC indicting that, in accumulating their position in [the company], they had formed a ‘control purpose’ with respect to the [company].” The plaintiff contended that “the filing of the Schedule 13D put an owner of [the company’s] shares in a managed account . . . on notice of the [investment adviser] defendants’ control purpose and that the owner thereby ‘agreed’ to become part of the group by failing to terminate the [investment adviser] defendants’ control of the managed account.”

The plaintiff “relie[d] principally on the theory that [the investment adviser’s] clients became members of a group with their investment advisor and its other clients when they signed investment management agreements delegating discretionary trading authority to [the

investment adviser].” The Second Circuit found the plaintiff’s “theory . . . incompatible with the text of the [Exchange] Act and its implementing regulations.” The court “straightforwardly conclude[d] that these provisions impose liability only when insiders enter an agreement . . . to trade the securities of *a particular issuer*.” *Id.* (emphasis added). The court noted that “[n]either [the company in question] nor any other issuer was identified as one whose stock [the investment advisor] might purchase for [the client’s] account.” Moreover, “the investment management agreement did not address whether, or to what extent, the [investment adviser] defendants might purchase or sell the same securities for the other accounts they managed; nor did the investment management agreement touch on the subject of whether the [investment adviser] defendants might seek to influence or control an issuer whose shares might be in an account they managed.” The court therefore determined that the plaintiff’s contention that “the investment management agreement constituted an ‘agreement’ to trade in [the company’s] securities” was “simply wrong.”

The Second Circuit also deemed unpersuasive the plaintiff’s policy argument that declining to impose Section 16(b) liability on an investment advisory client under these circumstances would “enable investment managers to evade Section 16(b) and to abuse inside information by trading in client funds rather than their own funds . . . and to earn profits from those trades.” The court explained that “[b]ecause of the strict liability imposed by Section 16(b), the Supreme Court has cautioned against exceeding the ‘narrowly drawn limits’ on the class of corporate insiders who may be subject to the statute.” The court found that it “may not expand the boundaries of the statute merely to address [the plaintiff’s] concerns,” particularly given that “[e]xempting certain client profits from Section 16(b) does not insulate investment advisors from liability under the more general anti-fraud provisions of the [Exchange] Act: Section 10(b) and Rule 10b-5.”

In addition, the Second Circuit rejected the plaintiff’s contention that once the investment advisor “filed a Schedule 13D with the SEC disclosing its status” as an insider with respect to the company at issue, the investment advisor’s clients “implicitly agreed to trade in the securities of [the company] as members of the insider group.” The court reasoned that adopting the plaintiff’s approach would require the court to “treat all investors as though they were conscious of the securities held by their advisors’ other clients and would mandate that they tailor their investment decisions to those other clients’ trades.” The court held that “[s]uch requirements are impracticable ones that are not contemplated by the securities laws.” The court emphasized that “Section 16(b) is not designed to threaten liability based on the trades of other investors to whom a defendant’s only connection is sharing an investment advisor.”

[1] Section 16(b) defines short-swing trading as “any purchase and sale, or any sale and purchase, of any equity of such issuer . . . within any period of less than six months . . . irrespective of any intention on the part [the insider].” 15 U.S.C. § 78p(b). Section 16(b) applies to “[e]very person who is directly or indirectly the beneficial owner of more than 10 percent of any of any class of any equity security” of the issuer. *Id.*

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