2 Investment Advice Rulings Offer Lessons On Insider Liability

By Renee Zaytsev and Philip Sineneng (July 9, 2020)

In recent years, several claims have been filed against registered investment advisers seeking disgorgement of short-swing profits under Section 16(b) of the Securities Exchange Act, with many of these cases premised on the existence of an alleged group comprising the investment adviser and its clients.

Renee Zaytsev

On May 20, the U.S. Court of Appeals for the Second Circuit handed an important victory to the investment advisory community when it issued a pair of decisions, Rubenstein v. International Value Advisers LLC and Rubenstein v. Rofam Inv. LLC.

Philip Sineneng

The court affirmed the dismissal of two Section 16(b) complaints and held that there is no Section 13(d) group comprising an investment adviser and its clients or among the investment adviser's clients where the only agreement is an investment management agreement that delegates investment authority to the registered investment adviser.

The Section 16 Framework

Section 16(b) requires certain corporate insiders, which include an issuer's directors, officers and greater-than-10% beneficial owners, to disgorge to the issuer any profits earned from purchases and sales of that issuer's securities that were made within six months of each other. Insiders can also include a group, as defined in U.S. Securities and Exchange Commission Rule 13d-5(b)(1), that collectively owns more than 10% of the issuer's securities.

Violating Section 16(b) can lead to harsh results. The purpose of Section 16 is to deter insiders, who are presumed to possess material nonpublic information about the issuer, from using such information as a basis to purchase or sell the issuer's securities. Actual knowledge or intent are irrelevant. Further, profits are typically computed via a lowest price in, highest price out methodology that can result in damages that far exceed actual profits.

Section 16(b) creates a private right of action for shareholders. Though profits are disgorged to the issuer, the plaintiff's attorneys typically recoup a percentage as attorney fees.

Most Section 16(b) claims are asserted by a small group of highly sophisticated plaintiffs' lawyers who frequently propound novel theories of liability. In recent years, several of these claims have been asserted against registered investment advisers on the theory that they formed a group with their clients.

Rubenstein v. International Value Advisers

In Rubenstein v. International Value Advisers, a shareholder of AdTalem Global Education Services, formerly known as DeVry Education Group, asserted a Section 16(b) claim against International Value Advisers, a registered investment adviser; IVA's managing members and portfolio managers; and an IVA client identified only as John Doe.

Though John Doe's account did not by itself hold more than 10% of DeVry's shares, the plaintiff, citing the existence of an investment management agreement granting investment authority to the manager, alleged that John Doe formed a group with IVA and IVA's other clients and that the group collectively owned more than 10% of DeVry's outstanding common stock.

The Second Circuit **affirmed** the U.S. District Court for the Southern District of New York's dismissal of the Section 16(b) claim, holding:

> An investment advisory client does not form a group with its investment advisor by merely entering into an investment advisory relationship. Nor does an investor become a member of a group solely because his or her advisor caused other (or all) of its clients to invest in securities of the same issuer.

As the Second Circuit explained, a group exists only when multiple individuals agree to act together for the purpose of trading "the securities of a particular issuer," rather than just any security.

The court thus squarely rejected the plaintiff's theory that an investment management agreement constitutes the requisite agreement to form a group as "incompatible with the text of '34 Act and its implementing regulations" and contrary to "the purpose of the statute."

The Second Circuit also rejected the plaintiff's argument that the investor's silence after IVA filed a Schedule 13D regarding the DeVry shares constituted the requisite "agreement." The court declined to require investors to monitor their advisers' activity and/or the securities held by the advisers' other clients, describing this burden as both "impracticable" and "not contemplated by the securities laws."

Rubenstein v. Rofam

On the same day that it **issued its decision** in Rubenstein v. International Value Advisers, the Second Circuit also affirmed the dismissal of a Section 16(b) complaint in Rubenstein v. Rofam.

In Rofam, the same plaintiff, this time as a shareholder of Sears Holding Corp., sought disgorgement of short-swing profits from clients of Fairholme Investment Management, LLC, a registered investment adviser. As in the case against IVA, the only agreement cited by the plaintiff was an investment advisory agreement that delegated discretionary investment authority to Fairholme.

In affirming the district court's dismissal, the Second Circuit referred to its opinion in Rubenstein v. International Value Advisers and reiterated that "an agreement, including an investment management agreement, must be issuer-specific before it can give rise to group liability. Accordingly, Defendants-Appellees did not become members of an insider group subject to Section 16(b)."

Implications

The Rubenstein decisions are important for the investment advisory community, which in recent years has been targeted with several cases seeking to impose Section 16(b) liability premised on the existence of an alleged group comprising an investment adviser and its clients. By rejecting the plaintiff's group theory, the Second Circuit has made it more

difficult for Section 16(b) plaintiffs to assert claims against investment managers and their portfolio clients.

The Second Circuit's decisions are especially important in light of several district court rulings issued in New York that have denied motions to dismiss based on an alleged group composed of an investment adviser and its client(s), albeit with additional allegations not present in the Rubenstein cases.

By contrast, two decisions by the U.S. District Court for the Northern District of California have held that the delegation of authority by an investment management client to its adviser is not sufficient to form a group.

The Rubenstein decisions also have implications for related arguments that have been made in recent years regarding the applicability of the so-called RIA exemption set forth in SEC Rule 16a-1(a)(1). This rule exempts a registered investment adviser who meets certain conditions, including trading for a client account and without a control purpose, from being deemed a greater-than-10% "beneficial owner" for purposes of Section 16.

The investment managers in the Rubenstein cases did not qualify for the RIA exemption because they had filed Schedule 13Ds disclosing control purposes with respect to the DeVry and Sears shares, respectively. However, in other cases where the exemption does apply, plaintiffs have argued that an investment manager loses the statutory exemption when it forms a group with its clients.

Finally, investment managers should be further comforted by the fact that, despite not meeting the RIA exemption criteria in Rule 16a-1(a)(1), both IVA and Fairholme were nevertheless not deemed beneficial owners pursuant to Rule 16a-1(a)(2), which requires a pecuniary interest in the securities. Presumably, it was for this reason that the plaintiff argued so vehemently to include the investment managers' clients in the alleged group.

Renee Zaytsev is senior counsel and Philip B. Sineneng is an associate at Thompson Hine LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.