Securities Litigation Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Second Circuit Holds Section 16 Plaintiff Needs to Identify an Issuer-Specific Agreement to Establish Creation of a Group Among Clients

May 22, 2020

Key Points

- The 2nd Circuit has affirmed two lower court decisions dismissing complaints alleging violations of Section 16(b) of the Securities Exchange Act. In so holding, the 2nd Circuit ruled that an investment advisor's client does not become a member of a Section 13(d) "group" with its advisor's other clients merely by delegating general discretionary investment authority to a common investment advisor.
- The 2nd Circuit focused its analysis on the client's investment management agreement with its investment advisor, which delegated to the advisor discretionary trading authority, but did not specify any agreement with respect to shares of a **particular** issuer.
- The 2nd Circuit concluded that because the plaintiff in both cases failed to identify any "agreement" or "common objective" between the investment advisor and the client with respect to "an issuer," that client could not be a member of a Section 13(d) "group." Accordingly, the client would not be subject to Section 16 and need not disgorge any short-swing trading profits.
- The 2nd Circuit's decision could have broader implications for Section 16(b) litigation involving multiple client funds managed by a common investment advisor.

On May 20, 2020, the 2nd Circuit affirmed the judgment of the district court in *Rubenstein v. Int'l Value Advisers, LLC*.[1] The 2nd Circuit rejected the plaintiff's argument that an advisory client's investment management agreement (IMA) delegating discretionary investment authority to a common investment advisor was sufficient to establish the client's membership in an insider group under Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and subject it to liability under Section 16.[2] In its ruling, the 2nd Circuit focused on the text of Section 13(d) and Rule 13d-5, which premise group formation upon an agreement to act together "for the purpose of acquiring, holding, voting or disposing of equity securities of an *issuer*."[3] In *Rubenstein*, because the IMA between the client and the investment advisor did not relate to any specific **issuer**, but was instead a general delegation of discretionary

Contact Information

If you have any questions concerning this alert, please contact:

Jason M. Daniel
Partner
jdaniel@akingump.com
Dallas
+1 214.969.4209

Robert H. Pees
Partner
rpees@akingump.com
New York
+1 212.872.1072

Douglas A. Rappaport
Partner
darappaport@akingump.com
New York
+1 212.872.7412

Jacqueline Yecies
Partner
jyecies@akingump.com
New York
+1 212.872.7479

William K. Wetmore
Senior Practice Attorney
wwetmore@akingump.com
San Francisco
+1 415.765.9572

Kaitlin D. Shapiro
Counsel
kshapiro@akingump.com
New York
+1 212.872.8096

Kaitlyn A. Tongalson
Associate
ktongalson@akingump.com
New York
+1 212.872.8106

investment authority from the client to its investment advisor, the IMA was not an “agreement” to trade in any particular securities under Section 13(d).

In a corresponding summary order, also issued on May 20, 2020, the 2nd Circuit affirmed the judgment of the district court in *Rubenstein v. Berkowitz*,[4] a case brought by the same plaintiff but involving different defendants and a different issuer. As in its *International Value Advisers* decision, the 2nd Circuit concluded that the IMAs did not present evidence that there was a “group” for Section 16(b) purposes because “[a]n agreement, including an investment management agreement, must be issuer-specific before it can give rise to group liability.”[5]

Background

Section 16(b) of the Exchange Act provides that a statutory insider who earns “short-swing” profits by buying and selling or selling and buying within a six-month period may be required to disgorge those profits to the issuer. The statutory insiders subject to Section 16 include 10 percent beneficial owners, members of a 10 percent beneficial owner group, directors and executive officers. In determining whether two or more persons or entities constitute a 10 percent beneficial owner “group,” the members of which would be deemed statutory “insiders” under Section 16(b), courts look to Section 13(d) of the Exchange Act and its related rules, which define a “group” as two or more persons who “agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer.”

Rubenstein v. International Value Advisers

Appellant Aaron Rubenstein, a shareholder of AdTalem Global Education Services, formerly known as DeVry Education Group, brought suit under Section 16(b) of the Exchange Act against International Value Advisers (IVA), its managing members and portfolio managers, and “John Doe,” the owner of a brokerage trading account managed by IVA (together, the “Defendants”). Although the “John Doe” account did not individually hold more than 10 percent of DeVry shares, the Defendants collectively owned 19.5 percent of DeVry’s outstanding common stock. During the time of the relevant trades, IVA filed Schedule 13D reports with the Securities and Exchange Commission (SEC) indicating that it had a “control purpose” with respect to accumulating its position in DeVry, and that IVA sought to appoint a managing partner to the DeVry board.

Rubenstein alleged that the Defendants, including the “John Doe” defendant, violated Section 16(b) by engaging in “group” conduct with respect to purchases and sales of DeVry securities. In his suit, Rubenstein only sought to recover short-swing profits from John Doe, who realized profits in an account managed for him by IVA. Specifically, Rubenstein alleged that John Doe’s IMA with IVA constituted an “agreement” to trade in the securities of an issuer under Section 13(d) and, further, that John Doe had “silent[ly] acquiesc[ed]” to group membership with the other IVA Defendants in connection with their investment in DeVry.[6]

The district court granted Defendants’ motion to dismiss Rubenstein’s complaint, holding that the complaint (1) did not plausibly allege a “common objective” among IVA and its managing members and John Doe, whose DeVry shares had been purchased for his account on a discretionary basis by his investment manager, and (2) failed to plead the existence of an agreement with respect to a **particular** issuer, precluding any “group” formation between John Doe and the IVA Defendants.

The 2nd Circuit affirmed. Focusing on the “text and structure of the ’34 Act and its implementing regulations, as well as the legislative purpose behind the short-swing profit rule,” the Court concluded that an agreement for Section 13(d) “group” formation must be specific to **an issuer**, and not based on investment management agreements delegating discretionary trading authority to an investment advisor. “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.”[7]

The 2nd Circuit further rejected a number of Rubenstein’s policy arguments, and concluded that: (1) Rubenstein’s arguments did not serve the purpose of the statute, because he did not allege any effort by IVA’s clients to evade the requirements of Section 16(b) by pooling their shares of an issuer; (2) other federal securities laws, such as Rule 10b-5, provide robust protections against insider trading; and (3) the court’s ruling would not undermine disclosure requirements.

The court likewise rejected Rubenstein’s theory of “implied agreement” of group membership by “silent acquiescence” after a Schedule 13D was filed by the advisor as impracticable and unsupported by the securities laws.

Finally, the 2nd Circuit rejected a new theory Rubenstein advanced for the first time on appeal—namely, that IVA acted as an agent and that the advisory client became a director by deputization—as unsupported by the facts and inappropriate as the theory was not timely raised.

Conclusion & Broader Application

The *Rubenstein* decisions make clear that “[a]n agreement, including an investment management agreement, must be issuer-specific before it can give rise to group liability” under Section 16(b).[8] Although the *Rubenstein* decisions addressed the liability as to specific clients holding accounts with investment advisors, the decisions could have broader implications for investment advisors with multiple clients and client funds. The *Rubenstein* decisions establish that the existence of an investment advisory relationship alone is insufficient to plead the existence of a “group,” at least in the context of Section 16. In turn, to plead a Section 16(b) claim premised on “group” liability against investment advisors with no single client that individually beneficially owns 10 percent of the issuer, shareholder plaintiffs will need to establish an **issuer-specific** agreement between the alleged defendants to act together, independent of a general investment advisory relationship. The rulings could potentially open avenues of defense against these claims where multiple clients or client funds need to be pooled together with the investment advisor to surpass the 10 percent beneficial ownership threshold for Section 16(b) purposes.

[1] 2019 WL 464873 (S.D.N.Y. Feb. 5, 2019).

[2] *Rubenstein v. Int’l Value Advisers, LLC*, No. 19-560, 2020 WL 254950 (2d Cir. May 20, 2020).

[3] Id. at *3 (quoting 15 U.S.C. § 78m(d)(3)) (emphasis added by Second Circuit); see also 17 C.F.R. § 240.13d-5(b)(1).

[4] 2019 WL 1382766 (S.D.N.Y. Mar. 27, 2019).

[5] *Rubenstein v. Berkowitz*, No. 19-cv-796, 2020 WL 2551039 at *1 (2d Cir. May 20, 2020).

[6] *Rubenstein v. Int'l Value Advisers*, 2020 WL 254950 at *2.

[7] Id. at *4.

[8] *Rubenstein v. Berkowitz*, 2020 WL 2551039 at *1.

akingump.com