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Second Circuit Cases Clarify Scope of Investors' "Insider" Status for Short-Swing Profit Statutes

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On May 20, 2020, in *Rubenstein v. International Value Advisers, LLC*[1] and *Rubenstein v. Rofam Inv. LLC*,[2] Judges Kearse, Parker and Sullivan of the Second Circuit issued a pair of opinions clarifying when a group of investors may be considered insiders for purposes of securities laws requiring the disgorgement of profits earned through short-term investments by dint of relationships with their investment advisors. While the issue has arisen elsewhere in lower courts,[3] *International Value* and *Rofam* are the first appellate decisions in this novel area of securities litigation. Accordingly, their determination that group liability for short-swing profits does not arise where investors grant their advisors discretionary authority over their accounts provides important and persuasive authority in support of investment managers facing related claims.

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The Short-Swing Profit Rule

In order to curb the risk that corporate insiders might trade based on material non-public information, the Securities Exchange Act of 1934 applies strict liability in requiring insiders to disgorge to the issuer any profits from certain "short-swing" trades in which an issuer's equity is purchased and then sold, or sold and then purchased, within a period of six months or less.[4] This rule applies to issuers' directors, officers, and any "person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security of the issuer."[5]

In this context, however, the term "person" refers not only to individuals but rather to groups as well. Specifically, the Exchange Act and rules under it provide that whenever multiple people "act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer," they are considered a single "person" for purposes of the short-swing profit rule.[6] SEC rules further clarify that when individuals "agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer," they are considered a single person for purposes of short-swing profits liability and each such individual is "deemed" to be the beneficial owner of equity securities owned by any other group member.[7] Stated otherwise, if members of such a group collectively own more than 10% of a company's equity, each member of that group becomes subject to strict liability disgorgement of their short-swing profits from investments in that issuer's equity securities.[8]

An investor, Aaron Rubenstein, claimed to rely on these rules in bringing two similar suits. He first sued clients of investment advisor Fairholme Investment Management based upon the ownership of more than 10% of Sears common stock by Fairholme and its clients and, subsequently, he sued both investment advisor International Value Advisers and a "John Doe" client in light of the advisory firm's holding more than 10% of the common stock of Adtalem Global Education Services (formerly and better-known as the DeVry Education Group). Rubenstein advanced the same theory in each case: the investment advisors' clients were part of a "group" for purposes of the short-swing profit rule in light of the investment advisors' undisputed insider status. Accordingly, Rubenstein argued that the clients of each investment advisor were liable for short-swing profits earned through investments in Sears and DeVry, respectively.

Investment Advisors' Insider Status Is Not Imputed To Their Clients

In a matter of first impression, the Second Circuit rejected Rubenstein's theory, explaining that an investor does not automatically "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," and an "investment advisory client does not form a group with its investment advisor by merely entering into an investment advisory relationship."[9] Rather, in light of the short-swing profit rule's use of the singular phrase "an issuer," the Second Circuit held that the short-swing profit rule imposes liability only when individuals agree to act as a group for purposes of investing in "the securities of a *particular* issuer."[10] Because Rubenstein alleged that the clients had entered agreements delegating discretionary investment authority to their investment advisors without reference to any specific securities, he failed to state a claim in either case. Since the investment management agreements were not "issuer-specific,"[11] they did not "constitute[] an 'agreement' to trade in DeVry [and Sears] securities"[12] giving rise to group liability.

The Second Circuit also rejected Rubenstein's implied agreement theory in which he argued that the client-defendants had agreed to invest in DeVry and Sears in light of the investment advisors' public disclosures concerning their beneficial ownership of significant holdings in those companies. That theory was based entirely on "unconstrained speculation about the knowledge and intent of [the] clients," however, and risked imposing liability on clients who were unaware of the advisors' disclosure statements or what securities were held in other clients' accounts.[13] As Judge Parker memorably wrote, the Second Circuit would not "hold a retiree on the beach in Florida liable when he fails to conduct an ongoing analysis of his IRA manager's trading in other clients' accounts."[14] Nor would it impose liability on the theory that the clients became members of an insider group by dint of the investment advisors' appointing directors to the boards of Sears and DeVry because most clients were likely also unaware of that fact and, "even if some clients were so aware, there is no indication that they agreed" to such appointments.[15]

In addition to its textual analysis, the Second Circuit analyzed the purpose of the group designation, which was "designed to 'prevent a group of persons who seek to pool their . . . interests in the securities of an issuer from evading the provisions of the [short-swing profit rule] because no one individual owns more than 10 percent of the securities."[16] In rejecting several policy arguments advanced by Rubenstein, the Second Circuit held that the short-swing profit rule's strict liability provisions required the exercise of "caution[] against exceeding [its] 'narrowly drawn limits'" while noting it was not offering "a safe harbor to investment managers engaged in insider trading" that would otherwise give rise to liability under the Exchange Act's general anti-fraud provisions.[17] Nor was the Second Circuit concerned that its holding would undermine the requirement that the beneficial owners of more than 5% of a company's shares file disclosure statements with the SEC[18] because investment advisors can still qualify as the beneficial owner of shares in their clients' accounts regardless of whether or not their clients have formed a group for purposes of the short-swing profit rule. Accordingly, firms that "purchase a sufficient quantity of a security in their clients' managed accounts will become subject to [the] disclosure requirement even if they do not form an insider group with their clients."[19]

Conclusion

It is fitting that the novel group theory of liability advanced in *Rofam* and *International Advisers* would first be addressed by the Second Circuit. In light of its jurisdiction over Wall Street and its long-recognized role as the "'Mother Court' of securities law,"[20] the Second Circuit's determination that clients of an investment advisor are not necessarily a "group" for purposes of the short-swing profit rule will likely be given significant weight by other courts who will inevitably face similar arguments in the future. We will continue to monitor this developing area of the law, however, as only time will tell whether other jurisdictions will find the Second Circuit's reasoning persuasive.

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[1] No. 19-560, --- F.3d --- (2d Cir. May 20, 2020) (hereinafter "*Int'l Value*").

[2] No. 19-796, --- F. App'x --- (2d Cir. May 20, 2020) (hereinafter "*Rofam*").

[3] *See, e.g.*, *Greenfield v. Criterion Capital Mgmt. LLC*, No. 15 Civ. 3583, 2017 WL 2720208 (N.D. Cal. June 23, 2017); *Brian B. Sand & Zachary B. Sand Joint Trust v. Biotechnology Value Fund, L.P.*, No. 16 Civ. 1313, 2017 WL 3142110 (N.D. Cal. July 25, 2017).

[4] 15 U.S.C. § 78p(b).

[5] *Int'l Value*, 2020 WL 2549507 at *1; *see also id.* at *1 n.1 (explaining the "somewhat involved" statutory definition of beneficial ownership).

[6] 15 U.S.C. § 78m(d)(3).

[7] 17 C.F.R. § 240.13d-5(b)(1).

[8] *See* 17 C.F.R. § 240.16a-1(a)(3).

[9] *Int'l Value*, 2020 WL 2549507 at *4.

[10] *Id.* at *3 (emphasis added).

[11] *Rofam*, 2020 WL 2551039 at *1.

[12] *Int'l Value*, 2020 WL 2549507 at *4

[13] *Rofam*, 2020 WL 2551039 at *2.

[14] *Int'l Value*, 2020 WL 2549507 at *7

[15] *Id.*

[16] *Id.* at *4 (quoting H.R. Rep. No. 90-1711 (1968)).

[17] *Id.* (quoting *Gollust v. Mendell*, 501 U.S. 115, 122 (1991)).

[18] *See* 15 U.S.C. § 78m(d).

[19] *Id.* at *5.

[20] *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247, 276 (2010) (Stevens, J., concurring) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 762 (1975)).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For additional information, please feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Securities Enforcement Group, or the following authors:

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