COHEN & GRESSER

June 1, 2020

Second Circuit Gives Guidance on Section 16 "Short-Swing" Profits with Possible Implications for Hedge Funds

Daniel H Tabak; Drew S Dean

On May 20, 2020, the Second Circuit affirmed the dismissal of Section 16 "short-swing profit" claims against the client of an investment advisory firm that was itself subject to Section 16(b) liability. *Rubenstein v. Int'l Value Advisers, LLC*, No. 19-560-CV, 2020 WL 2549507 (2d Cir. May 20, 2020). In a decision with potentially far-reaching implications, the Court held that the client was not subject to Section 16(b) liability as part of a "group" with the investment advisor in the absence of an agreement between the investment advisor and its client to trade in the securities of a specific issuer.

Although confined to the relationship between investment advisors and their clients, the Second Circuit's analysis raises the question of whether a family of hedge funds with a combined holding of over 10% of an issuer may similarly avoid short-swing trading liability under Section 16 even if the funds are all managed by the same advisor.

Section 16(b) and Short-Swing Liability

Section 16(b) of the Securities Exchange Act of 1934 provides that a corporation or a shareholder suing on a corporation's behalf may seek disgorgement of any profits realized from the purchase and sale of any equity security in the corporation within a six-month period by certain insiders, i.e. directors, officers, or 10% beneficial owners of the corporation. 15 U.S.C. § 78p(b). Short-swing trading covered by Section 16(b) is a strict liability offense and, unlike the general anti-fraud provisions of the Securities Exchange Act, does not require proof of actual abuse of insider information or intent to profit.

In determining whether shareholders are considered to own 10% of the issuer for purposes of Section 16(b), two or more shareholders who "agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer" are treated as a group that is deemed under Section 13(d) to hold beneficial ownership of all equity securities owned by any group members. 17 C.F.R. § 240.13d-5(b)(1); *accord* 15 U.S.C. § 78m(d)(3) (requiring concerted action as to "an issuer"). If members of such a group together hold more than 10% of any class of equity securities of an issuer, then each group member is subject to the short-swing profit rule.

Significantly, while someone who exercises voting or investment power over shares is considered to be a "beneficial owner," there are important exemptions. Rule 16a-1 exempts from the short-swing profit rule registered investment advisors ("RIAs") that hold securities "for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business," provided that the shares are acquired "without the purpose or effect of changing or influencing control of the issuer or [evading reporting requirements]." 17 C.F.R. § 240.16a-1(a)(1)(iv). Likewise, "control persons" of RIAs are exempt. 17 C.F.R. § 240.16a-1(a)(1)(vii)

The *Rubenstein* Case

The case before the Second Circuit involved defendant International Value Advisers, LLC ("IVA"), two individual defendants who served as managing members of IVA as well as portfolio managers for IVA-managed funds (together with IVA, the "IVA Defendants"), and IVA's unidentified client who was given the name John Doe. IVA managed a brokerage account for John Doe and, acting in its discretion as investment advisor of the account, had purchased shares in a successor entity to DeVry Education Group ("DeVry"). Collectively, the IVA Defendants, John Doe, and IVA's other clients owned 19.5% of DeVry's outstanding stock.

Between June and December 2016, the IVA Defendants disclosed in Schedule 13D filings that they had a "control purpose" in accumulating their position in DeVry and sought to appoint an IVA managing partner to DeVry's board. Because of this "control purpose," IVA did not qualify for the RIA exemption, and the individual IVA defendants consequently did not qualify as "control persons." As a result, the IVA Defendants were subject to the short-swing profit rule.

In July 2016, IVA purchased 31,847 shares of DeVry for John Doe's account and sold them at a profit within six months. Rubenstein, as a shareholder of DeVry, sued, alleging that John Doe was a member of a Section 13(d) group with the IVA Defendants and therefore had to disgorge the profits from the DeVry trades under Section 16. The defendants successfully moved to dismiss, with Judge Engelmeyer of the Southern District of New York finding that John Doe was not part of a group subject to Section 16 liability because there was no agreement between John Doe and the IVA Defendants to trade specifically in DeVry securities.

Before the Second Circuit, Rubenstein primarily argued that John Doe's investment management agreement with IVA qualified as an "agreement" under Section 13(d) to trade in the securities of an issuer. Even though the agreement did not mention DeVry specifically, Rubenstein contended that the agreement's grant of broad discretionary authority to IVA to trade securities in John Doe's account was sufficient to make John Doe part of a group. Rubenstein also argued that the IVA Defendants' Schedule 13D filings put John Doe "on notice" of IVA's control purpose in DeVry and caused John Doe to become a member of a group with them by his "silent acquiescence" to their plans. The Second Circuit rejected these theories, "straightforwardly" concluding that a group can exist under the plain language of Section 13(d)(3) and the applicable regulations only if an agreement demonstrates a "common objective" of the parties with respect to the securities of a specific issuer. The court thus determined that, "[a]n 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." *Rubenstein*, 2020 WL 2549507, at *4.

Rubenstein also made several policy arguments, including that not finding group liability for John Doe would allow advisors to trade on inside information on behalf of their clients and still earn profits from those trades. The court expressed discomfort with these arguments, emphasizing the Supreme Court's caution against exceeding the "narrowly drawn limits" of Section 16(b) given the strict liability it imposes and noting that in any event the general anti-fraud provisions under Section 10(b) and Rule 10b-5 continue to apply to investment advisors and their clients. *Id.*

Finally, Rubenstein argued for the first time on appeal that IVA acted as an agent for John Doe and IVA's other clients. Citing *Huppe v. WPCS International Inc.*, the court acknowledged that "there is some support in our precedent for the theory that a statutory insider may not escape liability by merely delegating investment responsibility to an agent. That is, an insider principal cannot shed its insider status by transferring trading authority to a non-insider agent." *Id.* at *7. Rubenstein's theory, however, was essentially the inverse of *Huppe*—that investment advisory clients could themselves become insiders because their investment advisor agents were insiders. The court rejected this theory, finding that "[n]o authority . . . suggests that a non-insider principal [John Doe] may unknowingly inherit the insider status of its agent [IVA]." *Id.*

Implications for Hedge Funds

The *Rubenstein* decision offers comfort to investment advisory clients that they will not be subject to short-swing trading restrictions as part of a group with each other or their advisors so long as their investment management agreements with their advisors are not issuer-specific and instead grant broad discretionary trading authority.

The Second Circuit's analysis also raises interesting questions regarding how Section 16(b) group status might apply to other investment structures, in particular hedge funds. Hedge funds are often structured as a "family" of separate funds with a common investment advisor and similar or the same investment objectives as each other. As a result, in a hypothetical hedge fund family, any individual fund might own less than 10% of the equity securities of a particular issuer while the funds collectively could hold more than 10%. One question is whether those separate funds should be considered a group for Section 16(b) purposes.

The Southern District of New York addressed this question in a 2016 case, *Greenfield v. Cadian Capital Management, LP*, 213 F. Supp. 3d 509 (S.D.N.Y. 2016). The plaintiff there alleged that two investment funds, Cadian Fund LP and Cadian Master Fund LP, acted as a group in purchasing and selling shares of Infoblox Inc. at a time when the two funds in combination were beneficial owners of more than 10% of Infoblox securities. The Cadian entities moved to dismiss, claiming they had delegated beneficial ownership of the Infoblox securities and should not be treated as a group that owned more than 10% of Infoblox. In denying the motion, Judge Ramos found that, as in *Huppe*, the Cadian entities retained beneficial ownership because they had merely delegated control over the Infoblox securities to their own agent. Judge Ramos also held that the plaintiff had plausibly alleged that the Cadian entities "operated as a group" for Section 16(b) purposes by pleading that the entities had the same sole decision maker and operated out of the same office with the same employees.

The *Rubenstein* case may give hedge funds a new argument to defend against Section 16 group liability. At the District Court level, Judge Engelmeyer found the *Greenfield* decision distinguishable because there was "common ownership or control over the entities in the 'group'" and explained that it is possible to read *Greenfield* to stand for the proposition that, "a group with a common or symbiotic objective [may] be more readily implied among entities with shared ownership or control." 363 F. Supp. 3d 379, 392 n. 8 (S.D.N.Y. 2019). But he also noted that the *Greenfield* court did not consider whether the statutory and regulatory text required a common objective as to a particular issuer. *Id.*

The Second Circuit in *Rubenstein* did not take up the question of whether common ownership may substitute for an issuer-specific agreement among group members. Although the court noted that John Doe's agreement with IVA "did not address whether, or to what extent, the IVA defendants might purchase or sell the same securities for the other accounts they managed," *Rubenstein*, 2020 WL 2549507, at *4, its focus on the issuer-specific language in the text as well as its description of its decision as "straightforward" should give pause to any plaintiffs arguing for a non-textual basis for establishing a group. And while the IVA Defendants conceded that they were subject to Section 16(b) because they had a "control purpose" when they acquired DeVry shares, hedge funds that do not act with a similar "control purpose" can argue that their investment advisor and control persons are exempt from Section 16(b) and that the funds, which may not individually hold 10% of the issuer's shares, do not constitute a group and therefore do not meet the ownership threshold for insider status.

It remains to be seen how plaintiffs in Section 16(b) cases will adjust their pleading strategies to account for the Second Circuit's ruling in *Rubenstein* or the extent to which courts will be willing to imply the existence of such agreements among commonly-owned and -operated entities in the absence of explicit writings. At least for hedge fund defendants, however, more independence and less common control among funds may further support a defense to claims based on group liability.

The Authors:

Daniel H Tabak
Partner

+1 212 957 7606
dtabak@cohengresser.com

Drew S Dean
Associate

+1 212 957 7077
ddean@cohengresser.com

About Cohen & Gresser:

Cohen & Gresser is an international law firm with offices in New York, Seoul, Paris, Washington, DC, and London. We have an outstanding record of success in high-stakes and high-profile litigation, investigations, and transactional work for our clients, including major financial institutions and companies across the world. Our attorneys have superb credentials, and are committed to providing the efficiency and personal service of a boutique law firm along with the quality and attention to detail that are the hallmarks of the best firms in the world. The firm has been recognized in a wide range of publications, including *Chambers* and *The Legal 500*.

New York | Seoul | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+1 212 957 7600

View C&G's Profile

C&G