WINSTON & STRAWN LLP

CLIENT ALERT

Delegation of Discretionary Authority to an Investment Advisor Insufficient to Confer “Insider” Status Upon Clients

JUNE 12, 2020

On May 20, 2020, the U.S. Court of Appeals for the Second Circuit addressed the scope of “insider” status under Section 13(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), in its decision of two related cases alleging liability under the Section 16(b) “short-swing profit rule.”[1] In affirming the decision of the lower courts, the court held that non-insider clients of investment advisors who entered a discretionary, non-issuer-specific, investment management agreement with their advisor were not liable for disgorgement of short-swing profits solely by virtue of their advisor’s insider status.

Key Takeaways:

- Clients of an investment advisor that is a statutory insider are not automatically deemed part of a “group” for purposes of Section 16(b) liability (disgorgement of short-swing profits) absent a specific reference to the issuer in the advisory contract.
- Investment advisors are always subject to the anti-fraud provisions of the securities laws when trading for clients, regardless of whether the investment advisor’s clients are subject to Section 16(b) liability.

Section 16(b) imposes strict liability on “insiders” of an issuer, requiring the return of any profits realized from the purchase and sale (or sale and purchase) of the issuer’s securities where both transactions occurred within a six-month period. In both cases before the Second Circuit, the defendant investment advisors were statutory insiders of certain issuers. Each defendant investment adviser beneficially owned more than 10% of the issuer’s stock, had filed a Schedule 13D and indisputably was subject to Section 16(b). The plaintiff, however, sought disgorgement of the short-swing profits from the advisors’ clients, who were not statutory insiders of the issuers, claiming that the clients acquired insider status by delegating discretionary investment authority to their advisors and were therefore subject to “group” liability. The court dismissed all claims, holding that defendant clients did not qualify as members of a Section 13(d) insider group and were therefore not required to disgorge any profits under Section 16(b). In rejecting each of the plaintiff’s six arguments, the court used the plain text of the Exchange Act and the legislative intent behind Section 16(b) to guide its analysis.

The plaintiff first argued that the defendant clients became members of an insider group with their advisor and its other clients when the defendant clients signed investment management agreements delegating trading authority to

the advisors. The court noted that a Section 13(d) insider group is formed when multiple individuals agree to act together "for the purpose of acquiring, holding, voting or disposing of equity securities *of an issuer*."[2] In such instances, each member of a group is considered a beneficial owner of all securities owned by the other members of the group. Thus, each group member is subject to disgorgement under the short-swing profit rule when the group's collective holdings exceed 10% ownership in an issuer. The court interpreted group liability under Sections 13(d) and 16(b) to require that the group members enter into an agreement to trade the securities of a specific issuer. Since the investment management agreements at issue granted broad discretionary authority and did not identify any particular issuer, the court concluded that the generality of the agreements failed to demonstrate a common objective to trade in the securities of "an issuer."

The plaintiff next appealed to policy, arguing that the court's holding would facilitate insider trading by offering a "safe harbor" to investment advisors, allowing them to illicitly trade their clients' shares and earn profits that are sheltered from disgorgement. The court summarily dismissed these concerns, heeding caution from the Supreme Court against exceeding the "narrowly drawn limits" on the class of statutory insiders subject to strict liability under Section 16(b), and citing other protections offered by the general anti-fraud provisions of the Exchange Act.[3] Specifically, the court noted that the abuse of insider information would subject any investment advisor to liability under Section 10(b) and Rule 10b-5, regardless of whether its clients were members of an insider group for purposes of Section 16(b) liability.

The plaintiff's third argument voiced similar policy concerns, contending that the court's holding would undermine the Section 13(d) disclosure requirement that beneficial owners of more than 5% of a company's shares file a statement of such ownership with the SEC. If clients are not considered members of an insider group with their advisors, the plaintiff argued, then advisors can easily spread out holdings across clients to evade the ownership threshold triggering disclosure. In rejecting this argument, the court noted that the hallmark of beneficial ownership, as defined in Rule 13d-3, is the power to vote or dispose of a security, and not the holder's pecuniary interest in the security.[4] The result of a client's delegation of trading authority is that an investment advisor may qualify as the beneficial owner of a particular client's account regardless of whether the investment advisor forms an insider group with or among its clients. Thus, when the collective holdings of an advisor's discretionary clients equal 5% or more in any one issuer, the advisor is required to file a disclosure statement with the SEC.

Moving away from policy considerations, the plaintiff next attempted to expand insider group liability by invoking the registered investment advisor (RIA) exemption to the short-swing profit rule. Under this exemption, when an investment advisor holds securities on its clients' behalf "without the purpose or effect of changing or influencing control of the issuer," the advisor does not qualify as the beneficial owner of its clients' securities for the purpose of the short-swing profit rule's 10% ownership threshold.[5] The plaintiff argued that because the defendant investment advisors did not qualify for the RIA exemption, as they undeniably had a control purpose with respect to the issuer and had filed Schedule 13Ds in each case, their clients are therefore liable as members of an insider group. In response, the court simply stated, "the RIA exemption is a separate component of the short-swing profit rule that is not relevant to this case."[6] The court further explained that the exemption makes no reference to insider group agreements and therefore had no bearing on its determination whether defendant advisors and their clients entered into agreements to trade in the securities of an issuer.

Offering no evidence of such agreements, the plaintiff next proposed a theory of implied liability. In each case, defendant investment advisors had filed Schedule 13D with the SEC disclosing their insider status before engaging in short-swing trading. The plaintiff argued that by "silently acquiescing in their advisor's trading for their benefit" after filing the Schedule 13Ds, each defendant client "implicitly agreed to trade… as members of the insider group."[7] The court found no support for this theory in the relevant statutes or regulations, and noted that adopting such theory would create requirements that clients diligently patrol advisor activity and monitor the extent to which advisors adopt a control purpose with respect to particular issuers. In the court's determination, such requirements would be impracticable and are "not contemplated by the securities laws."[8]

The plaintiff's final attempt to persuade the court raised a novel "director by deputization" theory. This theory argues that defendant clients are statutory insiders because in each case, they hired their investment advisors who then acted as their clients' agent in deputizing a director on the issuer's board. In rejecting the plaintiff's sixth and final argument, the court observed that most clients were likely unaware that their advisor had even appointed a director

to the issuer's board, and noted there is no authority to suggest that "a non-insider principal may unknowingly inherit the insider status of its agent."[9]

The court's decision makes clear that clients will not be subject to Section 16(b) liability simply by granting discretionary authority to an investment advisor. The investment management agreement must be specific to the issuer in question to evidence the formation of a group and therefore impose group liability. Moreover, an investment advisor's clients are not liable for disgorgement of short-swing profits simply because the advisor filed a Schedule 13D or deputized a director on an issuer's board. The court held that such actions are decidedly insufficient to confer insider group membership upon individual clients in the absence of an issuer-specific trading agreement.

[1] *Rubenstein v. International Value Advisers, LLC*, No. 19-560-cv (2d Cir. May 20, 2020) [hereinafter referred to as *IVA*]; *Rubenstein v. Rofam Inv. LLC*, No. 19-796-cv (2d Cir. May 20, 2020).

[2] 15 U.S.C. § 8m(d)(3) (emphasis added); see also 17 C.F.R. § 240.13d-5(b)(1).

[3] *IVA* at 13–14 (citing *Gollust v. Mendell*, 501 U.S. 115, 122 (1991)).

[4] *IVA* at 15–16.

[5] 17 C.F.R. § 240.16a-1(a)(1).

[6] *IVA* at 19.

[7] *IVA* at 20.

[8] *Id.*

[9] *Id.* at 22.

6 Min Read

Related Locations

Charlotte | Chicago | Dallas | Houston | Los Angeles | New York | San Francisco | Silicon Valley | Washington, DC

Related Topics

Financial Services | Capital Markets | Securities Exchange Act

Related Capabilities

Financial Services Transactions & Regulatory | Capital Markets

Related Regions

North America

Related Professionals

Basil Godellas

© 2024 Winston & Strawn LLP.