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2014 SEC ENFORCEMENT CASES – A YEAR IN REVIEW

As part of its "Fiscal Year 2014 Financial Report" released by the Securities and Exchange Commission ("SEC") last month, the SEC discussed how "new investigative approaches and the innovative use of data and analytical tools" helped contribute to a strong year of enforcement actions. According to the report, the SEC ended the fiscal year of 2014 (which for the SEC concludes on September 30th) having filed for a record 755 enforcement actions across a broad range of misconduct. Furthermore, the SEC stated the resulting disgorgement and monetary penalties arising from these enforcement actions totaled $4.16 billion according to preliminary figures. Compare this total to the $3.1 billion total in 2012 (based upon 734 enforcement actions), and $3.4 billion total in 2013 (based upon 686 enforcement actions), and it's clear to see that the SEC is not only increasing the number of enforcement actions, but such actions are more costly than ever before. According to SEC Chair Mary Jo White, "innovative use of technology, enhanced use of data and quantitative analysis was instrumental in detecting misconduct and contributed to the Enforcement Division's success."

A. Increased Volume

The enforcement actions in 2014 were spread out over a broad spectrum of misconduct. However, certain areas of misconduct seemed to attract more attention than others. For instance, the SEC reports to have charged 80 people in cases involving trading on the basis of inside information, more than 135 parties with violations relating to reporting and disclosure and multiple firms were charged for custody violations as well. The following is a sampling of some of the more notable enforcement matters seen in these areas during the SEC's past fiscal year:

1. Insider Trading

Securities and Exchange Commission v. Ronald N. Dennis, Civil Action No. 1746 (Mar. 13, 2014). The SEC charged a former analyst of hedge fund advisory firm CR Intrinsic Investors LLC, an affiliate of S.A.C. Capital, with insider trading based on nonpublic information that he obtained about a pair of technology companies. According to the SEC, Mr. Dennis received tips from friends, who were also hedge fund analysts, about impending announcements at Dell Inc. and Foundry Networks. Mr. Dennis used this information to perform illegal trades in Dell and Foundry stock, enabling hedge funds managed by CR Intrinsic Investors and S.A.C. Capital to generate illegal profits of roughly $3.2 million, and avoid significant losses in Dell stock. In an offer of settlement, Mr. Dennis, without admitting or denying the allegations, agreed to be barred from the securities industry and to pay $95,351 in disgorgement, $12,632.34 in prejudgment interest, and a penalty of $95,351.

2. Reporting and Disclosure

In the Matter of The Robare Group, LTD., Mark L. Robare, and Jack L. Jones Jr., IA Rel. No. 3907 (Sep. 2, 2014). The SEC charged Robare Group Ltd. ("Robare") with fraud for failure to disclose to clients key conflicts of interest. The SEC alleged that Robare, along with co-owners Mark Robare and Jack Jones, received a percentage of every dollar that its clients invested in certain mutual funds through an undisclosed compensation agreement with the brokerage firm. The SEC alleged that Robare failed to disclose this to clients initially, and that later attempts at disclosure were inadequate as they stated that Robare "may" receive compensation from the broker when in fact the firm and its co-owners "were definitively" receiving compensation. The matter is still pending resolution.

In the Matter of Strategic Capital Group, LLC and N. Gary Price, IA Rel. No. 3924 (Sep. 18, 2014). In this matter, the SEC alleged, amongst other things, that Strategic Capital Group violated the Investment Advisers Act of 1940 (the "Advisers Act"), and specifically the antifraud and principal transactions provisions, for engaging in hundreds of principal transactions through its affiliated broker-dealer without informing clients or obtaining their consent. A principal transaction is a situation where a firm acts as a principal for its own account and knowingly sells securities to, or buys securities from, a client. Principal transactions create the potential for advisers to engage in self-dealing, and therefore Section 206(3) of the Advisers Act makes it unlawful to perform a principal transaction without first disclosing the transaction to the client in writing and obtaining the consent of the client to such transactions. The written disclosure provided to the client must be in plain English, allow the client to revoke the written consent without penalty, explain the circumstances under which the investment adviser may engage in principal transactions and address the client's conflicts of interest and how the investment adviser addresses those conflicts. The SEC alleged that Strategic Capital engaged in more than 1,100 principal transactions over several years without making the required disclosures or obtaining client consent. Without admitting or denying the allegations, Strategic Capital agreed to pay nearly $600,000 to settle the charges, while Mr. Price, Strategic's CEO, paid an additional $50,000 for his role in the misconduct.

3. Custody

In the Matter of Knelman Asset Management Group, LLC and Irving P. Knelman, IA Rel. No. 30766 (Oct. 28, 2013). The SEC alleged, amongst other things, that Knelman Asset Management Group ("KAMG") and its CEO/Chief Compliance Officer, Irving P. Knelman, violated Rule 206(4)-2 of the Advisers Act which requires an adviser of a fund to perform an annual audit of the fund by a PCAOB registered accountant, and deliver audited financial statements to investors in within 120 days of the fund's fiscal year end. The SEC alleged KAMG had custody of the assets of a fund of private equity funds, but failed to perform an annual audit on the funds, and fund members did not receive audited financial statements, or quarterly account statements from a qualified custodian. In an offer of settlement, KAMG agreed to pay a $60,000 penalty, Knelman agreed to pay a $75,000 penalty and be barred from acting as a Chief Compliance Officer for at least three years, and both KAMG and Knelman consented to compliance training and other compliance-based undertakings.

B. First Time Enforcements

2014 could very well be marked as a "year of firsts" for the Enforcement Division of the SEC as items such as whistleblowing retaliation, "pay-to-play" and failure to protect a client's non-public information were marked by inaugural enforcement actions. The following briefly discuss such actions which occurred during the SEC's past fiscal year:

1. Whistleblowing Retaliation

In the Matter of Paradigm Capital Management, Inc. and Candace King Weir, IA Rel. No. 3857 (Jun. 16, 2014). The SEC charged Paradigm Capital Management, Inc. and Candace King Weir ("Weir" the majority owner of paradigm) for engaging in prohibited principal trading transactions, and then retaliating against an employee who reported the trading activity to the SEC. According to the SEC, the head trader exposed evidence to the SEC of Weir's involvement in causing Paradigm to engage in principal transactions to reduce tax liability on behalf of its hedge fund investors without effective disclosures or consent. The head trader later informed Weir of his actions. After this was discovered, Paradigm and Weir allegedly targeted the trader for retaliation by removing him from the trading desk, forcing him to work from home, preventing him access to trading account systems, demoting him and ultimately causing the trader to resign working for the firm. The SEC pressed anti-retaliation charges, amongst others, and in an offer of settlement, Paradigm and Weir agreed to jointly and severally pay disgorgement penalties of $1.7 million, prejudgment interest of $181,771 and a penalty of $300,000. Paradigm also agreed to retain an independent compliance consultant.

2. Pay-to-Play

In the Matter of TL Ventures, Inc., IA Rel. No. 3859 (Jun. 20, 2014). The SEC charged TL Ventures, Inc., amongst other things, with violating Rule 206 of the Investment Advisers Act of 1940, or the otherwise termed "Pay-to-Play" rule. Pay-to-Play rules impose a two-year moratorium on providing advisory services to a government client or a pooled investment such as a pension after a donation is made to any candidates or other officials who are able to influence the hiring process for pension money managers, and a showing of intent is not required to violate the rules. According to the SEC, TL Ventures continued to receive advisory fees from the city and state pension funds following campaign contributions made by a covered associate in 2011 to the governor of Pennsylvania and a candidate for mayor of Philadelphia (both positions were deemed capable of influencing the hiring of investment advisers of the funds in question). TL Ventures neither admitted nor denied the charges but agreed to pay nearly $300,000 to settle the charges.

3. Failure to Protect Client's Material, Non-Public Information

In the Matter of Wells Fargo Advisors, LLC, IA Rel. No. 3928 (Sep. 22, 2014). The SEC charged Wells Fargo Advisors LLC, amongst other things, with failing to maintain adequate controls to prevent one of its registered brokers from trading on inside information obtained from a customer's nonpublic information. According to the SEC, one of the bank's brokers learned, confidentially from a client, that Burger King was being acquired by a New York-based private equity firm. The broker then traded on that nonpublic information ahead of the announcement. Federal law requires broker-dealers and investment advisers to establish, maintain, and enforce policies and procedures designed to prevent the misuse of material nonpublic information. In this matter, the SEC alleged that while multiple groups responsible for compliance or supervision within Wells Fargo received indications that the broker was misusing customer information, they lacked coordination and failed to consistently enforce firm policies, resulting in a failure to act on these indications. Wells Fargo, which admitted wrongdoing in this matter, agreed to pay a $5 million penalty to settle the SEC's charges.

C. Conclusion

These cases highlight the ever increasing purview of the SEC. While the SEC has drawn increasing criticism for its "broken windows" strategy of enforcement — which is based on the premise that no securities law violation is too small to prosecute and that minor enforcement actions lead to greater overall compliance, look for the SEC to continue its bold examination focus in 2015 and expand upon its use of technology for performing technical and analytical analysis. With this in mind, its recommended firms perform a review as to the adequacy and efficiency of the firms' internal controls in order to help mitigate potential enforcement risks moving forward in 2015.

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