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Private Fund Adviser Charged with Retaliation after Principal Trade Violations

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Last week, the Securities and Exchange Commission ("SEC") settled the first anti-retaliation case under the Dodd-Frank Act whistleblower provisions against an investment adviser to private funds. The whistleblower reported, and the SEC alleged, that the adviser engaged in prohibited principal transactions with an affiliated broker-dealer while trading on behalf of a private fund client.[1] The SEC also alleged that the disclosure related to principal trading in the adviser's Form ADV was materially misleading. As part of the settlement, the adviser agreed to pay $2,181,771 in disgorgement and penalties and to appoint an independent compliance consultant.[2]

Section 206(3) of the Advisers Act prohibits an investment adviser from directly or indirectly acting as a principal for its own account and knowingly selling securities to or purchasing securities from a client without first: (i) disclosing to the client in writing the capacity in which the adviser is acting, and (ii) obtaining the consent of the client. Here, the adviser directed the sale of a hedge fund client's securities to a proprietary trading account at the adviser's affiliated broker-dealer, supposedly to realize trading losses to offset the client's realized gains for tax deduction purposes. The adviser established a "conflicts committee" to review and approve the pricing of the trades, and the affiliated broker-dealer did not charge a markup or commission on the transactions.

Each of the relevant entities—the adviser, the broker-dealer, and the fund client's general partner—was under the common control of a single majority owner; therefore, the transactions between the fund client and the proprietary trading account were principal transactions. The SEC stated that disclosure to and consent by the fund client's general partner would be insufficient for these principal transactions. Moreover, the SEC claimed that the conflicts committee tasked with approving the trades was itself conflicted. As one of only two members of the conflicts committee, the adviser's chief financial officer ("CFO") was evaluating the principal transactions pursuant to his obligation to act in the best interests of the fund client while, as the broker-dealer's CFO, he was simultaneously monitoring the transactions' impact on net capital. Under these facts, the SEC alleged that the adviser failed to provide effective written disclosure to its fund client and failed effectively to obtain the fund client's consent to the principal transactions.

The settlement also includes violations of Section 21F(h) of the Securities Exchange Act of 1934, which generally prohibits an employer from retaliating against a whistleblower who provides information to the SEC by, among other actions, demoting, suspending, harassing, or in any other manner discriminating against the whistleblower in the terms and conditions of his employment. When the adviser's head trader revealed that he had disclosed the principal transactions to the SEC, he was removed from his trading and supervisory responsibilities and tasked with investigating the very conduct he had reported to the SEC.[3] The whistleblower later resigned after the adviser accused him of violating certain of the firm's policies and the terms of his employment related to removing confidential business records.

Finally, the settlement also resolved an alleged violation of Section 207 of the Advisers Act, which makes it unlawful for any person to willfully make any untrue statement of material fact in any registration application or report filed under the Advisers Act. Although the existence of the conflicts committee was disclosed, the adviser's Form ADV failed to disclose the fund CFO's conflict as CFO of the fund and of the affiliated broker-dealer. This omission was alleged to be materially misleading.

Advisers to private funds should pay heed to the SEC's emphasis on compliance with principal trading limitations and, more generally, with mitigating conflicts of interest or providing fulsome disclosure where conflicts cannot otherwise be resolved. To minimize regulatory risk, firms should:

- reassess their policies and procedures;
- evaluate whether structural changes to conflict procedures are necessary;
- reinforce compliance by hiring independent compliance personnel to review firm policies; and
- enhance compliance monitoring and testing mechanisms.

O'Melveny & Myers is available to advise domestic and non-U.S. investment advisers and fund managers about compliance with U.S. securities laws. If you have questions, please contact Heather Traeger at (202) 383-5232 or Jim Harrigan at (202) 383-5226.

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[1] In the Matter of Paradigm Capital Management, Inc. and Candace King Weir, Exchange Act Release No. 72393 (June 16, 2014), *available* ***here.***
[2] Specifically, Paradigm and Weir agreed to jointly and severally pay $1,700,000 in disgorgement, $181,771 in prejudgment interest, and a civil penalty of $300,000. Paradigm also agreed to cease and desist from committing additional violations.
[3] Both the adviser and whistleblower were represented by counsel.

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upon as legal advice, and does not purport to represent the views of our clients or the Firm. Heather Traeger, an O'Melveny partner licensed to practice law in the District of Columbia and Texas, and Jim Harrigan, an O'Melveny associate licensed to practice law in the District of Columbia and Maryland contributed to the content of this newsletter. The views expressed in this newsletter are the views of the authors except as otherwise noted.