SEC Charges Hedge Fund Adviser With Conducting Conflicted Transactions and Retaliating Against Whistleblower

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Washington D.C., June 16, 2014 — The Securities and Exchange Commission today charged an Albany, N.Y.-based hedge fund advisory firm with engaging in prohibited principal transactions and then retaliating against the employee who reported the trading activity to the SEC. This is the first time the SEC has filed a case under its new authority to bring anti-retaliation enforcement actions. The SEC also charged the firm's owner with causing the improper principal transactions.

Paradigm Capital Management and owner Candace King Weir agreed to pay $2.2 million to settle the charges.

According to the SEC's order instituting a settled administrative proceeding, Weir conducted transactions between Paradigm and a broker-dealer that she also owns while trading on behalf of a hedge fund client. Such principal transactions pose conflicts between the interests of the adviser and the client, and therefore advisers are required to disclose that they are participating on both sides of the trade and must obtain the client's consent. Paradigm failed to provide effective written disclosure to the hedge fund and did not obtain its consent as required prior to the completion of each principal transaction.

A Commission rule adopted in 2011 under the Dodd-Frank Act authorized the SEC to bring enforcement actions based on retaliation against whistleblowers who report potential securities law violations to the agency. The SEC's order finds that after Paradigm learned that the firm's head trader had reported potential misconduct to the SEC, the firm engaged in a series of retaliatory actions that ultimately resulted in the head trader's resignation.

"Paradigm retaliated against an employee who reported potentially illegal activity to the SEC," said Andrew J. Ceresney, director of the SEC Enforcement Division. "Those who might consider punishing whistleblowers should realize that such retaliation, in any form, is unacceptable."

According to the SEC's order, Paradigm's head trader reported trading activity revealing that Paradigm engaged in prohibited principal transactions with affiliated broker-dealer C.L. King & Associates while trading on behalf of hedge fund client PCM Partners L.P. II. The SEC's subsequent investigation found that Paradigm engaged in the trading strategy from at least 2009 to 2011 to reduce the tax liability of the firm's hedge fund investors. As part of that strategy, Weir directed Paradigm's traders to sell securities that had unrealized losses from the hedge fund to a proprietary trading account at C.L. King. The realized losses were used to offset the hedge fund's realized gains. Paradigm engaged in at least 83 principal transactions by selling 47 securities positions from the hedge fund to C.L. King and then repurchasing 36 of those positions for the hedge fund.

According to the SEC's order, since Weir had a conflicted role as owner of the brokerage firm in addition to advising the PCM Partners hedge fund, merely providing written disclosure to her as the hedge fund's general partner and obtaining her consent was insufficient. Paradigm attempted to satisfy the written disclosure and consent requirements by establishing a conflicts committee to review and approve each of the principal transactions on behalf of the hedge fund.

The SEC's order finds that the conflicts committee itself, however, was conflicted. The committee consisted of two people: Paradigm's chief financial officer and chief compliance officer – who each essentially reported to Weir. Furthermore, Paradigm's CFO also served as C.L. King's CFO, which placed him in a conflict. Specifically,

there was a negative impact on C.L. King's net capital each time the broker-dealer purchased securities from the hedge fund. The CFO's obligation to monitor C.L. King's net capital requirement was in conflict with his obligation to act in the best interests of the hedge fund as a member of the conflicts committee.

According to the SEC's order, because the conflicts committee was conflicted, Paradigm failed to provide effective written disclosure to its hedge fund client and failed effectively to obtain the hedge fund's consent prior to the completion of each principal transaction. The SEC's order also finds that Paradigm's Form ADV was materially misleading for failing to disclose the CFO's conflict as a member of the conflicts committee.

"Paradigm's use of a conflicted committee denied its hedge fund client the effective disclosure and consent to which it was entitled," said Julie M. Riewe, co-chief of the SEC Enforcement Division's Asset Management Unit. "Advisers to pooled investment vehicles need to ensure that any mechanism developed to address conflicts in principal transactions actually mitigates those conflicts."

According to the SEC's order, Paradigm's former head trader made a whistleblower submission to the SEC that revealed the principal transactions between Paradigm and C.L. King. After learning that he had reported potential violations to the SEC, Paradigm immediately engaged in a series of retaliatory actions. Paradigm removed him from his head trader position, tasked him with investigating the very conduct he reported to the SEC, changed his job function from head trader to a full-time compliance assistant, stripped him of his supervisory responsibilities, and otherwise marginalized him.

"For whistleblowers to come forward, they must feel assured that they're protected from retaliation and the law is on their side should it occur," said Sean McKessy, chief of the SEC's Office of the Whistleblower. "We will continue to exercise our anti-retaliation authority in these and other types of situations where a whistleblower is wrongfully targeted for doing the right thing and reporting a possible securities law violation."

Paradigm and Weir consented to the entry of the order finding that Paradigm violated Section 21F(h) of the Securities Exchange Act of 1934 and Sections 206(3) and 207 of the Investment Advisers Act of 1940. The order finds that Weir caused Paradigm's violations of Section 206(3) of the Advisers Act. They each agreed to cease and desist from committing or causing future violations of these provisions without admitting or denying the findings in the order. Paradigm and Weir agreed to jointly and severally pay disgorgement of $1.7 million for distribution to current and former investors in the hedge fund, and pay prejudgment interest of $181,771 and a penalty of $300,000. Paradigm also agreed to retain an independent compliance consultant.

The SEC's investigation was conducted by Michael L. Riedlinger and Alex McCabe of the Asset Management Unit as well as Jacob Krawitz and David Williams. The case was supervised by Anthony Kelly of the Asset Management Unit.

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Related Materials

- SEC order