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COMMENTARY

Refusing to Buckle to SEC Intimidation

Regulators expect small firms to settle, and they often do. We chose to fight. It took 12 years and $12 million, but we won.

By **NELSON OBUS**

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On May 30, I stood outside the federal courthouse in Manhattan after a jury unanimously found me, my investment fund and all of my co-defendants innocent of insider trading. Although we had done nothing wrong, we were the target of a 12-year campaign by the Securities and Exchange Commission to intimidate us into settling the case. The campaign led to a courtroom battle with our small firm used as political cover in a war involving much larger players.

We won the case, after incurring more than $12 million in legal and trial expenses. But this story isn't only about us. Our story is only one example of unbridled regulatory overreach without accountability. It's about an abusive system that threatens the nation's economic vitality by jeopardizing small business and its entrepreneurial spirit. America and its business community need assurances that regulators can't wrongly bully small enterprises into costly legal settlements or false admissions of guilt. Yet such tactics are being used today, and the costs are high.

My firm, Wynnefield Capital, is a small investment fund with eight staff members. We invest in small-cap companies and have a range of investors, from individuals to institutions including pension funds. Our run-in with the SEC began in 2002, and it involved our trading in a single stock. The SEC requested information about our trading the previous year in a company named SunSource. We provided the information, confident that a review would show we had behaved appropriately. And with that, the SEC commenced its campaign. Days turned into weeks. Weeks into months. As years passed, we remained astonished that the matter hadn't been resolved expeditiously

from the start.

For a small fund such as ours, the potential cost and distraction of an extended investigation could be intimidating. Then there was the possibility that investors could depart, risking our very existence. Imagine the weight on one's shoulders day after day while the process grinds on.

This pressure is a powerful tool that can be easily abused by regulators. Even when the facts demonstrate the innocence of the investigated parties, it can be used to force wrongful settlements and false admissions—not least because firms fear the costs of a drawn-out investigation. Although the evidence showed that we had acted properly, the SEC kept up the pressure and proposed that we settle. We viewed a settlement as tantamount to an admission of guilt and told the SEC that we had no interest in settlement talks.

By late 2005 and early 2006, the SEC had come under intensifying scrutiny for failed oversight of hedge funds. Critics questioned how the regulator could have missed major fraud at firms such as Bayou and Wood River.

Unknown to us at the time, by mid-March 2006, former SEC investigator Gary Aguirre had also provided the Senate Banking Committee with a sworn statement alleging the SEC's improper termination of a suspected insider-trading investigation involving Pequot Capital Management, an influential and high-profile hedge fund.

By the time the committee called then-SEC Chairman Chris Cox to testify at a July 2006 hearing to defend his agency's reputation, the SEC had filed three cases against three small hedge funds that it highlighted in his testimony. One of those was a lawsuit against me, my firm and my staff alleging insider trading that led to $1.3 million in profits for trading in advance of a merger agreement's public announcement.

The timing was noteworthy: The SEC filed that case on April 25, 2006—just as the expiration of the statute of limitations approached. We learned that the SEC had filed its lawsuit when we saw its press release. Before we even received our copy of the suit, the SEC and its public-relations team were in full spin mode, giving interviews to journalists attacking us and defending the SEC.

In September 2006, the SEC's then-director of enforcement, Linda Chatman Thomsen, actually submitted testimony to the Senate Committee on the Judiciary claiming that we had settled with them—which was false. The reference to a settlement was corrected only after our attorney protested.

On and on it went. Eight grueling years passed before we had our day in court. Even after a U.S. district court dismissed the case in 2010, ruling in our favor on all claims made by the SEC, the agency appealed.

On May 30, 2014, our 12-year odyssey ended when a federal jury unanimously found in favor of every defendant and against the SEC. Our names were finally cleared. But the victory was not without cost, beyond the millions of dollars in legal fees. The price also was inordinate amounts of time and distraction, and untold opportunity cost to our business.

Large firms can bear these types of costs. But not many small firms could be expected to weather such a storm from a system that provides regulators with every incentive to overreach without repercussions. The abuse is not only unjust, its potential harm to small businesses—the engine of economic growth and job creation in this country—is enormous.

The SEC's behavior raises several questions:

• What accountability exists to prevent regulatory abuse? Is there any? What can be done to assure that bureaucrats are not incentivized—receiving good performance reviews, for example—to force small businesses under regulatory scrutiny into settlement negotiations?

• What is the cost to the U.S. economy of these long investigations and wrongful settlements? What are the ethical implications? How many firms feel compelled to settle or falsely admit wrongdoing?

• Are small firms treated differently? Why does this pattern continue: The SEC goes after a handful of larger firms when the agency's reputation is in jeopardy, but more often fails to act on cases involving influential and high-profile individuals and firms, instead pursuing settlements or lawsuits against smaller firms?

Writing today, I don't know all the answers, but I do know that this is just the beginning of an effort to find them.

Mr. Obus is a founding partner of Wynnefield Capital.

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