Cherry Picking: Strong Investment Management

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Recent cherry picking cases filed by the SEC against Strong Investment Management[1] ("SIM" or "Strong") and other advisers and brokers are instructive partly because of the participation of the SEC's Division of Economic and Risk Analysis ("DERA").[2] DERA was formed in the fall of 2009 and has a staff of 68 economists led by Acting Director Chyhe Becker, Ph.D. Finance, University of Chicago. DERA provides the SEC with significant resources to perform data analytics to detect fraud. In a recent case, Joseph Sansone, Chief of the SEC Enforcement Division's Market Abuse Unit said that: "SEC data analysis played an important role in identifying the alleged securities law violations." Mr. Sansone added: "We will continue to develop and use data analytics to root out cherry-picking and other frauds."[3]

As a threshold matter, we believe it is important for registered investment advisers and compliance professionals (i) to be aware of this trend at the SEC to use technology and data analytics to identify aberrational trading/allocations and (ii) to develop their own in-house capabilities, analytics and forensic testing to appropriately monitor trading activity, including trade allocations, in accordance with their obligations pursuant to their policies and procedures and consistent with disclosures made in Form ADV, Part 2A (the "Brochure"). In a March 2018 cherry picking case against Valor Capital, the SEC found that the odds that Valor's principal's personal account performed better than his client's accounts as a

[1] *SEC vs. Strong Investment Management, Joseph B. Bronson and John B. Engebretson*, United States District Court Central District of California Case No. 8:18-CV-00293 (February 2, 2018) (the "Strong Complaint"). See the Press Release at https://www.sec.gov/litigation/litreleases/2018/lr24054.htm and related Strong Complaint at https://www.sec.gov/litigation/complaints/2018/comp24054.pdf.

[2] The first cases were against registered investment advisers Jeremy Licht and Gary Howarth. See the Administrative Proceedings Summary at https://www.sec.gov/litigation/admin/2017/34-81584-s.pdf and related Complaints at https://www.sec.gov/litigation/admin/2017/34-81584.pdf and https://www.sec.gov/litigation/admin/2017/34-81585.pdf.

[3] See SEC Press Release https://www.sec.gov/news/press-release/2018-189 and related Complaint against Michael Bressman at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-189.pdf.

result of chance or luck was less than "a one-in-a-trillion chance."[4] This brief comment speaks volumes and is a window into the SEC's current thinking about probabilistic data analysis.

In Strong, John Engebretson (the SIM Chief Compliance Officer ("CCO") from 2012 until October 2014) "…wholly abdicated his responsibilities relating to ensuring that SIM's trading and allocations were fair and equitable as set forth in the firm's policies and procedures."[5] Engebrestson's discharged his duties as CCO "in an extremely reckless manner." Other than occasionally "spot-checking" trade paperwork that happened to be on the Chief Investment Officer's ("CIO") desk, Engebrestson did not conduct the required reviews.[6] Engebretson also ignored several "red flags" provided by Broker 1 (as detailed below), a registered broker dealer that custodied the majority of SIM's 65 client accounts, that something was amiss with the firm's trade allocation process.

Strong's CIO, Joseph Bronson, is the brother of Engebretson. He changed his name to Bronson as a result of a 1999 SEC enforcement action against his late father's firm Engebretson Capital Management, Inc. ("ECM").[7] Bronson and Engebretson worked for their father at ECM prior to founding Strong in 2009. The SEC found that ECM distributed misleading advertising that overstated performance and violated certain books and records requirements. Strong hired the same compliance consultant they worked with at ECM. That consultant recommended that Strong should utilize and maintain pre trade allocation documentation for all block trades.[8]

The consultant also recommended in March of 2014 that "SIM should review whether short-term trading activity of employees may interfere with or produce conflicts of interest with trading activity conducted for clients."[9]

Bronson did all of the trading for Strong and he often used an omnibus account. He would place a block trade in the omnibus account and subsequently allocate the trades to his own personal account as well as to his clients. Bronson would allocate the trades after seeing which were profitable and which were not. The profitable trades invariably were allocated to his personal account.

If used properly, an omnibus account can assist a manager to distribute trades to his clients at an average price for the day and ensure that no client receives preferential treatment.[10] From January 2012 through July of 2016, Bronson misused the omnibus account to defraud his investors in violation of his fiduciary duty as a registered investment adviser.

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[4] For the Press Release relating to In the Matter of Valor Capital Asset Management, LLC Advisers Act Release No 4864 (March 6, 2018), see https://www.sec.gov/news/press-release/2018-36; for the Order, see https://www.sec.gov/litigation/admin/2018/34-82816.pdf.
[5] Strong Complaint at par. 132.
[6] Strong Complaint at par. 7.
[7] Strong Complaint at par. 15.
[8] Strong Complaint at par. 15.
[9] Strong Complaint at par. 109.
[10] Strong Complaint at par. 33-34.

Broker 1 conducted an extensive analysis of Bronson's trade allocations for a twelve month period after identifying a suspicious trade allocation on August 9, 2013.[11] Broker 1 found that Bronson's personal account experienced a disproportionate gains on the first day of many trades while other clients experienced first day losses. For example, Bronson and another account both bought and sold "LULU" during the twelve month period tested. Bronson's account gained approximately $8,000 while the other account tested lost $41,500. Bronson had purchased and sold 2,800 shares of LULU while the other account purchased and sold 3,200 shares of the same security.

The Strong Complaint provides several other detailed examples of how Strong's personal account performed significantly better than Strong's clients. Broker 1 terminated SIM as a client in August of 2013 because it suspected Bronson was cherry picking. Prior to this action, Broker 1 brought suspicious trade allocations to Bronson's attention on at least three times in June of 2013.[12]

Consequently, Bronson moved to Broker 2 and wrote to his clients that Broker 1 considers SIM too small to continue using Broker 1's platform. The SEC cited this communication with SIM's clients as false and misleading.

Strong's Form ADV Part 2A contained several materially false and misleading statements concerning its allocation of trades and its management of conflicts of interest relating to personal trading by SIM personnel. SIM's 2013 update acknowledged its fiduciary duty to its clients and that it had an obligation to put its clients' interests above its own. The ADV said that: "We do not favor any account over any other account" including our own.[13] Each account will be allocated securities at the average price on any given trading day[14]. The ADV represented that client accounts would get an equal or better price than any employee's account and that trades would be reviewed to ensure that this was the case.[15] Perhaps the tallest tale in the ADV was that trades would be allocated "among clients according to a computer-generated pre allocation."[16]

The SEC charged SIM and Bronson first with violating Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) for cherry picking winning trades to Bronson's personal account, for sending a misleading letter to clients, misleading the firm's compliance consultant and for creating misleading allocation documentation that suggests trades were allocated pre-trade.

A second count against SIM and Bronson was for violating Section 10(b) of the Exchange Act and Rule 10b-5(b) for untrue statements of material fact in Sim's Form ADV concerning its trade allocation and

[11] Strong Complaint at par 47.
[12] Strong Complaint at par 53-61.
[13] Strong Complaint at par. 82.
[14] Strong Complaint at par. 83.
[15] Strong Complaint at par. 82.
[16] Strong Complaint at par. 87.

conflict management practices surrounding personal trading by SIM employees. The SEC also cited the false and misleading letter to clients about why it shifted to Broker 2.

The third and fourth counts against SIM and Bronson was for violating Sections 17(a)(1) and (2) of the Securities Act for fraud in connection with the offer or sale of securities.

The fifth charge against SIM and Bronson were for violations of Sections 206(1) and (2) of the Advisers Act. These claims cite the fiduciary nature of SIM's relationship with its clients and the false and misleading statements contained the Form ADV as well as in the letter to clients surrounding the change from Broker 1.

The sixth charge against SIM and Bronson was for violating Section 207 of the Advisers Act for false and misleading statements in Form ADV.

The seventh charge against SIM alone is for violating Section 206(4) and (7) of the Advisers Act for failure to adopt and implement written policies and procedures reasonably designed to prevent violations by SIM or its supervised persons of the Advisers Act and related rules.

The eighth and final charges are against Bronson and Engebretson for aiding and abetting the seventh charge above in violation of Section 209(f) of the Advisers Act.

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