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IS OBAMACARE STRANGLING BUSINESS?

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COVER STORY

The Perils of Regulatory Overreach

Since the 1980s, creeping precedent has allowed federal agencies to amass considerable regulatory and enforcement power. Undaunted by recent defeats in the courts, the SEC wants to become both judge and jury. But one small cap hedge fund managed to stop them in their tracks. BY **J.P. DONLON**

Last May, Nelson Obus stood outside the federal courthouse in Manhattan after a jury found him and two others innocent of an Securities and Exchange Commission charge for an alleged $1.3 million insider-trading scheme. Obus, who staunchly maintained from the beginning that he was innocent, felt vindicated, if weary, after 12 long years where the SEC, he feels, tried to intimidate him into settling the case.

A former Lazard manager, he later told reporters outside the courtroom that the case was less about him, but about the bullying tactics of the SEC, whose attorneys, in their zeal to prove they could notch up an insider-trader conviction, thought they could use their power to force him to capitulate.

Obus's story would be unremarkable were it not that he and his partners surprised the SEC attorneys by refusing to settle. The power of the SEC, like many federal agencies, is formidable and few companies resist it lightly. Last May, Obus argued in a *Wall Street Journal* op-ed that his case is just but one example of what he called an "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," he adds. He won his case after incurring more than $12 million in legal and court costs. To many S&P companies, this amount is a rounding error, but to a small hedge fund run by Obus, his partner Josh Landes and eight staff members, it was not a trivial sum. Even a settlement requiring no admission of guilt, he feels, would have stained his small company's reputation and stunted its growth. As it is, some 7 percent of investors withdrew their money because of the case.

Obus' company, Wynnefield Capital, is a small New York-based hedge fund managing $330 million in assets with a limited number of investors, including some institutions. It crossed swords with the SEC as far back as 2002, when it bought a block of stock in SunSource, an industrial-products company based in Philadelphia. Convinced that insider trading was involved the SEC requested information about Wynnefield's purchase, which the company provided. Confident that the information and review would show that it behaved appropriately, Wynnefield was stunned when four years later the SEC began its campaign to indict the firm and Obus himself. The SEC accused him of using an insider tip to buy shares in SunSource weeks ahead of its sale to Allied Capital, a trade that earned him a $1.3 million profit. Obus could have settled the case two years ago but chose instead to fight to prove his innocence. In 2010, a federal judge even sided with him, saying the SEC failed to prove its case. But The SEC won on appeal in 2012 and decided to make an example of Wynnefield.

Undeterred, the SEC indicates that it may take more of its law-enforcement cases away from courts and juries, altogether, by prosecuting defendants before SEC administrative law judges. Since the passage of Dodd-Frank in 2010, the agency has increased the number of administrative law judges from three to five. In other words, an agency founded as a law-enforcement arm is moving to become its own judge and jury as well.

The problem of regulatory overreach is not confined to the SEC. Energy business leaders have worried for sometime about the EPA's pernicious rulings, particularly those that make it impossible for the coal industry to operate. Two scholars at the Mercatus Center at George Mason University, Patrick McLaughlin and Richard Williams conducted a recent study that found that the accumulation of federal regulations slowed economic growth by an average of two percent per year between 1949 and 2005. Not all regulations are anti-growth, but this finding supports several earlier studies by the World Bank and the Organisation for Economic Cooperation and Development (OECD) that found that the effects of certain types of regulations can slow growth when they impede innovation and entrepreneurship.

Why do you reckon your company was singled out and given the treatment it experienced?

At the time, there was some very suspicious trading that the SEC was looking at, and they were connecting the dots. The agency was criticized for not being vigorous in its oversight of hedge funds. Some members of Congress were critical of the agency for being lax. I don't exactly know about the timing, but all of a sudden, three smaller hedge funds were told that a complaint would be lodged against them. Two of them settled quickly.

It was inconceivable to the SEC that anyone accused who was

Former NYSE director Ken Langone, Eli and Nelson Obus, Wynnefield Capital co-founder Josh Landes, and Buckingham Capital Management's Larry Leeds

small would ever fight it. The reasons being the cost and the likelihood that their investors would abandon them. So the SEC believed that filing a complaint was tantamount to getting a settlement. Settling without admitting innocence or guilt, on the surface, appears to be no problem. But people understand that it's a big stigma, and you're basically incapable of raising money from endowments and pension funds. I knew we had done nothing wrong and felt it was wrong to admit to something that we did not do.

The case echoes the dispute former attorney general Eliot Spitzer had with then NYSE director Ken Langone. I understand you sought Langone's advice in the matter.

I've known Ken for 25 years—maybe longer. I asked him what he thought I should do. To cut to the chase, Ken said, "There's no better use of your net worth than to clear your name." Then he took me through a very interesting drill. In 1981, when the market was really bad, maybe the fall of '81, he did the first IPO that had been done in 10 years. But unfortunately, right at the end of the day, somebody kicked the company's share price up an eighth, so it closed an eighth above the offering price, which was a technical violation of front running.

He decided he'd fight it. But then the bull market took off, and he couldn't do any IPOs because he was in this battle with the regulators about front running for an eighth that he didn't control. So while the bull market got into full swing, he paid the $8,200 fine and got into the fray. At the time his company, Invemed, was a very successful institutional broker.

Ken then said that Spitzer brought this up as part of the record in terms of Ken's character. And Ken said, "I let this thing slide. I basically paid these guys off so I could get on with my life instead of fighting it, and it came back and got me 20 years later."

So I decided to fight the SEC not because I'm a hardass, but because I couldn't allow the consequences of this being used against me like Spitzer used it against my friend Ken. Besides when the SEC actually issued its complaint, they made me look like Jack the Ripper. You wouldn't want to be in the same room with me. That didn't help.

Why do you think your case is significant to other businesses?

We were targeted not because they felt we were particularly guilty, but because they thought that they had enough enforcement weapons in terms of regulatory powers that the mere accusation would lead to our capitulation. They thought they could bully us and get away with it because we were small and they were powerful.

Over the years, the SEC has gathered powers that make them formidable to any company. As a result of many new insider-trading laws, a regulatory acorn has given rise to a judicial oak, or a judicial forest of oaks. Congress has never passed a law giving them these powers; they have accrued over the years due to precedent. It's time for Congress to reign them back.

What advice would you give other CEOs who may find themselves in a predicament with the SEC?

As a small company, I could afford to put my ideals forward. For larger company CEOs, this may not be so straightforward owing to multiple stakeholders such as employees and shareholders.

If you're going to fight these guys, obviously you need to clearly figure out what the fact pattern is. You first need to get the facts straight, and sometimes that's not always clear. There could be people in your organization who have done some things that weren't appropriate that you didn't know about, but you have responsibility for. Then you will would need to assess the spectrum of penalties, and determine—almost stakeholder by stakeholder—how people would be affected.

So it's not a simple calculus. To some degree, it was easier for me because I could very clearly identify the downside. Also, legal counsel becomes very important, because they can look at comparable situations and tell you what you need to do.

There's also who you know in government. Try to get to somebody in power who could argue what the deleterious economic effects might be by your being left in limbo. Even if you are innocent, you do not want to the outcome delayed. Postponing judgment or some outcome can sometimes be just as bad in terms of attrition to your business. ■