

SEC Brings Enforcement Action Against Investment Adviser for Section 13 Beneficial Ownership Reporting Failures

September 21, 2020

On September 17, 2020, the U.S. Securities and Exchange Commission (the “SEC”) announced the institution of a settled cease and desist proceeding against WCAS Management Corporation (“WCAS”), an SEC-registered investment adviser to five private funds operating under the name Welsh, Carson, Anderson & Stowe (the “WC Funds”), for failures to satisfy reporting obligations under Section 13(d) of the Securities Exchange Act of 1934 (the “Exchange Act”). Specifically, the SEC’s Cease and Desist Order (the “SEC’s Order”), which WCAS consented to without admitting or denying the SEC’s findings, found that WCAS caused the WC Funds to violate Section 13(d)(2) and Rule 13d-2 of the Exchange Act by failing to timely update its Schedule 13D to reflect (i) the investment intent to liquidate its reported position in a public company and (ii) the subsequent sales disposing of such position. The SEC’s Order required WCAS to pay a civil penalty of \$100,000 and to cease and desist from future violations of the applicable provisions of the Exchange Act. This latest action serves as another reminder of the SEC’s continued focus on beneficial ownership disclosures by institutional investors and the need to implement and adhere to robust controls and procedures to ensure compliance.

BACKGROUND

According to the SEC’s Order, in 2016, the WC Funds began acquiring shares of common stock of Hanger, Inc. (“Hanger”), a prosthetics company listed on the New York Stock Exchange, with the intent of taking Hanger private. In July 2016, the WC Funds first reported a combined 6.7% ownership stake in Hanger on a Schedule 13D filed with the SEC in July 2016 (the “2016 13D Filing”), with Item 4 noting that the WC Funds “may explore a possible acquisition or restructuring” of Hanger. Shortly thereafter, WCAS discussed with Hanger management the possibility of a take-private transaction. Hanger, however, indicated that it was not interested in such a transaction, and no further action was taken by WCAS or the WC Funds in respect of Hanger over the next three years.

In early June 2019, WCAS engaged an external consultant to assist with a possible sale of its entire position in Hanger and evaluate how and when to sell the WC Funds' position. At that same time, WCAS also contacted its broker-dealer about the forthcoming sale. According to the SEC's Order, by no later than June 17, 2019, WCAS "had abandoned its interest in acquiring Hanger, formulated a definitive intention to liquidate the entirety of its Hanger holdings, and taken steps to liquidate its Hanger shares." On July 1, 2019, the WC Funds sold shares totaling approximately 4.6% of the outstanding shares of Hanger common stock. On August 8, 2019, the WC Funds sold their remaining shares, which equaled approximately 1.9% of the outstanding shares of Hanger. On September 6, 2019, WCAS, on behalf of the WC Funds, filed Amendment No. 1 to the 2016 13D Filing, which disclosed the disposition of all of the WC Funds' shares of Hanger common stock.

ANALYSIS

Failure to Amend Upon a Material Change in Investment Intent

According to the SEC's Order, WCAS caused the WC Funds to violate Section 13(d)(2) and Rule 13d-2 of the Exchange Act when it failed to promptly amend the description of its investment intent, as disclosed in the 2016 13D Filing. The 2016 13D Filing included disclosure indicating that the acquisition of Hanger stock was for "investment purposes" and that, based on discussions with Hanger management, the WC Funds could "explore a possible acquisition or restructuring" of Hanger. In addition, in response to Item 4(a) of Schedule 13D, the 2016 13D Filing stated that WCAS did not have any plan to dispose of Hanger securities, while reserving its right to do so. Section 13(d)(2) and Rule 13d-2(a) of the Exchange Act together require prompt amendments to a previously filed Schedule 13D when there are any material changes or developments in the information previously reported, with "material" defined as information regarding matters where there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities. Further, generic or boilerplate disclosure that indicates that the insider is reserving the right to engage in any of the kinds of transactions enumerated in Item 4(a)-(j) of Schedule 13D (including plans related to acquisitions or disposition of securities) must be amended promptly when a material change occurs in the facts previously reported. According to the SEC's Order, WCAS's investment intent had materially changed from the disclosure set forth under Item 4 of the 2016 13D Filing by no later than June 17, 2019, as WCAS had abandoned its interest in acquiring Hanger and formulated a definitive intention to liquidate the entirety of its Hanger holdings. In making this assessment, the SEC focused on specific steps taken by WCAS to liquidate its position, as well as internal and external discussions of key decision-makers at WCAS.

Failure to Amend Upon the Disposition of a Material Amount of Securities

WCAS's second stipulated violation of Section 13(d) of the Exchange Act arose from a failure to promptly file an amendment to the 2016 13D Filing to disclose the actual disposition of Hanger securities by the WC Funds. Rule 13d-2(a) specifies that acquisitions or dispositions of registered securities of one percent or more of the class of securities are considered "material" and trigger an amendment obligation. As the July 1, 2019 sale exceeded four percent of Hanger's then-outstanding shares of common stock, the eventual disclosure of such sale in Amendment No. 1 to the 2016 13D Filing filed on September 6, 2019 was delinquent. According to the SEC's Order, due to WCAS's failure to disclose changes in beneficial ownership from the 2016 13D Filing, "Hanger investors were deprived of information explaining the potential cause of the surge in trading volume on July 1, 2019."

The SEC's Order also includes a discussion of WCAS's Section 13(d) compliance procedures and the specific deficiencies that contributed to the cited filing delinquencies. At the time of the events, two WCAS employees were responsible for the firm's compliance with Section 13(d) and were expected to work with outside legal counsel for both identifying any filing obligations and preparing the necessary filings. In the words of the SEC, WCAS "essentially outsourced the responsibility to comply with Section 13(d) to outside counsel," and in this case, the designated WCAS employees failed to retain and notify outside legal counsel in connection with the contemplated, and then completed, sale of securities. According to the SEC's Order, WCAS has since implemented a process to address its compliance with Section 13(d).

TAKEAWAYS

The SEC's enforcement action demonstrates the SEC's ongoing interest in monitoring and enforcing beneficial ownership reporting obligations by private funds. In particular, the SEC's Order's focus on an insider's evolving intent and when preliminary activities constitute a "plan or proposal" serves as a cautionary lesson as to the importance of continuously evaluating existing Schedule 13D disclosures as to whether an amendment is required. While investor and regulatory focus may naturally be more immediately focused on activities that involve acquisitions of additional securities or that translate into additional control of an issuer, the obligation to update promptly applies to any of the disclosure elements of Schedule 13D, including those that relate to material changes in investment intent, as in the case of WCAS. The action also reflects a continuing focus by both the Division of Corporation Finance and Division of Enforcement of the SEC on disclosure practices by institutional investors and other insiders of public companies involving beneficial ownership.

Further, the SEC's Order is yet another example of the importance of sound compliance polices and procedures. Consistent with the messaging in the 2014–2015 SEC enforcement sweeps in this area, the SEC's Order emphasizes the importance the SEC places on establishing and adhering to procedures that reinforce an insider's responsibility for satisfying its reporting obligations. For institutional investors that rely on outside counsel to assist in their compliance with beneficial ownership reporting obligations, both internal legal and business teams must be cognizant of the disclosure requirements of Schedule 13D and, to the extent such responsibilities are outsourced, engage outside counsel as early as possible when actions that could implicate material changes thereunder are being contemplated.

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