SEC Enforcement Case Summary
Co-CIO Accused of Fraud in Connection with Cherry-Picking

On November 25, 2024, the SEC filed fraud charges against Stephen Kenneth Leech, the former co-chief investment officer (***CIO***) of registered investment adviser Western Asset Management Company LLC (***WAMCO***), for engaging in a multi-year scheme to allocate favorable trades to certain portfolios, while allocating unfavorable trades to other portfolios, a practice known as cherry-picking. The case was filed in U.S. District Court for the Southern District of New York. The U.S. Attorney's Office for the Southern District of New York announced parallel criminal charges against Leech.

According to the SEC's complaint, Leech was portfolio manager for several investment strategies and placed trades in omnibus brokerage accounts that combined trades for multiple WAMCO clients. Contrary to WAMCO's mandatory training for portfolio managers, Leech did not allocate trades to specific portfolios at or near the time his trades were executed. Instead, he typically allocated trades hours later, often waiting until near or even after the end of the trading day. In the interim, Leech had the opportunity to see whether the market value of his trades went up or down. As a result, Leech was able to cherry-pick trades, allocating trades with first-day gains to favored portfolios, including higher-fee paying funds and accounts, and trades with first-day losses to disfavored portfolios. The SEC noted that Leech allocated hundreds of millions of dollars in net first-day gains to favored portfolios and hundreds of millions of dollars in net first-day losses to disfavored portfolios and that the statistical probability that this pattern occurred by random chance is less than one in one trillion.

The SEC's complaint alleged that Leech stood to profit significantly from his cherry-picking scheme, both professionally and financially. At a time of declining performance at WAMCO, Leech's fraud boosted the returns of a strategy he had started and managed for numerous favored portfolios for years. When Leech accelerated his scheme, he shifted millions of dollars of his own personal investments through his deferred compensation plan to favored portfolios.

The SEC noted that WAMCO instructed its portfolio managers, including Leech, that the best practice was to allocate trades as soon as possible after execution. WAMCO's compliance department provided mandatory training to investment staff stating that trades should be allocated promptly after execution. The SEC highlighted one compliance training in which WAMCO's CCO warned employees to finalize "allocations and the trade ticket promptly after the trade execution." He explained, "this is another thing that we know that the regulators are doing, they're looking at time stamps. So, if they get a sense that you executed first thing in the morning, but we didn't allocate until the end of the day, they may come to us … and wonder … 'you only allocated after you saw what the market did.'" The case highlighted other emails and training provided by WAMCO's compliance team highlighting the SEC's focus on fraudulent cherry-picking schemes and reiterating that trades should be allocated promptly, and that delayed or late allocations cause WAMCO to assume unnecessary risk and might require the firm "to defend and explain . . . a pattern of market movements and allocations made late in the day."

WAMCO's electronic trade management system apparently allowed portfolio managers to prepare draft trade tickets and specify an allocation instruction even before placing a trade. The firm's documented trade flow process purported that the firm's investment professionals would submit draft allocation tickets for compliance review in advance of trade execution. The SEC noted that most of WAMCO's portfolio managers used its electronic trading system and pre-allocated trades prior to trading and/or allocated trades shortly after they placed a trade, consistent with the firm's instructions and training. However, contrary to the firm's training, Leech did not document or communicate intended allocations at the time of his trades and typically did not use the electronic trading system or specify trade allocations in draft tickets when placing trades. Instead, he predominately placed trades by calling his contacts at brokerage firms.

As Leech's trades were filled, brokers issued trade confirmations that were typically received on a rolling basis throughout the day by Leech and his dedicated trade assistant, as well as by other personnel in WAMCO's trade operations group. The SEC complaint noted that Leech did not discuss allocations with the Trade Association when the trades were placed or filled and routinely provided his allocations for most of a day's trading activity in a single afternoon phone call after the settlement price was determined on the Chicago Mercantile Exchange, which sets the daily prices for many of the instruments Leech traded. In the time between when Leech placed trades and when he allocated them, he was able to observe price changes in the relevant instruments using a Bloomberg screen that he had displayed on his computer monitors at his home and in his office.

This case represents an egregious cherry-picking scheme by a high-level employee that was allowed to continue for an extended period of time, in direct violation of the firm's compliance policies, procedures, and training. It should serve as an important reminder to investment advisers and private fund managers regarding potential abuses that can be perpetrated by an employee at any level. The SEC expects investment advisers to adopt and actively enforce robust controls with respect to trade allocations to avoid, monitor for and promptly detect and address potential cherry-picking.

See Summary – https://www.sec.gov/newsroom/press-releases/2024-187