Client Update

SEC Brings First Anti-Retaliation Enforcement Action Under Dodd-Frank

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This week, the U.S. Securities and Exchange Commission ("SEC") brought its first case under the whistleblower anti-retaliation provision of Dodd-Frank, alleging that an investment adviser, Paradigm Capital Management, Inc., and its owner engaged in prohibited principal transactions and then retaliated against an employee who reported prohibited principal transactions at the firm to the SEC.[1] Both Paradigm and its owner, Candace Weir, settled with the SEC, without admitting or denying the SEC's allegations, agreeing to cease and desist from committing future violations of the Securities Exchange Act and Investment Advisers Act and to pay $2.2 million in disgorgement and civil penalties.

This enforcement action and recent statements from the SEC, serve as an important reminder to employers, including public and private companies, private equity and hedge fund advisers, and other SEC-regulated firms, that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which became law in 2010, imposed some important changes in relation to whistleblower protection. In addition to creating the financial incentives (up to 30 percent of monetary sanctions) for whistleblowers that report securities law violations to the SEC, Dodd-Frank also enhanced anti-retaliation protections for whistleblowers. Specifically, Exchange Act Section 21F(h) prohibits an employer from discharging, demoting, suspending, threatening, harassing, or in any other manner discriminating against a whistleblower in the terms of employment because the whistleblower engaged in protected whistleblowing activities, including providing information to the SEC related to a violation of the securities laws. The Paradigm case demonstrates that the SEC will not hesitate to pursue actions against companies that are viewed as retaliating against alleged whistleblowers.

[1] *In re Paradigm Capital Mgmt, Inc.*, Exchange Act Release No. 72,393, Investment Advisers Act Release No. 3857 (June 16, 2014) ("SEC Order").

THE UNDERLYING MISCONDUCT

According to the SEC Order, Candace Weir caused Paradigm to engage in principal transactions with C.L. King & Associates, Inc., a broker-dealer also owned and controlled by Weir, "without providing effective disclosure to, or obtaining effective consent from, PCM Partners L.P. II, a hedge fund client advised by Paradigm."[2] Weir also owned and controlled an entity that was the general partner of PCM Partners. From 2009-2011, Paradigm—in an effort to reduce the tax liability of its client PCM Partners—allegedly engaged in 83 principal transactions in which Paradigm sold securities with unrealized losses held by PCM Partners to a proprietary account at C.L. King. Occasionally, these securities would later be repurchased for PCM Partners. The trades were executed at the market price, and there were no commissions or markups charged, but Paradigm purportedly never provided written disclosure to, or obtained consent from, PCM Partners in violation of Section 206(3) of the Investment Advisers Act. The SEC also noted that a Conflicts Committee established at Paradigm to review and approve principal transactions, in an attempt to comply with the disclosure and consent requirements, could not do so because one of its two members also served as C.L. King's Chief Financial Officer, which put him in a conflicted position.[3]

RETALIATION AGAINST THE WHISTLEBLOWING

In March 2012, the then-head trader at Paradigm made a whistleblower submission to the SEC, informing them about the principal transactions at Paradigm and, in July 2012, the whistleblower informed Weir that he had made the submission to the SEC. According to the SEC, on the next day, the whistleblower was informed that he would be relieved of his day-to-day trading and supervisory responsibilities while Paradigm investigated his actions. He was also asked to work off-site and prepare a report detailing his allegations made to the SEC and facts used to support them. A week later, Paradigm purportedly told the whistleblower that the employment relationship was "irreparably damaged" and sought to come to an agreement on severance. Paradigm and the whistleblower were unable to come to an agreement, so in August 2012, the whistleblower sought to return to his old position as head trader. Paradigm did not permit that, but allowed him to return to the office, albeit not on the trading floor, and instructed him to continue to investigate potential wrongdoing at the

[2] SEC Order, at 2.

[3] The SEC also viewed the failure to disclose the CFO's conflict as a material omission on Form ADV. SEC Order at 5.

firm. A month after the whistleblower informed Weir of his report to the SEC, the whistleblower resigned.

Although Paradigm never cut the whistleblower's pay or benefits or changed the whistleblower's title, the SEC's order cites several adverse employment actions, which the SEC viewed as retaliation, including "removing the Whistleblower from his position as head trader, tasking him with investigating the very conduct he had reported to the Commission, changing his job function from head trader to a full-time compliance assistant, stripping him of supervisory responsibilities, and otherwise marginalizing him."[4]

TAKEAWAYS

The *Paradigm* action reflects both the SEC's broad reading of the Dodd-Frank whistleblower and anti-retaliation provisions and the agency's determination to make enforcement of those provisions a priority. When announcing the Paradigm enforcement action, Andrew Ceresney, the director of the SEC Enforcement Division, warned others against interference with SEC whistleblowers, stating "Those who might consider punishing whistleblowers should realize that such retaliation, in any form, is unacceptable."[5] And, Sean McKessy, the head of the SEC's Office of the Whistleblower, added that the SEC "will continue to exercise our anti-retaliation authority in these and other types of situations where a whistleblower is wrongfully targeted for doing the right thing and reporting a possible securities law violation."

Employers should be cautious not just about retaliation but also about any activity that could be seen as seeking to prevent or discourage whistleblowing before it happens. McKessy, earlier this year, warned employers and corporate counsel about drafting confidentiality agreements, separation agreements and other employee agreements in a way that would condition certain benefits on not engaging in whistleblowing activities, and indicated the SEC may bring enforcement actions against employers who do so under Rule 21F-17.[6]

As the Paradigm decision and other statements by SEC officials make clear, employers should not retaliate, in any way, against an employee who they learn

[4] SEC Order, at 8.

[5] Press Release, SEC Charges Hedge Fund Adviser with Conducting Conflicted Transactions and Retaliating Against Whistleblower (June 16, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307.

[6] *See* Debevoise & Plimpton LLP, Client Update: SEC Warns Against Interference with Potential Whistleblowers (May 6, 2014), *available at* http://www.debevoise.com/clientupdate20140506a/.

has engaged in protected whistleblowing activity. Importantly, retaliation can take many forms and simply continuing to employ and compensate an employee at his or her pre-whistleblowing level will not inoculate an employer against anti-retaliation charges. Finally, although the SEC obtained a $2.2 million sanction against Paradigm and Weir, the settlement does not specify whether any portion of the monetary penalty applied to the retaliation claim as opposed to the principal trading violations, leaving open how much of the sanction the SEC attributed to the anti-retaliation aspects of the case.

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Please do not hesitate to contact us with any questions.

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