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Client Alert
Commentary

Latham & Watkins Litigation Department

June 19, 2014 | Number 1697

Investment Adviser Charged For Demoting Whistleblower in SEC's First Anti-Retaliation Case

Investment adviser and its owner settle SEC enforcement action for nearly US$2.2 million.

On June 16, 2014, the US Securities and Exchange Commission issued a cease and desist order and assessed a US$300,000 civil penalty, as part of a nearly US$2.2 million settlement, against a New York-based investment adviser and its owner in the first enforcement action based in part on provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that protect whistleblowers from retaliation by their employers. The SEC's prosecutorial use of the anti-retaliation provisions is a reminder to US public companies and regulated entities that they must tread carefully when dealing with whistleblowers.

Improper Principal Transactions

The SEC's findings regarding the misconduct that led to the protected whistleblowing are described in the SEC's cease and desist order as follows: Investment adviser Paradigm Capital Management, Inc. and its majority owner and founder Candace King Weir engaged in over 80 prohibited principal transactions with an affiliated broker-dealer majority-owned and founded by Weir, without providing adequate written disclosure to, or obtaining consent from, Paradigm's hedge fund client. Paradigm set up a conflicts committee in an attempt to avoid running afoul of the principal transaction rules. However, the committee was ineffective because it was itself conflicted – both of its two members were under Weir's control and thus could not eliminate the conflict issues. In addition, Paradigm's Form ADV omitted material facts concerning its process for obtaining consent to the principal transactions.

The SEC found that by engaging in this conduct, Paradigm violated, and Weir caused violations of, Section 206(3) of the Investment Advisers Act of 1940, which prohibits an investment adviser from, directly or indirectly, "acting as principal for his own account, knowingly to sell any security or to purchase any security from a client … without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." Paradigm was also found to have violated Section 207 of the Advisers Act, which makes it unlawful for any person willfully to make any untrue statement or omission of material fact in any registration application or report filed under the Advisers Act.

Head Trader Blows The Whistle To The SEC

The SEC also found the investment adviser retaliated against the whistleblower. According to the order, in March 2012, Paradigm's then-head trader reported to the SEC what he believed to be improper principal transactions. On July 16, 2012, the whistleblower made Weir and the affiliated broker-dealer's chief operating officer aware of his submission to the SEC, and immediately thereafter the investment adviser initiated adverse employment actions. For example, the whistleblower was relieved of his duties and responsibilities as head trader, denied access to his work email account and other trading and account systems, directed to work offsite and instructed to prepare a report detailing all of the facts that supported the potential securities violations he reported to the SEC. He eventually resigned on August 17, 2012.

The SEC found that by engaging in this conduct, the investment adviser violated the anti-retaliation provisions of Dodd-Frank found in Section 21F(h) of the Securities Exchange Act of 1934, which prohibits an employer from discharging, demoting, suspending, threatening, harassing, directly or indirectly, or in any other manner discriminating against, a whistleblower in the terms and conditions of employment because he or she lawfully provided information to the SEC.

Paradigm and Weir settled without admitting or denying the findings in the cease and desist order. Under the settlement, they are to pay US$2,181,771, consisting of disgorgement of US$1,700,000 to compensate the hedge fund investors, as well as prejudgment interest of US$181,771 and a civil penalty of US$300,000, both to be paid to the US Treasury. Paradigm must also adopt all recommendations of an independent consultant retained to review Paradigm's supervisory, compliance, and other policies and procedures intended to prevent and detect prohibited principal transactions.

The SEC Finally Uses Dodd-Frank Anti-Retaliation Provisions

The SEC's Dodd-Frank whistleblower rules became effective almost three years ago and have so far produced eight whistleblower awards and the single retaliation enforcement action against Paradigm. In our view, the relative dearth of awards to date is mainly a function of the length of the SEC processes for investigating violative conduct and approving whistleblower awards. Given the focus on the whistleblower program, and statements from SEC senior staff, we expect to see an uptick in announced awards in the next year.

The anti-retaliation provisions require the SEC to move outside its comfort zone of securities law and make determinations grounded in traditional employment law. For example, when does an employer's actions affect the terms and conditions of employment? The SEC must now grapple with that and other unfamiliar questions. But despite that lack of experience and the fact that only one retaliation case has been brought to date, in our view there is a high likelihood that the SEC will aggressively investigate whistleblowers' allegations of retaliation and will file charges if there is sufficient evidence the employer has retaliated.

The message of the Paradigm case is unmistakeable: public companies and other entities regulated by the SEC must be extremely careful in their treatment of employees who acknowledge or are suspected of reporting compliance concerns to the SEC, or face the SEC's wrath. And just as lying or obstructing justice during an SEC investigation dramatically increases the likelihood of adverse consequences from possible misconduct, engaging in conduct that might be viewed by the SEC as retaliation can result in a broader SEC inquiry and enhanced charges.

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