Compliance Corner

Anti-Retaliation: What's the Paradigm?

How to Respond to a Whistleblower

By Paul Huey-Burns, Meredith S. Campbell, and Megan Raker, Shulman Rogers Gandal Pordy & Ecker, P.A.*

As with sausages and legislation, the process by which the SEC manufactures administrative orders sometimes is best left unknown. One consequence is that, in situations where the Commission uses an administrative order to articulate a regulatory policy, investment advisers and others subject to SEC regulation can carefully parse such pronouncements yet still emerge with only limited guidance. Such is the case with the SEC's Administrative Order (the Order), issued on June 16, 2014, available at http://www.sec.gov/litigation/admin/2014/34-72393.pdf, which found that Paradigm Capital Management had retaliated against an employee-whistleblower who had told the SEC about potential securities law violations at the firm. This matter is the first time that the SEC has exercised its authority under the anti-retaliation provisions of the Dodd-Frank Act. In this article, we review the details of the Order and attempt to fill in the blanks.

The Order provides an apparently straight-forward narrative. In March 2012, Paradigm's former head-trader (the Whistleblower) told the SEC that he believed that the firm had engaged in undisclosed and unapproved principal transactions with an affiliated broker-dealer. The SEC found that the Whistleblower had told Paradigm that he had contacted the SEC and that Paradigm then had engaged in a series of actions that the SEC deemed retaliatory and in violation of § 21(F) of the Securities Exchange Act of 1934 (which provides securities whistleblower incentives and protection). These actions had ranged from the firm requiring the Whistleblower to prepare a report on the transactions at issue to, eventually, accusing him of violating the firm's confidentiality policies by using his personal email account for work purposes.

Although the Order does not identify any particular actions as "retaliatory," it appears that the escalating nature of the actions—and the increasing marginalization of the Whistleblower—were the critical factors. SEC officials have been vocal about the Commission's lack of tolerance for retaliation against whistleblowers. The press release that accompanied the Order quoted Sean McKessy, chief of the SEC's Office of the Whistleblower, as saying, "We 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."

More retaliation cases are likely to follow. When dealing with a whistleblower, investment advisers and others should take precautions against the perception that they have engaged in retaliatory conduct. This especially is true because of the lack of clarity in the Order as to the tipping point between "retaliatory" and "reasonably responsive" actions.

The Alleged Facts

According to the Order, Paradigm undertook the trading at issue to realize certain tax benefits on behalf of investors in a hedge fund it advised. Paradigm would trade securities that had unrealized losses to an affiliated broker-dealer, and the firm would then use the realized losses to offset the fund's realized gains. Regulations require that Paradigm provide written disclosure and obtain the fund's consent when trading with the affiliated broker-dealer. Paradigm established a conflicts committee to effectuate this consent; yet the Order found that this conflicts committee was itself conflicted (the conflict primarily arose because Paradigm's CFO, who served on the conflicts committee, also was the CFO of the affiliated broker-dealer). As a result, any disclosure and subsequent approval was inadequate.

It does not appear that the transactions at issue caused any direct harm to the investors. Nonetheless, absent the required disclosure and consent, the Commission found that Paradigm had violated §§ 206(3) (principal transactions) and 207 (material misstatements)

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of the Investment Advisers Act of 1940.

The Whistleblower/head trader, who had effected the transactions, reported these potential violations to the SEC in March 2012. The Whistleblower continued to work for Paradigm as head trader for over two months until, the day after he had revealed himself as a whistleblower, Paradigm removed him from the trading desk. Paradigm and its principal told the Whistleblower that he should devote his time to preparing a report of the potential violations. Initially, the Whistleblower was directed to prepare this report at a different office building, but Paradigm eventually allowed him to prepare the report from his home.

Throughout this process, Paradigm denied the Whistleblower access to certain trading and account systems (which he previously had been able to access) and denied him access to his work email. After the Whistleblower submitted his report, he notified Paradigm of his intention to return to work. Paradigm, however, delayed his return and informed the Whistleblower's counsel that the relationship between the firm and the Whistleblower had been "irreparably damaged." After Paradigm and the Whistleblower were unable to agree to a severance package, Paradigm allowed the Whistleblower to return to work but denied his request to return to his former position as head trader. Instead, Paradigm relieved the Whistleblower of all trading responsibilities and tasked him with identifying any potential wrongdoing by the firm. Paradigm assigned the Whistleblower more than 1,900 pages of hard-copy trading data to review, and denied his request for access to electronic records. The firm then assigned the Whistleblower the additional task of consolidating multiple trading procedure manuals and proposing improvements to the firm's trading policies and procedures.

The final straw came after the Whistleblower sent a confidential report from his personal email (which previously had been approved for communications while the Whistleblower was working from home) to Paradigm's Chief Compliance Officer. Paradigm accused the Whistleblower of violating the firm's policies and the terms of his confidentiality agreement. The Whistleblower resigned the following day.

The Order concluded that "Paradigm had no legitimate reason for 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 . . . to full-time compliance assistant, stripping him of his supervisory responsibilities, and otherwise marginalizing him." With that, the SEC concluded that Paradigm had engaged in these actions in retaliation for the Whistleblower's disclosure to the SEC.

Reading Between the Lines of the Order

The Paradigm matter is a "message" case. But the question remains: "What exactly is the message?" The Commission often brings its first enforcement action under new statutory authority in situations where the facts as alleged demonstrate an incontrovertible violation. That is not the case here. Although the conclusion may be that Paradigm's overall course of conduct was retaliatory, it is not clear whether the Commission believes that each individual action was sufficient to warrant liability. Indeed, several of the actions that Paradigm took—suspending an employee involved in a potential violation from ongoing responsibilities for the very conduct implicated, or asking an employee who has reported wrongdoing to prepare a report—are not unusual in such situations. Further, it appears that Paradigm consulted with counsel throughout the process.

The narrative in the Order is most intriguing in what it does not say. As is true in many such situations, the Whistleblower's motives likely were mixed. The reader may speculate that the relationship between the Whistleblower and Paradigm was tenuous, and the Whistleblower appears to have spoken with his own counsel prior to coming forward and obtaining the additional leverage that attends the protections of the anti-retaliation provisions. In sum, the Order takes a situation that presents advisers and other regulated entities with a dangerous and complex landscape (that is, how to respond to a whistleblower) and makes it even more perilous.

To help navigate this more perilous landscape, we offer a few guideposts:

1. Have a Plan

The Order devotes almost three full pages to describing Paradigm's response to the Whistleblower. While this list includes some actions that might appear clearly retaliatory (such as looking for that "gotcha" moment when the Whistleblower used his personal email for confidential communications), it is not clear whether the result would have been different had the firm taken only some of the actions eventually deemed problematic. It does appear, however, that the escalation of action taken against the Whistleblower as the investigation unfolded was an essential factor in the result.

When a whistleblower reveals him or herself, the firm should act, not react. A plan, with contemporaneous justification for each action taken, might serve both as a check against escalation and a defense to an allegation of retaliation.

2. Transparency and Communication Can Make a Difference

After developing a plan for the firm's response, it is critical to communi cate that plan to the whistleblower

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effectively and without animosity. The chain of actions that Paradigm took against the Whistleblower appeared to escalate—especially in light of the lack of transparency and communication between the firm and the Whistleblower. Also, the Whistleblower's compliance tasks appeared to be busywork, designed just to give him something to do to keep him off the trading floor. These events probably contributed to the SEC's finding that Paradigm's response was not legitimate and marginalized the Whistleblower.

3. Keep Your Cool

Most whistleblowers make the jump into this protected status with the assistance of counsel. That the Whistleblower made his report to the SEC, continued to work as head-trader for two months, then disclosed his report to Paradigm almost certainly was not a random chain of events. This calculated delay gave the Whistleblower support for his claim that the retaliation came as a direct response to his whistleblower submission. One suspects that the Whistleblower pushed other of the firm's buttons during this time period.

Firms must realize, and accept, that whistleblowers are probably advised by counsel and that they know how to protect their status and claims. This tends to be a one-sided process which makes it all the more important to refrain from reacting to any whistleblower instigation and to stick to the earlier crafted plan of response.

After finding that Paradigm and its principal had violated § 21(F)(h) of the Securities Exchange Act of 1934 and §§ 206(3) and 207 of the Investment Advisers Act of 1940, the Commission ordered Paradigm and its principal to pay $2.2 million in disgorgement of administrative fees and monetary penalties. (It is not clear what portion of the monetary penalty—if any—relates to the alleged retaliatory conduct.) The Order also included cease and desist orders from any future violations and a requirement that Paradigm retain the services of an independent compliance consultant.

Paradigm is an example of how securities law violations can come with the secondary cost of a whistleblower retaliation suit if the firm is not careful. The reality is, as whistleblower protections become more stringent, and the payoff to a whistleblower becomes more attractive, it is increasingly important for a firm to be prepared to face a whistleblower situation in the future.

** Paul Huey-Burns is a shareholder in Shulman Rogers' Securities Enforcement practice and may be reached at (301) 945-9241 or phuey-burns@shulmanrogers.com. Meredith S. Campbell is a shareholder in Shulman Rogers' Employment and Labor practice and may be reached at (301) 255-0550 or mcampbell@shulmanrogers.com. Megan Raker is a summer associate at the firm.* *This article is intended to provide general information on the matters discussed herein. It should not be relied upon for legal advice on any matter.* ■

Paul Huey-Burns
Shareholder
Shulman Rogers

Meredith S. Campbell
Shareholder
Shulman Rogers

Megan Raker
Summer Associate
Shulman Rogers