WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON PARIS LONDON MILAN ROME FRANKFURT BRUSSELS

CLIENT MEMORANDUM

Paradigm Capital Pays Over $2 Million in First Ever SEC Whistleblower Retaliation Enforcement Action

June 23, 2014

AUTHORS

Martin Weinstein | **Robert Meyer** | **Jeffrey Clark**

On June 16, 2014, Paradigm Capital Management, Inc. ("Paradigm"), a New York-based investment firm, agreed to pay over $2 million for improper trading and whistleblower retaliation violations in an administrative proceeding brought by the Securities and Exchange Commission ("SEC"). The proceeding is the first ever enforcement action brought by the SEC for whistleblower retaliation under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The proceeding provides important guidance for companies in dealing with Dodd-Frank whistleblowers who report allegations to the SEC concerning potential violations of securities laws, including the Foreign Corrupt Practices Act ("FCPA").

Background

Paradigm is a New York-based investment firm founded and controlled by Candace King Weir. Weir also controls another New York-based company, C.L. King, which is a broker-dealer registered with the SEC. Weir owns 73 percent of both Paradigm and C.L. King.

According to the settlement papers, from at least 2009 through 2011, Weir caused a Paradigm client, PCM Partners L.P. II ("PCM"), to engage in a trading strategy without disclosing and obtaining PCM's consent regarding a conflict of interest involving Weir, Paradigm, and C.L. King. In particular, Weir directed Paradigm's traders to sell certain securities from PCM to a proprietary trading account controlled by Weir at C.L. King. Because Weir controlled both Paradigm and C.L.

King, Paradigm had an obligation to disclose the proposed trades and to obtain PCM's prior consent under Section 206(3) of the Investment Advisors Act of 1940. Paradigm, however, failed to do so. Although the trades were executed at market value and the trading strategy was designed to reduce the tax liability of PCM's investors, Paradigm still had an obligation to disclose the conflict of interest and to obtain PCM's consent under Section 206(3).

Paradigm's Alleged Violations of Dodd-Frank's Whistleblower Retaliation Requirements

On March 28, 2012, Paradigm's then-head trader submitted a whistleblower report to the SEC regarding the alleged violations of Section 206(3). The whistleblower did not notify Paradigm at the time, but several months later, on July 16, 2012, the whistleblower told Weir and C.L. King's Chief Operating Officer that he had reported the issue to the SEC.

The next day, Paradigm informed the whistleblower that, because he had executed trades that were reported to the SEC, Paradigm would need to investigate his conduct. Paradigm temporarily relieved the whistleblower of his day-to-day trading and supervisory responsibilities and directed him to work off-site preparing a report on the alleged violations.

From July 18, 2012 to July 20, 2012, Paradigm denied the whistleblower access to Paradigm's trading and account systems while the whistleblower worked at home. Paradigm also denied the whistleblower access to his Paradigm email account. On Friday, July 20, 2012, the whistleblower completed the report and asked to return to work on Monday, July 23, 2012. Paradigm, however, rejected the request.

On July 24, 2012, Paradigm informed the whistleblower's counsel that the relationship was "irreparably damaged" and that Paradigm wanted him to leave with "as little difficulty or acrimony as possible." After the parties failed to agree on severance terms, the whistleblower demanded that he return to work as Paradigm's head trader. On August 8, 2012, Paradigm asked the whistleblower to return to work on August 13, 2012. Paradigm stated that his compensation would remain the same and that he would have a "meaningful" role at Paradigm; however, Paradigm later clarified that the whistleblower would not serve as head trader until Paradigm's investigation was complete.

When the whistleblower returned to work on August 13, 2012, Paradigm did not allow the whistleblower to resume his job at the trading desk and instead assigned him the task of identifying any further potential wrongdoing by Paradigm. This included reviewing 1,900 pages of hard-copy trading data. When the whistleblower asked Paradigm to generate the trading data in an electronic format to isolate potential trades or to provide him with electronic access to Paradigm's trading systems so he could do so, Paradigm refused. Paradigm also asked the whistleblower to consolidate its trading procedure manuals into one comprehensive document and to propose revisions to enhance the firm's trading policies and procedures.

Finally, even though Paradigm had previously consented to allowing the whistleblower to use his personal email address after denying him access to his Paradigm email account, Paradigm accused the whistleblower of policy violations when the whistleblower sent a confidential report from his personal email address. Paradigm reprimanded the whistleblower,

and, on August 16, 2012, sent a formal memorandum to the whistleblower accusing him of violating Paradigm policy. On August 17, 2012, the whistleblower resigned from Paradigm.

Based on the foregoing events, the SEC found that Paradigm violated the Dodd-Frank whistleblower retaliation provision, Section 21F(h) of the Exchange Act, which prohibits employers, directly or indirectly, from discharging, demoting, suspending, threatening, or harassing, or in any other manner discriminating against, a Dodd-Frank whistleblower in the terms and conditions of employment. The SEC asserted 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 from head trader to a full-time compliance assistant, stripping him of his supervisory responsibilities, and otherwise marginalizing him."

To settle the charges, Paradigm agreed to pay a total of $2,181,771, including $1,700,000 in disgorgement, $181,771 in prejudgment interest, and a civil penalty of $300,000. The SEC also issued a cease-and-desist order prohibiting further violations and compelling Paradigm to retain an independent compliance consultant. Under the cease-and-desist order, the independent compliance consultant will conduct a comprehensive review of Paradigm's policies, and Paradigm must implement policy improvements recommended by the consultant.

Discussion

This enforcement action illustrates the importance of complying with Dodd-Frank whistleblower requirements and handling Dodd-Frank whistleblower allegations with extreme care. Here, the whistleblower himself allegedly participated in the unlawful trades in question and did so in a supervisory role as the firm's head trader. Accordingly, removing the whistleblower from his position pending an investigation arguably would be defensible at first glance; however, based on the facts set forth in the cease-and-desist order, Paradigm's owner initiated the conduct in question, and other traders participated in the conduct, yet only the whistleblower was singled out for adverse employment action. Moreover, Paradigm made clear that the relationship was "irreparably damaged" not because of the conduct in question, but because the whistleblower had reported the conduct to the SEC.

Dodd-Frank whistleblower protections cover violations of securities and commodities laws and extend to a wide variety of reportable conduct, including accounting fraud, market manipulation, insider trading, misleading statements in public filings, misrepresentations in the sale of securities or commodities, bribery of foreign public officials under the FCPA, and books, records, and internal controls violations of the FCPA.

Companies should expect more such cases. The FY 2013 annual report of the SEC Office of the Whistleblower ("OWB") discusses retaliation and states that the OWB is:

- coordinating actively with the SEC Enforcement Division to identify matters where employers may have taken retaliatory measures or where employers may have utilized confidentiality, severance, or other agreements in an effort to prohibit their employees from voicing concerns about potential wrongdoing;

- identifying and monitoring whistleblower complaints alleging retaliation;
- monitoring federal court cases addressing the anti-retaliation provisions of the Dodd-Frank Act and the Sarbanes-Oxley Act of 2002; and
- reviewing employee confidentiality agreements and other agreements provided by whistleblowers for potential concerns arising under the whistleblower provisions.

The SEC is actively looking for instances of whistleblower retaliation. Accordingly, companies should handle Dodd-Frank whistleblower issues with extreme care and work closely with legal counsel in doing so.

If you have any questions or need assistance on FCPA compliance, please contact Martin Weinstein (202-303-1122, mweinstein@willkie.com), Robert Meyer (202-303-1123, rmeyer@willkie.com), Jeffrey Clark (202-303-1139, jdclark@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Paris, London, Milan, Rome, Frankfurt and Brussels. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

June 23, 2014