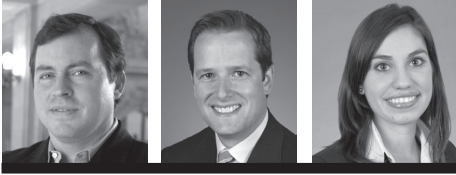


## Bounty hunting under Dodd-Frank

*Hedge funds should take special note of new SEC regulations on whistleblower incentives*



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### Corporate Governance and Compliance

**O**n Nov. 3 the Securities and Exchange Commission released its proposed rules for implementing the whistleblower provisions established by §922 of the Dodd-Frank Act. The SEC rules attempt to address the fear that large bounty awards for whistleblowers will create a perverse incentive for tipsters to bypass internal compliance mechanisms and report potential securities violations directly to the SEC.

Many commentators have addressed the hardships issuers will face in conducting effective internal investigations to detect misconduct in light of the new whistleblower program. However, the whistleblower provisions will also have a profound effect on financial firms such as hedge funds, which may want to re-evaluate or implement internal compliance mechanisms to best protect themselves in this changing enforcement environment.

#### THE ACT'S WHISTLEBLOWER PROGRAM

Under §922 of Dodd-Frank, any person who voluntarily supplies original in-

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formation that leads to a successful SEC enforcement action, resulting in sanctions of at least \$1 million, will receive between 10 and 30 percent of the recovered monetary sanctions. The whistleblower is also entitled to an award from any successful, related action based on the same information. "Original" information is defined as information derived from independent knowledge or analysis, arguably meaning that anyone, not just employees, can be a whistleblower and qualify for an award.

**Given the government's increasing focus on hedge funds and the changed enforcement landscape enhanced by the act's whistleblower bounty provision, hedge fund managers should take pains to create a culture of compliance within their firms, while also protecting confidentiality of firm information.**

Section 922 expanded the SEC's whistleblower program beyond evidence of insider trading to cover tips regarding any violation of the federal securities laws by any individual or company, public or private. The act also protects whistleblowers from retaliation by establishing a federal cause of action for employees who suffer retaliation for providing the SEC with information. The commission has already set aside \$452 million to fund anticipated whistleblower bounties.

Given the potential payout tipsters stand to receive by reporting violations directly to the SEC, many employers have expressed concern that §922 will undermine internal company investigative processes established after Sarbanes-Oxley to root out and address potential misconduct. In response to these concerns, the proposed rules contain provisions that reduce the incentive for employees to bypass internal compliance programs. First, the SEC would treat an employee as a whistleblower for purposes of the award from the date the employee reports a violation internally, as long as the employee reports the same violation to the SEC within 90 days. The SEC also would consider paying higher-percentage awards to employees who initially report violations through effective internal mechanisms. Furthermore, the rules would not allow attorneys, independent auditors, or compliance personnel to claim an award on the basis of information obtained in the course of carrying out their duties. However, employees who perform compliance functions become eligible for an award if the company fails to report information to the SEC within a reasonable time.

The rules also lay out 11 factors that the SEC staff will weigh to determine the bounty size. Among these are the significance of the information provided, the harm to investors allegedly prevented by the tip and the extent to which the whistleblower attempted to prevent the violation from occurring or continuing. The SEC staff would set the size of the award, but the commission would have the power to adjust or deny the bounty. The rules further clarify that the whistleblower anti-retaliation protections would apply to any person who reports a potential violation, regardless of whether the tip results in an SEC enforcement action.

## **DODD-FRANK IN THE HEDGE FUND CONTEXT**

Many whistleblower claims will of course come from public company employees and be related to accounting practices, revenue recognition, FCPA-related matters, self-dealing, executive compensation, insider trading and the like. Yet, with all the understandably intense focus on issuers, it bears noting that hedge fund employees and others associated with hedge funds may also become whistleblowers, causing more hedge funds to become the subjects of SEC investigations. Furthermore, §748 of the act provides a similar whistleblower provision for violations of the Commodity Exchange Act, overseen by the Commodity Futures Trading Commission. This provision may implicate hedge funds in potential commodity futures trading violations.

In the past, the SEC has had a difficult time bringing insider trading cases against hedge funds given the complex and sophisticated trading strategies that define them. However, the current SEC Enforcement Division has demonstrated an increased commitment to uncovering insider trading in the hedge fund context, recently filing several cases involving hedge funds based on tipsters and informants. The act's whistleblower provisions strengthen the SEC's already enhanced arsenal of enforcement tools against hedge funds by incentivizing citizens to act as government watchdogs. These traditionally opaque institutions are now more likely than ever before to face scrutiny of their practices and allegations of misconduct lodged against them by current and former employees seeking a bounty.

Whistleblowers can thus play a critical role in building a case against hedge funds, their employees and their associates. For example, in May 2010 the SEC charged Pequot Capital's principal manager, Art Samberg, and former employee, David Zhilka, with insider trading. The SEC had previously investigated Samberg, but investigators closed the case without filing charges. However, Zhilka's ex-wife later uncovered information that indicated insider trading and turned it over to the SEC. Pequot and Samberg eventually settled the case for \$28 million. On July 23rd, two days after Dodd-

Frank was signed into law, the SEC awarded Zhilka's ex-wife \$1 million for the tip. While the SEC granted the award under its previous authority to reward whistleblowers in insider trading cases, the amount was far in excess of any prior awards, sending a clear message to potential whistleblowers that the SEC is prepared to pay handsomely for tips.

In August an anonymous whistleblower filed a complaint with the SEC against Plainfield Asset Management under the Dodd-Frank Act. The complaint alleged that the firm intentionally overvalued its portfolio assets so that it could fraudulently charge higher management fees. Separately, the SEC recently filed an enforcement action, accompanied by a criminal complaint, against a French doctor who tipped a hedge fund portfolio manager about unfavorable results in a clinical drug trial, allegedly causing the manager to unload a position and avoid \$30 million in losses. While the SEC has not (yet) filed an action against the hedge fund, the case highlights the federal government's heightened scrutiny of hedge fund managers and use of tips to build enforcement cases.

## **RECOMMENDATIONS FOR HEDGE FUNDS**

A securities law violation by a hedge fund has the power to destroy the fund itself through collateral and reputational damage and loss of client confidence. Given the government's increasing focus on hedge funds and the changed enforcement landscape enhanced by the act's whistleblower bounty provision, hedge fund managers should take pains to create a culture of compliance within their firms, while also protecting confidentiality of firm information. Senior management should encourage employees to raise concerns or questions without fear of retribution, and should consult regularly with their compliance officers. They should also design internal procedures specific to the business model of the particular fund, make personnel aware of those procedures, and strictly enforce the resulting internal policies to prevent anyone at the fund from misusing inside information. If a compliance program is already in place, the fund

should review its policies with employees and discuss the activities likely to attract SEC attention.

While hedge funds have not traditionally implemented whistleblower hot lines like those required for public companies after Sarbanes-Oxley, such hot lines can be useful in demonstrating a culture of compliance and curbing potential violations. A whistleblower hot line can be open to personnel at all levels, as well as service providers. Because hedge fund management companies are typically smaller than public companies, however, managers should explore external reporting hot lines to reduce the fear of retribution and preserve the anonymity of those who wish to report violations. In addition, hedge fund management companies should immediately follow up with all reported violations to avoid creating independent problems in a subsequent enforcement action.

Dodd-Frank's whistleblower provisions may create financial incentives for would-be whistleblowers to go directly to the SEC; however, hedge funds should strive to create their own incentives to encourage personnel to report potential securities law violations through internal channels. Regulators tend to respond favorably to self-policing, and the SEC has emphasized that it does not intend for §922 to undermine effective internal company compliance mechanisms. The proposed rules indicate that the SEC is trying to strike a balance between maintaining robust internal compliance programs and generating helpful tips. Hedge fund managers should avail themselves of the comment period on the proposed rules to clear up lingering questions about the interplay between internal company procedures and enforcement actions stemming from whistleblower tips.

Hedge funds are in a better position if they are apprised of potential wrongdoing before the SEC commences an investigation. Establishing effective internal compliance mechanisms and incentivizing internal reporting of compliance concerns will decrease a hedge fund's chance of finding itself on the receiving end of an SEC enforcement action driven by a bounty hunter from within.