Brooklyn Law Review

Volume 79
Issue 3 *SYMPOSIUM: When the State Speaks, What Should It Say?*

Article 12

2014

The Confluence of *Sullivan v. Harnisch* & Dodd-Frank: Adapting New York's Common Law to Fill a Compliance Hole

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The Confluence of *Sullivan v. Harnisch* & Dodd-Frank

ADAPTING NEW YORK'S COMMON LAW TO FILL A COMPLIANCE HOLE

INTRODUCTION

In May 2012, Joseph Sullivan lost a wrongful termination suit against Peconic Partners LLC and Peconic Asset Managers LLC (together, Peconic).[1] Sullivan, a partner of both firms, alleged that he was fired after bringing improper trading activity to the attention of Peconic's CEO.[2] In its decision, the New York Court of Appeals adhered to New York's strict at-will employment doctrine, which states that "absent violation of a constitutional requirement, statute or contract, 'an employer's right at any time to terminate an employment at will remains unimpaired.'"[3] The court affirmed the Appellate Division's decision to grant the defendants' motion for summary judgment.[4] The court in *Sullivan* declined to create a new exception to New York's at-will employment doctrine and rejected an application of the doctrine's only exception[5] to salvage Sullivan's claim.[6]

Although the Court of Appeals may have ruled in Peconic's favor, its decision may ultimately undercut the ability of New York's private investment advisers to maintain effective compliance programs. When coupled with existing state and federal whistleblower protections, the outcome in *Sullivan* only adds to the already strong incentives encouraging a similarly

[1] Sullivan v. Harnisch, 969 N.E.2d 758 (N.Y. 2012).

[2] *Id.* at 759.

[3] *Id.* at 760 (quoting Murphy v. Am. Home Prods. Corp., 448 N.E.2d 86, 91 (N.Y. 1983)).

[4] *Id.* at 761.

[5] The exception pertains to attorneys within law firms, and it protects attorneys who internally report the improper behavior of colleague attorneys. *See* Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992).

[6] *Sullivan*, 969 N.E.2d at 760.

situated employee to *externally* disclose a potential securities law violation instead of making the complaint in-house.[7]

Neither New York's common law nor its whistleblower statute[8] provide employees of private investment advisers adequate protection against retaliatory action for disclosing potential securities law violations.[9] These firms include hedge funds and private equity funds, many of which under Dodd-Frank were required to register with the SEC pursuant to the Investment Advisers Act of 1940.[10] As registered investment advisers, these firms must appoint chief compliance officers and create policies and procedures that promote adherence to federal securities laws.[11]

To protect oneself against retaliatory action, an employee like Sullivan—one who becomes aware of a potential securities law violation by her employer but works as an at-will employee for a private company and therefore cannot rely on an employer's promise against retaliatory conduct[12]—faces a stark choice when considering whether to blow the proverbial whistle. If the employee is concerned primarily with retaining her position and avoiding other retaliatory action by her employer, she must either remain silent, allowing the possible securities law violation to go unaddressed, or she must externally report the potential violation to the SEC.[13] Although Dodd-Frank augments the protections and incentives for would-be whistleblowers,[14] this law does not extend protection to employees of private companies who limit disclosure to an internal audience.[15] In order for employees like Sullivan to invoke Dodd-Frank's protection against retaliatory action, they must externally disclose the impropriety to the SEC.[16]

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[7] *See infra* Part III.

[8] N.Y. LAB. LAW § 740 (McKinney 2013).

[9] *See infra* Part I.

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1571 (2010) [hereinafter Dodd-Frank Act] (codified as amended at 15 U.S.C. § 83b-3(b) (2012)).

[11] 17 C.F.R. § 275.206(4)-7(a) (2012); *see infra* Part II.

[12] Sullivan v. Harnisch, 915 N.Y.S.2d 514, 517–18 (N.Y. App. Div. 2010), *aff'd*, 969 N.E.2d 758 (N.Y. 2012).

[13] *See infra* Part II.

[14] *See* 17 C.F.R. §§ 240.21F-2–F-3.

[15] *See infra* Part II. As an employee for a private company, Sullivan was not eligible for Sarbanes-Oxley whistleblower protection, which provides whistleblowers with a private cause of action in the event they incur retaliatory action after internally reporting fraudulent activity. *See* Public Company Accounting Reform and Corporate Responsibility Act, Pub. L. No. 107-204, § 806 116 Stat. 802–04 (2002) [hereinafter SOX] (adding Section 1514A to 18 U.S.C.); Egan v. TradingScreen, Inc., 10 CIV. 8202 LBS, 2011 WL 1672066 at *7 (S.D.N.Y. May 4, 2011); 17 C.F.R. § 240.21F.

[16] *See* Egan, 2011 WL 1672066. There, the court held as a matter of first impression that, because the plaintiff's disclosure did fall within one of the few statutory exceptions, "the anti-retaliation whistleblower protection provisions of the

The *Sullivan* decision and current securities laws strip from the employee's consideration the sensible option of limiting disclosure to a supervisor or the firm's internal compliance program.

This note examines the effect *Sullivan v. Harnisch* has on securities-related disclosure among private investment advisers in New York in a post Dodd-Frank world. Depending on one's vantage point, the combination of federal securities laws and the holding of *Sullivan v. Harnisch* either promotes a policy of external disclosure—one facilitating adherence to securities laws—or it further skews employee incentives to stay silent, one promoting an ineffective method of compliance enforcement. Although these incentives may promote the enforcement goals of the SEC,[17] they may also run counter to the motivations and considerations of would-be whistleblowers.[18] The goal of policy-makers should be to craft a policy that creates the most efficient mechanism to ensure compliance with securities laws. In order to achieve this result, either New York or federal policy must change so that employees are protected if they choose to limit disclosure of a possible securities law violation to an internal audience.

Because the current paradigm pushing employees to make external disclosure arises from a combination of state and federal policies, many sources for a potential solution exist. Companies can create and promote strong compliance programs—systems that proscribe retaliation or that preserve anonymity.[19] Further, Congress could amend Dodd-Frank to forbid retaliation for internally reporting violations among all financial companies.[20] Finally, although perhaps unlikely,[21] New York courts could adapt existing common law to protect internal disclosure. In *Wieder v. Skala*,[22] the court recognized the role self-policing plays

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Dodd-Frank Act require Plaintiff to show that he . . . provided information to the SEC." *Id.* at *7; *see infra* Part II.

[17] *See* Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 34-64545, 97 (Aug. 12, 2011), *available at* http://www.sec.gov/rules/final/2011/34-64545.pdf; *see also* SEC OFFICE OF THE WHISTLEBLOWER, http://www.sec.gov/whistleblower (last visited Jan. 17, 2013) [hereinafter Implementation of the Whistleblower Provisions] ("Assistance and information from a whistleblower who knows of possible securities law violations can be among the most powerful weapons in the law enforcement arsenal of the Securities and Exchange Commission.").

[18] *See infra* Part IV.

[19] *See infra* Part IV.

[20] *See infra* Part IV.

[21] "American courts, including our own, 'have proved chary of creating common-law exceptions to the rule and reluctant to expand any exceptions once fashioned.'" Sullivan v. Harnisch, 969 N.E.2d 758, 760 (N.Y. 2012) (quoting Horn v. N.Y. Times, 790 N.E.2d 753, 755 (N.Y. 2003)).

[22] Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992).

in the legal profession and carved out the only exception to its at-will employment doctrine for an attorney who was fired after attempting to discipline a colleague.[23] By augmenting established contractual principles with this policy of self-regulation, New York courts can establish a framework that protects employees who make internal disclosure without significantly undermining its at-will employment doctrine. Employees should have the option of limiting disclosure of potential securities law violations to an internal audience. And although the adoption of a new common law policy would, in certain circumstances, infringe upon an employer's right to discharge employees, establishing these legal protections would foster internal disclosure and improve a firm's ability to maintain effective compliance programs.

Part I of this note will focus on New York common law and the statute relevant to would-be whistleblowers of private companies. This section will review *Sullivan v. Harnisch* as well as other cases to reveal the current contours of New York's at-will employment doctrine. This section will also address New York's whistleblower statute and the difficulty one would face trying to invoke its protections in the context of reporting securities law violations. Part II will explore the impact of Dodd-Frank, emphasizing the heightened regulatory standards imposed upon most private investment advisers. This section will also explore the implementation of Dodd-Frank's whistleblower protections and the related SEC rules. Part III will juxtapose New York's employment and whistleblower policies with Dodd-Frank. This juxtaposition will demonstrate how all roads now point to external disclosure and how such a path may not align with the behavior of employees or the compliance interests of employers. Part IV will assess possible remedies, including those that would extend anti-retaliatory protections to employees that engage in internal disclosure.

I. NEW YORK'S COMMON LAW AND STATUTORY PROTECTIONS AGAINST RETALIATORY TERMINATION

In order to understand how the combination of current federal and state policies pushes an employee of a private investment adviser to externally disclose potential securities law violations, one must first understand the protection against retaliatory employer conduct, or lack thereof, offered to employees by New York law. To do so, the contours of New

[23] *Id.* at 108–09.

York's at-will employment doctrine and its whistleblower statute must be explored.

A. New York's Common Law Provides Little Help

1. *Sullivan v. Harnisch*

The New York Court of Appeals addressed the issue of internal disclosure of alleged hedge fund improprieties in *Sullivan v. Harnisch*.[24] Joseph Sullivan was a 15% partner of Peconic and bore many titles at the firm, such as Chief Compliance Officer, Executive Vice President, and Chief Operating Officer.[25] Sullivan alleged he was fired days after confronting William Harnisch, Peconic's CEO, over Harnisch's alleged "manipulative and deceptive trading practices"[26] known as "front-running," where one "[takes] advantage of investment opportunities that should first be accorded to its clients."[27]

In his appeal, Sullivan asserted that he was required to disclose trading activity that ran afoul of federal securities laws and the firm's internal code of ethics.[28] Sullivan argued that his objection to the misconduct was improper grounds for termination.[29] The court rejected Sullivan's position and reaffirmed its staunch adherence to New York's at-will employment doctrine.[30] Without a finding of breach of contract, or a violation of Sullivan's statutory or constitutional rights, Harnisch and Peconic reserved the right to fire Sullivan for any reason.[31]

The court also rebuffed Sullivan's attempt to invoke the only judicially recognized exception to New York's at-will employment doctrine.[32] This exception, espoused in *Wieder v.*

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[24] *Sullivan*, 969 N.E.2d 758.

[25] *Id.* at 759.

[26] *Id.*

[27] Sullivan v. Harnisch, 915 N.Y.S.2d 514, 516-17 (N.Y. App. Div. 2010), *aff'd*, 969 N.E.2d 758 (N.Y. 2012). Harnisch sold two-thirds of a personal $100 million position in Potash Corp.—a security also held in his clients' funds—days before the release of a disappointing earnings report from a related company. *Id.* at 516. Harnisch did not execute similar trades on behalf of his clients until after the release of the earnings report. *Id.* As a result, Harnisch pocketed $132 per share whereas the funds earned $103 per share. According to Sullivan, this practice violated Peconic's SEC filings and its internal compliance manual. *Id.* at 517.

[28] *Sullivan*, 969 N.E.2d at 759.

[29] *Id.*

[30] *Id.*

[31] *Id.* at 760.

[32] *Id.* at 760–61; *see* Wieder v. Skala, 609 N.E.2d 105, 110 (N.Y. 1992) (discussed *infra* Part I).

Skala,[33] recognized a breach of contract based upon an implied obligation where an attorney, bound by his professional responsibilities, was fired after insisting that a colleague face disciplinary action for malpractice.[34] The court in *Sullivan* noted that Sullivan's compliance duties at Peconic were not "so closely linked [to his position] as to be incapable of separation," or that compliance was not "at the very core, and indeed, the only purpose of Sullivan's employment."[35] In dissent, Chief Judge Lippman opined that "the majority unwisely limits the exception to the at-will employment . . . . In so doing, it creates a great potential for abuse in the financial services industry."[36]

Although never raised by the parties or the court, Sullivan's conduct was not protected by New York's whistleblower statute.[37] And although Sullivan's termination occurred before the passage of Dodd-Frank, the court observed that Dodd-Frank's whistleblower protections would have nevertheless been inapplicable.[38]

2. The Confines of New York's Common Law

The court's decision in *Sullivan v. Harnisch* represents one of the latest in a line of decisions that express New York's at-will employment doctrine as highly deferential to the judgment and decisions of employers. The cases that follow articulate the contours of New York's at-will employment doctrine. As they demonstrate, plaintiffs who allege that they were wrongfully discharged without asserting a claim that is cognizable under a contractual lens likely will fail in their lawsuit.

In *Weiner v. McGraw-Hill*,[39] however, the New York Court of Appeals held that the plaintiff brought a facially valid breach of contract action after being fired.[40] Walter Lewis Weiner, a long-time employee of McGraw-Hill who steadily ascended through the ranks there before being fired, successfully persuaded the Court of Appeals that a provision in the McGraw-Hill's personnel handbook might have constituted an express promise

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33 *Wieder*, 609 N.E.2d 105.

34 *Id.* at 110.

35 *Sullivan*, 969 N.E.2d at 761 (quoting *Wieder*, 609 N.E.2d at 108 (internal quotation marks omitted)).

36 *Id.* at 765 (Lippman, C.J., dissenting).

37 *See infra* Part I.B.

38 *Sullivan*, 969 N.E.2d at 761 ("[Dodd-Frank] seems not to apply to conduct like that alleged in Sullivan's complaint; Sullivan does not claim to have blown a whistle—i.e., to have told the SEC or anyone else outside Peconic about Harnisch's alleged misconduct—but only to have confronted Harnisch himself.").

39 Weiner v. McGraw-Hill, Inc., 443 N.E.2d 441 (N.Y. 1982).

40 *Id.* at 443.

within his employment contract.[41] The employee handbook limited termination to instances where there was "just and sufficient cause."[42] The company's application for employment stipulated that Weiner's "employment [was] subject to the provisions of [the handbook]."[43] These factors, along with Weiner's alleged reliance on this for-cause provision as a basis for working for McGraw-Hill and the employer's prior insistence that Weiner adhere to the corporate policy when faced with staffing decisions, led the court to conclude that Weiner articulated a legitimate question of whether McGraw-Hill had breached a contract it held with Weiner.[44]

In *Murphy v. American Home Products Corporation*,[45] the court considered two separate causes of action that, when combined, form the spine of the single claim considered by the *Sullivan* court. Plaintiff Joseph Murphy alleged that he was terminated after internally disclosing accounting improprieties that resulted in an overstatement of the firm's earnings.[46] These overstatements allegedly enabled the firm's management to receive "unwarranted" bonuses.[47] Murphy raised several causes of action, including one sounding in wrongful, retaliatory termination and another in breach of an implied employment contract.[48] In addressing Murphy's retaliatory discharge claim, the court concluded that whether a wrongful termination cause of action should be created was a matter reserved for "a principled statutory scheme, adopted after opportunity for public ventilation, rather than in consequence of judicial resolution of the partisan arguments of individual adversarial litigants."[49] Murphy also argued that "he was required by the terms of his employment to disclose accounting improprieties" and that by his termination, his employer breached the implied "obligation on the part of the employer to deal with . . . employees fairly" that

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41 *Id.* at 442–43, 45

42 *Id.* at 442. The pertinent text of the personnel handbook read:

> [t]he company will resort to dismissal for just and sufficient cause only, and only after all practical steps toward rehabilitation or salvage of the employee have been taken and failed. However, if the welfare of the company indicates that dismissal is necessary, then that decision is arrived at and is carried out forthrightly.

Id. (alteration in original).

43 *Id.*

44 *Id.* at 445–46.

45 Murphy v. Am. Home Prods. Corp., 448 N.E.2d, 86 (N.Y. 1983).

46 *Id.* at 87.

47 *Id.*

48 *Id.* at 89, 91.

49 *Id.* at 90.

permeates all employment contracts.[50] Finding no precedent to support this proposition and wary of its broad policy implications, the court rejected Murphy's argument and held that whether an employer's right to terminate an at-will employment should be infringed is a matter best left to the legislature.[51]

The only judicially recognized exception to New York's at-will employment doctrine was espoused in *Wieder v. Skala*.[52] Howard Wieder, an associate at a law firm, reported to his supervising partners the "false and fraudulent material misrepresentations" a colleague attorney made in an effort to conceal his negligence in handling a real estate transaction for Wieder.[53] Wieder, who at that time claimed he spearheaded the firm's most important litigation project, insisted that his firm pursue disciplinary action against his colleague before the New York Appellate Division Disciplinary Committee.[54] He abandoned this request after his supervisors threatened to fire him.[55] That action, apparently, did not pacify Wieder's employer; he was fired soon after he submitted important filings related to his litigation project.[56]

In review of his action for wrongful termination and breach of contract, the court concluded that an exception to New York's at-will employment doctrine was warranted. The court noted "the unique function of self-regulation belonging to the legal profession"[57] and the "essential compact that in conducting the firm's legal practice both plaintiff and the firm would do so in compliance with the prevailing rules of conduct and ethical standards of the profession."[58] In its analysis, the court placed great emphasis on the fact that, as an attorney, Wieder's conduct was governed by a code of professional responsibility.[59] The code, in pertinent part, prohibits attorneys from keeping secret unprivileged conduct or statements made by another attorney that would impeach that attorney's integrity and trustworthiness.[60] The court held that the plaintiff stated a

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50 *Id.* at 91.
51 *Id.*
52 Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992).
53 *Id.* at 106.
54 *Id.*
55 *Id.*
56 *Id.*
57 *Id.* at 108.
58 *Id.* at 110.
59 *Id.* at 108–09.
60 *Id.* at 106 n.1; N.Y. COMP. CODES R. & REGS. tit. 22, § 1200.0 rule 8.3(a) (2012).

valid breach of contract claim "based on an implied-in-law obligation in his relationship with defendant."[61]

B. New York's Whistleblower Law Does Not Apply to Financial Harms

Under New York's whistleblower statute, an employee who shares or threatens to share "an activity, policy or practice of the employer that is in violation of law, rule or regulation which violation creates and presents a substantial and specific danger to the public health or safety" is protected from retaliatory action.[62] The statute protects both internal and external disclosure by a whistleblower.[63]

The application of New York's whistleblower statute, however, is limited. First, "the requirements of a violation and a danger to health or safety are conjunctive, the statute does not protect an employee who reports activity presenting such a danger . . . if the activity does not violate a specific statute or regulation."[64] Further, "[t]he law requires that there be . . . an actual, as opposed to a possible, violation . . . . Reasonable belief as a basis for protection under [New York's whistleblower law] will not suffice."[65] Finally, the jurisprudential interpretation of New York's whistleblower statute does not affiliate "corporate wrongdoing or white-collar crimes" with the type of danger to the public the law is intended to prevent.[66] For example, in *Clarke v. TRW, Inc.*,[67] the court noted that a defective electrical relay that could give rise to problems with an automobile's brakes or fuel pump qualified as a harm covered by New York's whistleblower law.[68] In *Susman v. Commerzbank Capital Markets Corp.*,[69] on the other hand, the court affirmed a lower court's dismissal of a state whistleblower claim because the firm's alleged

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[61] *Wieder*, 609 N.E.2d at 110.

[62] N.Y. LAB. LAW § 740(2)(a) (McKinney 2013).

[63] *Id.*

[64] Sandra J. Mullings, *Is There Whistleblower Protection for Private Employees in New York?*, 69 N.Y. ST. B.J. 36, 36 (1997).

[65] Remba v. Fed'n Emp't & Guidance Serv., 545 N.Y.S.2d 140, 143 (N.Y. App. Div. 1989), *aff'd*, 559 N.E.2d 655 (N.Y. 1990).

[66] Silvia X. Liu, Note, *When Doing the Right Thing Means Losing Your Job: Reforming the New York Whistleblower Statute*, 7 N.Y. CITY L. REV. 61, 71 (2004). Liu argues, among other things, that New York's whistleblower statute should be amended such that "an employee should be protected if she or he reasonably believes that a violation of the law, rule or regulation has occurred or is occurring." *Id.* at 64.

[67] Clarke v. TRW, Inc., 921 F. Supp. 927 (N.D.N.Y. 1996).

[68] *Id.* at 935–36.

[69] Susman v. Commerzbank Capital Mkts. Corp., 945 N.Y.S.2d 5 (N.Y. App. Div. 2012), *leave to appeal denied*, 975 N.E.2d 914 (N.Y. 2012).

illegality—engaging in transactions with the Central Bank of Iran, a federally proscribed activity—did not constitute a "substantial and specific danger to the public health or safety."[70] As one court noted, "financial improprieties [are not] placed on the same plane as threats to public health or safety."[71] One justification for this distinction was to "avoid the cumulative effect of a potential flood of lawsuits seeking to convert ordinary employment disputes into 'whistle-blower' protection cases."[72]

In sum, neither New York's common law nor its whistleblower statute extend protection against retaliatory conduct to an employee who makes internal disclosure about a potential securities law violation. The tools exist, however, for New York courts presented with these circumstances to craft a common law remedy against retaliatory conduct.

II. DODD-FRANK'S IMPACT—PRIVATE INVESTMENT ADVISER REGISTRATION REQUIREMENTS AND WHISTLEBLOWER PROTECTIONS

A. *Hedge Fund Compliance Requirements*

Prior to the passage of Dodd-Frank, hedge funds and other private investment advisers largely avoided SEC registration and the Commission's direct oversight by taking advantage of Section 203(b)(3) of the Investment Advisers Act of 1940.[73] This provision extended a registration exemption for certain investment advisers with fewer than 15 clients in the preceding year.[74] The D.C. Circuit in *Goldstein v. SEC*[75] molded the shape of this exemption and determined that the term "clients" referred to the "advising of

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[70] *Id.* at 7.

[71] McGrane v. Reader's Digest Ass'n, Inc., 822 F. Supp. 1044, 1046 (S.D.N.Y. 1993) *supplemented*, 92 CIV. 8132 (VLB), 1993 WL 525127 (S.D.N.Y. Dec. 13, 1993) (declining to extend New York state whistleblower protections to an employee that was fired after internally reporting financial improprieties). The plaintiff submitted a five-pound complaint but the court determined that it neither established a continuing fraud or a "hazard to health or safety which has not been remedied by [the employer]." *Id.*

[72] *Id.* at 1046.

[73] Press Release, Sec. & Exch. Comm'n, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act, 2 (June 22, 2011), *available at* http://www.sec.gov/news/press/2011/2011-133.htm [hereinafter SEC Adopts Dodd-Frank Act Amendments].

[74] Seth Chertok, *A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 6 VA. L. & BUS. REV. 1, 6 (2011). Additionally, to qualify for the exemption, funds could not "hold themselves out to the public as investment advisers, and [could] neither act[ ] as an investment adviser to any registered investment company, nor to a company which has elected to be a 'business development company.'" *Id.*

[75] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

pooled investment vehicles rather than the individual investors therein."[76] This statutory interpretation allowed a hedge fund, regardless of the number of its investors, to avoid registration so long as it managed less than 15 funds.[77]

Title IV of Dodd-Frank in large part eliminated this exemption for large private investment advisers.[78] Noting that "their trades can move markets,"[79] Congress determined that "information regarding [a private investment adviser's] size, strategies, and positions could be crucial to regulatory attempts to deal with a future crisis."[80] Consequently, as of March 2012, large private investment advisers must now comply with the Investment Advisers Act of 1940.[81] This change resulted in a large increase in the number of registered investment advisers, expanding the number of firms regulated by the SEC.[82] Registered private investment advisers must draft a code of ethics that, among other things, include "[p]rovisions *requiring* [the firm's] supervised persons to comply with applicable Federal securities laws"[83] and "[p]rovisions *requiring* supervised persons to report any violations of [the firm's] code of ethics promptly to [the firm's] chief compliance officer or, provided [the firm's] chief compliance officer also receives reports of all violations, to other persons . . . designate[d] in [the firm's] code of ethics."[84] A registered private investment adviser must also maintain "books and records" that, among other things, record employee violations of the firm's code of ethics and the remedial actions taken in response.[85] These firms must also appoint a chief compliance officer[86] and create

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[76] Chertok, *supra* note 74, at 8.

[77] SEC Adopts Dodd-Frank Act Amendments, *supra* note 73, at 2; S. Rep. No. 111-176, at 73 (2010).

[78] Dodd-Frank Act, Pub. L. No. 111-203, § 403, 124 Stat. 1571 (2010).

[79] S. Rep. No. 111-176, at 38 (2010).

[80] *Id.* at 72.

[81] SEC Adopts Dodd-Frank Act Amendments, *supra* note 73. Dodd-Frank created three new exemptions for private advisers. "Certain foreign advisers without a place of business in the U.S.," private advisers that only oversee venture capital funds, and advisers to only private funds "with less than $150 million in assets under management in the U.S.," are exempt from SEC registration. *Id.* at 3.

[82] Press Release, Sec. & Exch. Comm'n, More Than 1,500 Private Fund Advisers Registered With the SEC Since Passage of the Financial Reform Law; SEC Notifies Advisers Who Have Not Yet Moved to State Regulation (Oct. 19, 2012), *available at* http://www.sec.gov/news/press/2012/2012-214.htm.

[83] 17 C.F.R. § 275.204A-1(a)(2) (2012) (emphasis added).

[84] *Id.* at § 275.204A-1(a)(4) (emphasis added). Hedge Funds must further include in their code of ethics a standard of conduct that reflects the firm's and employees' fiduciary standards, the disclosure by employees and the review by supervisors of all "personal securities transactions," and provisions requiring the written confirmation by employees confirming the receipt of the code. *Id.* §§ 275.204A-1(a).

[85] *Id.* at § 275.204–2(a)(12)(ii).

[86] *Id.* at § 275.206(4)–7(c).

policies and procedures that are "reasonably designed to prevent violation[s] . . . of the [Investment Advisers] Act."[87]

B. Dodd-Frank Whistleblower Provisions

Federal securities law does not extend protection to employees of private financial companies who make internal disclosure of a possible securities law violation. Dodd-Frank altered the scheme of incentives for would-be whistleblowers, but it failed to add protections for certain internal disclosures. In addition to augmenting the registration requirements for private investment advisers, Section 922 of Dodd-Frank added Section 21(F), titled "Securities Whistleblower Incentives and Protections," to the Securities and Exchange Act 1934.[88] This new provision builds upon and incorporates existing whistleblower protections promulgated by Sarbanes-Oxley (SOX).[89] Under SOX, which passed in 2002 in the wake of the collapse of publicly traded firms like Enron and WorldCom,[90] employees of a publicly traded company[91] are protected against retaliatory actions taken by their employer for disclosing potential fraud.[92] SOX protects employees whether they externally disclose the perceived fraud to federal authorities or internally report the issue to their immediate supervisors.[93] Finally, SOX provides a

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87 *Id.* at § 275.206(4)–7(a).

88 *Corporate Law—Securities Regulation—Congress Expands Incentives for Whistleblowers To Report Suspected Violations to the SEC—Dodd-Frank Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841–49 (2010)*, 124 Harv. L. Rev. 1829, 1831 (2011) [hereinafter *Whistleblower Incentives*]; *see also* Dodd-Frank Act, Pub. L. No. 111-203, § 922, 124 Stat. 1842–49 (2010) (adding Section 21(F), "Securities Whistleblower Incentives and Protections," to Securities and Exchange Act, 15 U.S.C. §§ 78a–78pp (2012)).

89 Joel D. Hesch, *Whistleblower Rights and Protections: Critiquing Federal Whistleblower Laws and Recommending Filling in Missing Pieces to Form a Beautiful Patchwork Quilt*, 6 LIBERTY U. L. REV. 51, 105 (2011) ("In many ways, the Dodd-Frank Act supersedes SOX because it expands protections.").

90 Elisabeth Bumiller, *CORPORATE CONDUCT: THE PRESIDENT; Bush Signs Bill Aimed at Fraud In Corporations*, N.Y. TIMES, July 31, 2002, at A1, *available at* http://www.nytimes.com/2002/07/31/business/corporate-conduct-the-president-bush-signs-bill-aimed-at-fraud-in-corporations.html.

91 *See* SOX, Pub. L. No. 107204, § 806, 116 Stat. 802–04 (2002) (adding Section 1514A to 18 U.S.C.). SOX's whistleblower covers employees of publicly traded companies, its contractors, subcontractors and "any subsidiary or affiliate whose financial information is included in [the company's] consolidated financial statements." *Id.* Section 929A of Dodd-Frank expanded SOX protections to include subsidiaries. Dodd-Frank Act, Pub. L. No. 111-203, § 929A, 124 Stat. 1852 (2010) (amending 18. U.S.C. § 1514A).

92 *See* 18 U.S.C. § 1514A (2012).

93 *See* 18 U.S.C. § 1514A(a) ("No company [that is publicly traded] . . . may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee . . . because of any lawful act done by the employee—(1) to provide information . . . regarding any conduct the employee reasonably believes constitutes a

private cause of action to whistleblowers that incur retaliatory action; those who bring suit are eligible to recover compensatory damages, including reinstatement, back pay with interest, and compensation for any special damages.[94]

Unlike SOX's whistleblower protections, Dodd-Frank's provisions incentivize whistleblowing-employees in both publicly traded and private companies.[95] Under Dodd-Frank, an individual is a whistleblower if she provides information to the SEC about a possible violation of securities laws that "has occurred, is ongoing, or is about to occur."[96] The SEC interprets the term "possible violation" as embodying a requirement that the violation be potentially actionable.[97] Therefore, the information provided to the SEC cannot be frivolous but must have a "facially plausible relationship to some securities law violation."[98]

Dodd-Frank's whistleblower provisions also extend anti-retaliation protection to whistleblowers.[99] An employer may not take any retaliatory action—including threats, demotion, harassment, termination, or suspension—if a whistleblower provides to the SEC information about a possible securities law violation; assists the SEC, through testifying or helping in its or a judicial investigation; or makes "disclosures that are required or protected under [SOX, the Securities Exchange Act of 1934, including 10A(m) of such Act,] and any other law, rule or regulation subject to the jurisdiction of the Commission."[100]

A close reading of the anti-retaliatory provisions indicates that unless one works for a publicly traded company—and is thus protected under SOX's anti-retaliatory measures—one must report the possible securities law violation to the SEC.[101] The SEC rules stipulate that those who seek to avail themselves of Dodd-Frank's retaliatory protection must have a reasonable belief, "one that a similarly situated employee might reasonably possess,"[102] that a possible securities law violation has,

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violation of . . . any rule or regulation of the [SEC], . . . when the information . . . is provided to . . . (C) a person with supervisory authority over the employee . . . ").

[94] *See* 18 U.S.C. §§ 1514A(c)(2).

[95] *See* 15 U.S.C. § 78u-6(a)(6) (2012).

[96] 17 C.F.R. § 240.21F–2 (2012).

[97] *See* Implementation of the Whistleblower Provisions, *supra* note 17, at 15 n.31.

[98] *Id.* at 13.

[99] *See* 15 U.S.C. § 78u-6(h)(1)(A); 17 C.F.R. § 240.21F–2(b)(iii).

[100] 15 U.S.C. § 78u-6(h)(1)(A).

[101] Implementation of the Whistleblower Provisions, *supra* note 17, at 18 ("[T]he retaliation protections for internal reporting afforded by [15 U.S.C. § 78u-6(h)(1)(A)] do not broadly apply to employees of entities other than public companies."); *see also Whistleblower Incentives*, *supra* note 88, at 1834.

[102] Implementation of the Whistleblower Provisions, *supra* note 17, at 16.

is, or will occur and they must provide the information to the SEC through certain prescribed methods.[103] However, so long as whistleblowers do not offer a frivolous tip, they are protected under Dodd-Frank's anti-retaliatory provisions regardless of whether the submitted information leads to a successful SEC enforcement action.[104] Like SOX, Dodd-Frank extends a private cause of action to whistleblowers that suffer retaliatory action by their employers.[105]

In addition to extending anti-retaliatory protection to whistleblowers, Dodd-Frank's whistleblower provisions include significant monetary incentives to encourage disclosure of possible violations.[106] Lawmakers "[r]ecogniz[ed] that whistleblowers often face the difficult choice between telling the truth and the risk of committing 'career suicide'."[107] If one provides original information[108] about a possible securities law violation to the SEC that, in turn, leads to a successful enforcement action yielding for the SEC a recovery of over one million dollars, the whistleblower who provided the information is entitled to receive a *qui tam*[109] award between 10% and 30% of the total amount recovered by the SEC.[110] These large awards are important, because they are "what it takes to have an employee risk everything."[111] Whistleblowers do not have to provide the damning information to their employer to be eligible for the award. Instead, one's participation in an internal compliance program is taken into account as a factor by the SEC when deciding whether to increase a whistleblower's total award.[112]

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[103] 17 C.F.R § 240.21F-2(b)(i); *see* "Procedures for Submitting Original Information" 17 C.F.R. § 240.21F-9 (a whistleblower must either submit their information online through the SEC's website or send the SEC, via mail or fax, a Form TCR (Tip, Complaint, or Referral)).

[104] 17 C.F.R. § 240.21F–2(b)(iii).

[105] 15 U.S.C. § 78u-6(h)(B)(i).

[106] *See id.* at § 78u-6(b).

[107] S. Rep. No. 111-176, at 111 (2010); *see also* Paul Sullivan, *The Price Whistle-Blowers Pay For Secrets*, N.Y. TIMES, Sept. 21, 2012, *available at* http://www.nytimes.com/2012/09/22/your-money/for-whistle-blowers-consider-the-risks-wealth-matters.html.

[108] Original information is information "derived from independent knowledge or analysis . . . ; is not known to the Commission from any other source, unless the whistleblower is the original source . . . ; and is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information." 15 U.S.C. § 78u-6(a)(3).

[109] "An action brought under a statute that allows a private person to sue for a penalty, part of which the government or some specified public institution will also receive." BLACK'S LAW DICTIONARY 1368 (9th ed. 2009).

[110] 15 U.S.C. § 78u-6(b).

[111] Sullivan, *supra* note 107 (quoting Stephen M. Kohn, whistleblower attorney).

[112] 17 C.F.R. § 240.21F-6(a) (2012). Other factors that may affect the size of the bounty include the significance of the information provided by the whistleblower,

To further incentivize whistleblower participation in their employer's internal compliance apparatus, the SEC's rules include a "look back provision," which retroactively applies the date the whistleblowers informed their compliance department as the date of the SEC submission.[113]

Whether an employee who internally discloses a potential securities law violation is protected under federal law depends on the nature of the company for whom the employee works. In this context, an employee of a privately owned hedge fund like Sullivan is left without any federally prescribed recourse.

III. Confluence of Federal and State Policy Help Neither Employees Nor Employers

A. Policy Juxtaposition—New York and Dodd-Frank

The intersection of New York law and Dodd-Frank's whistleblowing provisions leave those who work for New York-based private investment advisers with few options to safely disclose a possible securities law violation.[114] To receive federal protection, one must first statutorily qualify. In the case of SOX, one must be an employee of a publicly traded company.[115] Under Dodd-Frank, employees of a private investment adviser must externally disclose an impropriety to the SEC to avail themselves of the law's anti-retaliatory protection.[116]

Further, neither New York's whistleblower statute nor its at-will employment doctrine protect employees who make disclosures regarding possible securities law violations from retaliatory conduct.[117] As noted above, New York's courts typically

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the level of assistance the whistleblower provided to the SEC, and whether the SEC seeks to deter similar firm behavior in the future. *Id.*

[113] Implementation of the Whistleblower Provisions, *supra* note 17, at 89-90 ("[A] whistleblower who first reports to an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law and within 120 days reports to the Commission could be an eligible whistleblower whose submission is measured as if it had been made at the earlier internal reporting date.").

[114] *See supra* Part I.A-B.

[115] *See* 18 U.S.C. § 1514A (2012). SOX's whistleblower covers employees of publicly traded companies, its contractors, subcontractors and "any subsidiary or affiliate whose financial information is included in [the company's] consolidated financial statements." *Id.*

[116] *See* Egan v. TradingScreen, Inc., 10 CIV. 8202 LBS, 2011 WL 1672066, at *7 (S.D.N.Y. May 4, 2011). ("[Unless the statutory exceptions apply,] the anti-retaliation whistleblower protection provisions of the Dodd-Frank Act require Plaintiff to show that he . . . provided information to the SEC . . . ."); *see also Whistleblower Incentives*, *supra* note 88, at 1834.

[117] *See supra* Part I.

analyze at-will employment disputes under a contractual framework. Unless the employer has borne an express obligation to refrain from arbitrarily terminating an employee[118] or, and in only very narrow circumstances, there exists some type of implied obligation of self-regulation,[119] "an employer's right at any time to terminate an employment at will remains unimpaired."[120] New York's whistleblower statute, too, provides little comfort to those who detect, and seek to internally disclose, a securities law violation. Courts sustain actions brought under New York's whistleblower statute only in a context of protecting the public from tangible dangers, such as health and safety emergencies.[121] Even though financial scandals will continue to threaten the economic health of New Yorkers, New York's whistleblower statute does not apply to protect those that disclose financial or securities-related infractions.[122]

Without any state protections, New York employees like Sullivan—those who work for a private company in the financial services industry—must look to federal law for protection. "Dodd-Frank has created a two-tiered structure of protections where potential whistleblowers receive different sets of protections depending on whether they chose to report internally or externally."[123] Employees of publicly traded companies—those subject to SOX—who disclose possible securities law violations receive anti-retaliatory protection regardless of whether the recipient of the disclosure is the whistleblower's boss or the SEC.[124] Employees of private companies that are not subject to SOX, such as Peconic, however "receive no protection if they report internally."[125]

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[118] *See, e.g.*, Weiner v. McGraw Hill, Inc., 443 N.E.2d 441, 442 (N.Y. 1982).

[119] Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992).

[120] Sullivan v. Harnisch, 969 N.E.2d 758, 760 (N.Y. 2012) (citations omitted).

[121] *See, e.g.*, Clarke v. TRW, Inc., 921 F. Supp. 927, 931, 935 (N.D.N.Y. 1996) (noting, among other things, that a defective electrical relay that could affect car's brakes or fuel pump constituted "a specific and substantial risk to the health and safety of the public"); Liu, *supra* note 66, at 71.

[122] *See, e.g.*, Remba v. Fed'n Emp't & Guidance Serv., 559 N.E.2d 655, 655 (N.Y. 1990) ("Fraudulent billing—is not the type of violation which creates a substantial and specific danger to the public health or safety."); *see also* Susman v. Commerzbank Capital Markets Corp., 945 N.Y.S.2d 5, 7 (N.Y. App. Div. 2012), *leave to appeal denied* 975 N.E.2d 914 (N.Y. 2012) (federally prohibited financial activities are not covered under New York's whistleblower umbrella); Leibowitz v. Bank Leumi Trust Co. of New York, 548 N.Y.S.2d 513, 520 (N.Y. App. Div. 1989) (holding that purported violations of N. Y. banking laws does not constitute the type of harm New York's whistleblower statute is intended to prevent).

[123] *Whistleblower Incentives*, *supra* note 88, at 1834.

[124] *Id.*

[125] *Id.*

B. *Confluence of State and Federal Policies May Not Align with Whistleblower Motives*

Internal disclosure should be promoted and protected. Not only is internal disclosure arguably easier for an employee, it is often the first course of action for those that detect that something may be wrong. The confluence of federal and state policies—the "all roads point to the SEC" framework—may not align with the best interests and motivations of most whistleblowers. Although a significant number of whistleblowers state that they incurred retaliatory actions by their employer, including termination in many instances,[126] the majority of whistleblowers who ultimately pursue *qui tam* bounties, such as the one offered under Dodd-Frank, first reported the matter internally to their employer.[127] These employees generally do not rely on employer hotlines, where confidentiality is preserved, but instead report a problem to their supervisor.[128] In fact, one study suggests that only one in six employees who first reported a matter internally decided to later disclose the potential violation to regulators.[129] The same study suggests that only three percent of whistleblowers pursue external disclosure as a first course of action.[130]

This reluctance to publicly "blow the whistle" may be understandable as public disclosure can carry with it a heavy financial and emotional cost.[131] Even after the passage of SOX, approximately 40% of employees in one survey stated that they remained silent upon detecting a problem, opting not to share the matter with anyone in their firm.[132] This behavior may

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[126] Frank J. Cavico, *Private Sector Whistleblowing and the Employment-at-Will Doctrine: A Comparative Legal, Ethical, and Pragmatic Analysis*, 45 S. TEX. L. REV. 543, 545-46 (2004) (citing a report by the National Whistleblower's Center).

[127] Stephen Martin Kohn, Amended Remarks, *The Impact of Qui Tam Whistleblower Rewards On Internal Compliance*, 41 *in* Michael D. Greenberg, FOR WHOM THE WHISTLE BLOWS: ADVANCING CORPORATE COMPLIANCE AND INTEGRITY EFFORTS IN THE ERA OF DODD-FRANK (RAND, 2011). Kohn, Executive Director of the National Whistleblower Center, noted that "[i]n cases under the False Claims Act . . . [e]mpirical data show that approximately 90 percent of employees who filed a *qui tam* case initially reported their concerns internally." *Id.*

[128] *Id.* at 42. Kohn, Executive Director of the National Whistleblower Center, cites a report from the Ethics Resource Center. *Id. See Blowing the Whistle on Workplace Misconduct*, ETHICS RESOURCE CENTER (Dec. 2010), http://www.ethics.org/files/u5/WhistleblowerWP.pdf.

[129] ETHICS RESOURCE CENTER, INSIDE THE MIND OF A WHISTLEBLOWER; A SUPPLEMENTAL REPORT OF THE 2011 NATIONAL BUSINESS ETHICS SURVEY 8 (2012), http://www.ethics.org/nbes/files/reportingFinal.pdf

[130] *Id.* at 19.

[131] Sullivan, *supra* note 107 (collecting opinions of prominent whistleblower attorneys).

[132] Kohn, *supra* note 127, at 42.

make sense as a different study questioning financial service professionals indicated that only 35% of respondents believed that their firm would not take retaliatory action.[133] Additionally, the reward one may eventually receive through a bounty program and a successful lawsuit may not fully compensate the whistleblower.[134] In addition to lost wages from being fired, whistleblowers will become pariahs in their field and will likely struggle to find similar work.[135]

Although Joseph Sullivan limited disclosure to Peconic's CEO,[136] his rationale for doing so may not be representative of the would-be whistleblower. At the time of the alleged trading improprieties, Sullivan and Harnisch were embroiled in an ownership dispute regarding a partnership agreement that "would have eliminated Sullivan's ownership interest" in Peconic.[137] Harnisch fired Sullivan the same day Sullivan's attorney contacted Peconic to discuss the agreement.[138] Although this context may have colored the court's impression of Sullivan's claim, the fact remains that an employee of a private investment adviser that limits disclosure to an internal audience is not protected against employer retaliation.

C. Confluence of State and Federal Polices May Not Align with Employers' Interests

In addition to failing to protect the natural behavior of the common employee, neither federal nor state whistleblower policies adequately align with employers' interests. While Peconic may have won the litigation battle in *Sullivan v. Harnisch*, the ruling may cause private investment advisers in New York to lose ground in the compliance war. Many commentators and practitioners of the corporate bar bemoaned the SEC's final whistleblower rules as creating a system that overly incentivizes whistleblowers to make external disclosure and, at the same time, one that undermines a firm's ability to self-police.[139] Although these points of concern arose

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[133] LABATON SUCHAROW, WALL STREET FLEET STREET MAIN STREET: CORPORATE INTEGRITY AT A CROSSROADS; US & UK FINANCIAL SERVICES INDUSTRY SURVEY 6 (2012), *available at* http://www.labaton.com/en/about/press/upload/US-UK-Financial-Services-Industry-Survey-July-2012-Report.pdf.

[134] Sullivan, *supra* note 107.

[135] *Id.*

[136] Sullivan v. Harnisch, 969 N.E.2d 758, 761 (N.Y. 2012).

[137] *Id.* at 759.

[138] *Id.*

[139] *See, e.g.*, Letter from Cleary Gottlieb Stein to Sec. & Exch. Comm'n, Re Proposed Rules For Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934—File No. S7-33-10 (Dec. 17, 2010), *available at*

in a national debate concerning the implementation of federal legislation, they remain equally potent—and perhaps the predicted effects by these commentators become compounded—when assessed under a local, New York-based lens.

With the release of the final rules implementing Dodd-Frank's whistleblower provisions, the SEC believes that it "charted a Solomonic middle ground in an attempt to prevent harming companies' internal compliance programs while also not putting up too many obstacles for whistleblowers to overcome."[140] While noting the value of internal compliance programs, the SEC also observed that, at times, these programs "cannot serve as adequate substitutes for our obligation to identify and remedy violations of the federal securities laws."[141] The whistleblower program, according to the SEC, the whistleblower program "encourages the whistleblower to report allegations internally, yet ultimately and appropriately leaves that decision to the whistleblower."[142]

Companies, as can be imagined, disagree with the SEC's final rules. Many fear that the bounty program, which grants an award to the whistleblower of up to 30% of any SEC recovery exceeding one million dollars,[143] will inhibit "well-meaning, compliant" firms from investigating and rectifying compliance issues internally.[144] "The ability to bypass pre-existing internal procedures for reporting wrongdoing also may limit the role of internal investigations in future enforcement actions by inhibiting companies from conducting such investigations before the government becomes involved."[145] Others believe that internal disclosure should not be a factor that augments an award but, rather, should be "a prerequisite to recovery by an employee-whistleblower."[146] Without setting internal disclosure as a precondition to recovery, companies fear that the "bounty

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http://www.sec.gov/comments/s7-33-10/s73310-148.pdf; Letter from James Moore, Exec. Vice President, Gen. Counsel and Corporate Compliance Officer, Huntsman Corp., to Sec. & Exch. Comm'n, (Dec. 16, 2010), *available at* http://www.sec.gov/comments/df-title-ix/whistleblower/whistleblower-74.pdf.

[140] Michael E. Clark, *The Dodd-Frank Act's Bounty Hunter Provisions*, 44 No. 3 REV. SEC. & COMMODITIES REG. 31, 38 (2011), *available at* http://documents.jdsupra.com/e557167e-8ac7-417b-b7d9-e1119ef8df43.pdf.

[141] Implementation of the Whistleblower Provisions, *supra* note 17, at 237.

[142] *Id.*

[143] *See* 15 U.S.C. § 78u-6(a)-(b) (2012).

[144] Letter from James Moore, *supra* note 139.

[145] Michael Delikat and Renée Phillips, *Internal Investigations After Dodd-Frank*, *in* CORPORATE WHISTLEBLOWING IN THE SARBANES-OXLEY/DODD-FRANK ERA § 11:2.1 (Practising Law Institute 2013).

[146] Letter from Cleary Gottlieb Stein, *supra* note 139.

program will . . . drive companies to view all compliance matters equally—as matters of potentially severe consequence, given the increased risk of regulatory intervention."[147] Not only will this lead to an inefficient allocation of compliance resources, as companies would have to probe a potentially catastrophic matter with the same vigor as a frivolous issue, it may also compel companies to self-report to the SEC all matters to avoid its employees from whistleblowing, thereby flooding the SEC with problems and unnecessarily tarnishing the reputation of firms.[148]

Although the current Dodd-Frank whistleblowing paradigm encourages external whistleblowing, the lack of state protection for internal disclosure demands external disclosure from employees of New York private investment advisers. The problem is not that Dodd-Frank over-incentivizes would-be whistleblowers, as some commentators have suggested,[149] but rather that, at least in New York, public disclosure is the only way in which an employee of this firm type can guarantee legal protection against retaliatory action. This confluence of state and federal policies places undue pressure on employees who seek to report a potential violation and deprives employers of a meaningful opportunity to self-police securities compliance.

IV. REMEDIES

Under the current paradigm created by the confluence of Dodd-Frank and New York's policies, those employed by New York private investment advisers with knowledge of a potential securities law violation are stuck between a rock and a hard place. To preserve their jobs, these employees face the choice of doing nothing, which may cause a problem to fester, or taking the risky path of disclosing a violation to the SEC. Changes to either New York or federal policies are necessary to efficiently balance the interests of employees, employers, and society. Fortunately, there are several possible remedies available to companies, policy makers, and the courts. The menu of available cures is divided into two parts. First, there are private remedies; steps that firms can take to induce and promote internal disclosure. Second, there are public remedies; measures policymakers and the courts can pursue to extend legal

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147 *Id.*

148 *Id.*

149 Jenny Lee, Note, *Corporate Corruption & The New Gold Mine; How the Dodd-Frank Act Overincentivizes Whistleblowing*, 77 BROOK. L. REV. 303, 339 (2011).

protections to those who, but for the fear of retaliatory action, seek to internally disclose possible securities law violations.

A. *Private Remedy: Establishing Strong Compliance Policies*

In light of Dodd-Frank's significant incentives to externally disclose possible securities law violations, many commentators and practitioners recommend that firms establish strong compliance programs that provide employees with "a visibly safe pathway" for internal disclosures.[150] "The occurrence of external whistleblowing . . . usually indicates not only the failure in a firm's commitment to morality but also a breakdown in its ethical structure and communication channels."[151] Practitioners recommend that firms either establish written policies that proscribe retaliatory action or provide employees with a means to confidentially relay information regarding a possible problem, and, in doing so, create a disclosure infrastructure that makes it impossible for an employer to take retaliatory action.[152]

The adoption of internal policies that facilitate confidential internal disclosure and or proscribe retaliatory action is a strong solution. These policies both align with whistleblower behavior and an employer's interest in maintaining strong compliance programs. Although this remedy is attractive, it is not sufficient. Widespread implementation of corporate policies that protect internal disclosure cannot be guaranteed. The adoption of internal policies, by its very definition, is firm dependent. Society's interest in compliant investment advisers may be better served by the promulgation of a uniform floor of legal protection upon which employees can stand, and not through ad-hoc policies that likely vary among different firms.

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[150] Michael D. Greenberg, *Corporate Integrity in the Wake of Dodd-Frank: How Do We Fortify Internal Compliance, Reporting, and Culture? in* FOR WHOM THE WHISTLE BLOWS: ADVANCING CORPORATE COMPLIANCE AND INTEGRITY EFFORTS IN THE ERA OF DODD-FRANK 23 (RAND, 2011) [hereinafter *Corporate Integrity*].

[151] Cavico, *supra* note 126, at 623.

[152] *See Corporate Integrity*, *supra* note 150, at 23–24.

B. *Public Remedies*

1. Update Dodd-Frank

Perhaps the clearest cut remedy to protect internal disclosure is to amend Dodd-Frank. Indeed, as some commentators have noted, the inconsistency between SOX and Dodd-Frank regarding anti-retaliatory protections for those who internally disclose may be unintentional.[153] This theory, however, is likely misplaced, as the SEC definitively stated: "[T]he retaliation protections for internal reporting afforded by [15 U.S.C. § 78u-6(h)(1)(A)(iii)] do not broadly apply to employees of entities other than public companies."[154] The SEC has further signaled its intent that disclosure should be publicly made, noting, "[I]nternal compliance programs are not substitutes for rigorous law enforcement."[155]

Courts, too, have recognized the bifurcation in anti-retaliatory protection. Recent judicial interpretations of this area of Dodd-Frank indicate that courts will not interpret the new law so that anti-retaliation protection extends to employees of private companies who pursue internal disclosure.[156] In the first case to review Dodd-Frank's SEC whistleblower provisions,[157] the court compared the SEC's whistleblower program and scope with a different whistleblower program promulgated by Dodd-Frank for the Bureau of Consumer Financial Protection (CFPB).[158] The court noted that the CFPB's anti-retaliation provisions[159] were

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153 *See, e.g.*, Hesch, *supra* note 89, at 105–06.

154 Implementation of the Whistleblower Provisions, *supra* note 17, at 18.

155 *Id.* at 97.

156 *See* Egan v. TradingScreen, Inc., No. 10 Civ. 8202, 2011 WL 1672066, at *5 (S.D.N.Y. May 4, 2011) ("The contradictory provisions of the Dodd-Frank Act are best harmonized by reading 15 U.S.C. § 78u-6(h)(1)(A)(iii)'s protection of certain whistleblower disclosures not requiring reporting to the SEC as a narrow exception to 15 U.S.C. § 78u-6(a)(6)'s definition of a whistleblower as one who reports to the SEC."). In other words, unless an employee makes an internal disclosure protected or required by SOX, the Securities Exchange Act, or "any other law, rule or regulation subject to the jurisdiction of the Commission," 15 U.S.C. § 78u-6(h)(1)(A)(iii), one must also externally disclose the possible securities law violation in order to receive protection from employer retaliation. *Accord* Kramer v. Trans-Lux Corp., No. 3:11-cv-01424, 2012 WL 4444820 (D. Conn. Sept. 25, 2012) (denying a motion to dismiss after finding that an employee covered under 15 U.S.C. § 78u-6(h)(1)(A)(iii) who wrote a letter to the SEC did not have to make a disclosure to the SEC for anti-retaliation protection and did not need to adhere to the SEC procedures for submitting information).

157 *Egan*, 2011 WL 1672066, at *4.

158 12 U.S.C. § 5567(a)(1) (2012).

159 The CFPB's anti-relation provisions extend protection to those who disclose possible violations under the agency's jurisdiction "to the employer, the Bureau, or any other State, local, or Federal, government authority or law enforcement agency." 12 U.S.C. § 5567(a)(1); *see also* Egan, 2011 WL 1672066, at *4.

broader than the SEC's whistleblower provisions, "indicat[ing] that Congress intended to encourage whistleblowers reporting [securities] violations to report to the SEC."[160]

One commentator has argued that amending Dodd-Frank to incorporate SOX's anti-retaliation protection for internal disclosure within private firms "could certainly be one of the most important [amendments aimed toward] fulfilling the investor protection mission of Dodd-Frank and of the SEC in general."[161] In fact, one proposed amendment to the SEC's whistleblower program has already been introduced before Congress.[162] New York Representative Michael Grimm introduced the Whistleblower Improvement Act of 2011.[163] Under this proposed legislation, whistleblowers must first disclose a possible violation to their employer in order to maintain eligibility for an award under Dodd-Frank's bounty program.[164] Grimm's bill includes an exception to this default rule and allows for recovery of an award without internal disclosure when "the whistleblower alleges and the Commission determines that the employer lacks either a policy prohibiting retaliation for reporting potential misconduct or an internal reporting system allowing for anonymous reporting."[165]

This legislation has its sights fixed on Dodd-Frank's bounty program.[166] The proposed bill, however, does not adequately address the current disconnect among Dodd-Frank's and SOX's anti-retaliatory protections. In effect, this proposal is an unfair exchange as employers benefit at the expense of their employees. The bill's internal disclosure requirement addresses firm's concerns about the strength of their compliance programs but the bill does not provide something of equal value, like protection against retaliation, to employees.[167]

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[160] *Egan*, 2011 WL 1672066, at *4.

[161] *Whistleblower Incentives*, *supra* note 88, at 1836 (internal quotation marks omitted).

[162] *See* Whistleblower Improvement Act of 2011, H.R 2483, 112th Cong. (2011), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr2483ih/pdf/BILLS-112hr2483ih.pdf.

[163] *Id.*

[164] *Id.* at § 2(a)(2)(A).

[165] *Id.* at § 2(a)(2)(D).

[166] *See id.* at § 2(b)(1–2) (eliminating a minimum award amount and amending Dodd-Frank's language such that the maximum award is capped but the minimum amount is left to the SEC's discretion); *see also* Dana Liebelson, *New Bill to Weaken Protections, Incentives for Whistleblowers Sneaks Through Committee*, TRUTH-OUT.ORG (Feb. 16, 2012), http://truth-out.org/news/item/6721:new-bill-to-weaken-protections-incentives-for-whistleblowers-sneaks-through-committee.

[167] *See* Whistleblower Improvement Act of 2011, H.R 2483, 112th Cong. § 2. The proposed legislation allows for external disclosure as a first course of action where the employer does not have a policy proscribing retaliation but the proposed legislation does not proscribe employer retaliation for internal disclosure. *Id.*

2. Adapt New York Common Law

New York does not recognize a common law tort claim for wrongful discharge,[168] or a public policy exception to the at-will employment doctrine.[169] Where an employee is at-will, "absent a constitutionally impermissible purpose, a statutory proscription, or an express limitation in the individual contract of employment, an employer's right at any time to terminate an employment at will remains unimpaired."[170] New York courts, however, should recognize the effect the juxtaposition of its at-will employment doctrine and Dodd-Frank's whistleblower provisions have on employees and their respective employer's compliance program. Further, crafty plaintiffs should recognize that the current jurisprudence of New York's at-will employment doctrine, when juxtaposed with the new requirements that Dodd-Frank imposes upon private investment advisers, might afford a means of obtaining protection from retaliatory termination.

As noted above, New York has carved one exception to its strict at-will employment doctrine when it recognized a claim sounding in breach of contract "based on an implied-in-law obligation" in an action brought by an attorney against his employer law firm.[171] The exception, espoused in *Wieder v. Skala*, is founded, in part, upon the principle that attorneys are a self-regulating industry and are subject to a code of professional responsibility.[172] "Erecting . . . disincentives to compliance with the applicable rules of professional conduct . . . would subvert the central professional purpose of [an attorney's] relationship with the firm—the lawful and ethical practice of law."[173] In his dissent in

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[168] DANIEL P. WESTMAN & NANCY M. MODESITT, WHISTLEBLOWING, THE LAW OF RETALIATORY DISCHARGE 357 (2d ed. BNA Books 2004); *see also* Gary Minda, Katie R. Raab, *Time For An Unjust Dismissal Statute In New York*, 54 BROOK. L. REV. 1137, 1139 (1989) (advocating for the adoption of a wrongful termination statute).

[169] *See* Nadjia Limani, Note, *Righting Wrongful Discharge: A Recommendation for the New York Judiciary to Adopt A Public Policy Exception to the Employment-at-Will Doctrine*, 5 CARDOZO PUB. L. POL'Y & ETHICS J. 309, 336 (2006) (arguing that New York should adopt a public policy exception modeled on various elements of other states' public policy exemption).

[170] Murphy v. Am. Home Prods. Corp, 448 N.E.2d 86, 91 (N.Y. 1983).

[171] Wieder v. Skala, 609 N.E.2d 105, 110 (N.Y. 1992).

[172] *Id.* at 108 ("The particular rule of professional conduct implicated here (DR 1-103[A]), it must be noted, is critical to the unique function of self-regulation belonging to the legal profession."). DR 1-103[A], now codified at N.Y. COMP. CODES R. & REGS. tit. 22, § 1200.0 rule 8.3(a) (2012), states: "A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer shall report such knowledge to a tribunal or other authority empowered to investigate or act upon such violation."

[173] *Wieder*, 609 N.E.2d at 108.

Sullivan v. Harnisch, Chief Judge Lippman argued that the *Wieder* exception should apply to a hedge fund's chief compliance officer.[174] Just as in *Wieder*, Sullivan was "an employee of a business that was subject to certain legal and ethical obligations to its clients and his reason for being, as a compliance officer, was to ensure that in providing services to those clients, those rules were followed at all times."[175] If applied, the application of Judge Lippman's extension of the *Wieder* exception would cover only those that were employed as compliance personnel for a private investment adviser.[176] And while the implementation of such a policy would be a step in the right direction, it does not go far enough as it leaves all other non-compliance employees without meaningful protection against retaliatory conduct.

There may yet be hope for protecting non-compliance personnel from retaliatory conduct. New York also recognizes an action sounding in breach of express contract in cases involving at-will employees where an employer's handbook or written policies prohibit arbitrary termination.[177] In *Weiner v. McGraw Hill*, the New York Court of Appeals held that a discharged at-will employee had put forward a sufficient breach of contract claim because an express obligation in the company's handbook prevented the employer from terminating him without sufficient cause and "only after all practical steps toward rehabilitation or salvage of the employee have been taken and failed."[178]

If the principles of self-regulation and employee obligation embedded in *Wieder* are combined with the contractual principles of *Weiner*, New York courts may be able to devise a way to extend anti-retaliatory protection for employees of private investment advisers while remaining generally adherent to New York's current at-will employment doctrine. Among other things, Dodd-Frank requires newly registered private investment advisers to create a code of ethics that must have "[p]rovisions requiring [the firm's] supervised persons to comply with applicable Federal securities laws" and "[p]rovisions requiring supervised persons to report any violations of your code of ethics promptly to your chief compliance officer or, provided your chief compliance officer also

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[174] Sullivan v. Harnisch, 969 N.E.2d 758, 763–64 (N.Y. 2012) (Lippman, C.J., dissenting).

[175] *Id.* at 764.

[176] *Id.* ("[W]here an employee is merely peripherally responsible for informing his or her employer (or others) of violations of certain obligations, that person is unlikely to be covered by the *Wieder* exception. This is not such a case.").

[177] Weiner v. McGraw Hill, Inc., 443 N.E.2d 441 (N.Y. 1982).

[178] *Id.* at 442.

receives reports of all violations, to other persons you designate in your code of ethics."[179] In effect, these provisions place a duty on private investment advisers to craft policies that require their employees to internally report possible securities law violations. An employee should be able to point to these provisions and argue that they were obligated, pursuant to an express condition in their code of ethics, to make internal disclosures.

Because, however, the provisions outlining the requirements of a private investment adviser's code of ethics do not require a firm to put in place a policy proscribing retaliation for internal disclosure, the court may not be satisfied that an express obligation exists against which a breach of contract can be established. "As has been observed, courts should not 'infer a contractual limitation on the employer's right to terminate an at-will employment absent an express agreement to that effect which is relied upon by the employee.'"[180] For example, in *Lobosco v. New York Tel. Co./NYNEX* the court dismissed a breach of contract claim raised by a terminated employee where the employer had a code of conduct that both required employees to internally disclose misconduct and provided assurances that retaliatory action would not be taken as a result of disclosure.[181] The same handbook, however, contained an express disclaimer stating that the code of conduct could not be interpreted as a contract.[182]

It is here, critically, where the courts should impute the policy principles of *Wieder*. In *Wieder*, the court placed significant weight on the idea that attorneys are subject to a code of professional conduct.[183] Both New York's Rules of Professional Conduct discussed in *Wieder*[184] and the registration requirements of Dodd-Frank impute a duty upon those that practice in their respective fields to disclose possible violations. Unlike the policy in *Lobosco*, the policies referenced in *Wieder* and required by Dodd-Frank are universally applied across a profession. And unlike a failure to adhere to a private corporate policy in *Lobosco*, the failure by attorneys or securities professionals to

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179 17 C.F.R. § 275.204A-1(a) (2012). The *Sullivan* court did not focus on these requirements but instead focused its attention on 17 C.F.R. § 275.206(4)-7, which requires companies to appoint chief compliance officers and to create policies to prevent violations of securities laws. *Sullivan*, 969 N.E.2d at 761.

180 Sullivan v. Harnisch, 915 N.Y.S.2d 514, 518 (N.Y. App. Div. 2010), *aff'd*, 969 N.E.2d 758 (2012) (quoting Chazen v. Person/Wolisky, Inc., 766 N.Y.S.2d 360, 360 (N.Y. App. Div. 2003)).

181 Lobosco v. New York Tel. Co./NYNEX, 751 N.E.2d 462, 465 (N.Y. 2001).

182 *Id.*

183 Wieder v. Skala, 609 N.E.2d 105, 108–09 (N.Y. 1992).

184 *Id.*

abide by their respective universal policies could have a wide-ranging, systemic impact.

Employees of private investment advisers are required to abide by their code of ethics and disclose to their colleagues potential securities law violations. Incurring retaliation for this adherence, consequently, could be interpreted as an action taken by one party to a contract to frustrate the counterparty's ability to satisfy its contractual obligations. As the *Wieder* court stated: "It is the law that in 'every contract there is an implied undertaking on the part of each party that he will not intentionally and purposely do anything to prevent the other party from carrying out the agreement on his part.'"[185] Such conduct, as the *Wieder* court held, could constitute a breach of an implied contract.[186]

Although this litigation strategy likely would receive a cold reception before New York courts,[187] it is worth noting that an approach that borrows from and bends existing jurisprudence is not as radical as some may fear. The strategy of applying both the *Wieder* exception and existing contract jurisprudence to sustain a claim of wrongful termination is inherently circumscribed by the unique characteristics arising from the obligations imposed by Dodd-Frank upon private investment advisers. Recognizing that this new approach would arise only in the context of retaliation for internal disclosure, private investment advisers may be willing to forfeit a portion of their unencumbered right to discharge employees because the adoption of this policy may further their own compliance goals. As home to half of the world's 20 largest hedge funds,[188] a New York policy that promotes and protects internal disclosure may be in the best interest of employees, employers, and the State.

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[185] *Id.* at 109 (quoting Patterson v. Meyerhofer, 97 N.E. 472, 473 (N.Y. 1912)).

[186] *Id.*

[187] "American courts, including our own, 'have proved chary of creating common-law exceptions to [the at-will] rule and reluctant to expand any exceptions once fashioned.'" Sullivan v. Harnisch, 969 N.E.2d 758, 760 (N.Y. 2012) (quoting Horn v. N.Y. Times, 790 N.E.2d 753, 755 (N.Y. 2003)). The majority in Sullivan also noted that "the existence of federal regulation furnishes no reason to make state common law governing the employer-employee relationship more intrusive." *Id.* at 761.

[188] Anthony Effinger et al., *Top Hedge Fund Returning 45% Under Julian Robertson's 36-Year-Old Disciple, Attachment*: *The Largest Hedge Fund Firms*, BLOOMBERG (Jan. 9, 2012, 7:01 PM), http://www.bloomberg.com/news/2012-01-10/chase-coleman-channels-ancestor-stuyvesant-with-45-robertson-like-return.html?cmpid= (Attachment *available at* http://media.bloomberg.com/bb/avfile/r_qp33SAA4YE).

CONCLUSION

The financial crisis of 2008–2009 triggered the worst recession since the Great Depression.[189] Between October 2007 and March 2009, the world watched as U.S. stock prices halved.[190] With a goal of promoting stability within the U.S. financial system, Congress responded and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[191] Among the many amendments Dodd-Frank incorporated into federal securities laws, Title IV of the statute required most private investment advisers like hedge funds and private equity funds to register under the Investment Advisers Act of 1940.[192] Dodd-Frank did not, however, extend SOX's protections against retaliatory action for internal disclosure to employees of private investment advisers.[193]

Under its current jurisprudence, however, New York courts may be able to formulate a method to protect against retaliatory action for employees of private investment advisers that make internal disclosure. This framework would combine the policy of industry-wide self-regulation espoused in *Wieder v. Skala*[194] with the contractual analysis found in *Weiner v. McGraw-Hill*.[195] The application of either case's precedent alone is insufficient to safeguard internal disclosure; the compliance obligations imposed by Dodd-Frank upon employees of private advisers neither represent "the very core"[196] of their employment nor do they create a "promise not to discharge . . . without . . . sufficient cause."[197] By applying both *Wieder* and *Weiner* simultaneously, however, the shortcomings of either may be digestible to a court that is wary of changing its at-will employment doctrine.[198] This adaptation would

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[189] Bob Willis, U.S. Recession Worst Since Great Depression, Revised Data *Show*, BLOOMBERG (Aug. 1, 2009, 12:00 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNivTjr852TI.

[190] Gerald P. Dwyer, *Stock Prices in Financial Crisis*, FEDERAL RESERVE BANK OF ATLANTA (2009), *available at* http://www.frbatlanta.org/cenfis/pubscf/stock_prices_infinancial_crisis.cfm.

[191] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1377; S. Rep. No. 111-176, at 1 (2010).

[192] Dodd-Frank Act, Pub. L. No. 111-203, § 403, 124 Stat. 1571 (2010) (amending Registration of Investment Advisers, 15 U.S.C. § 83b-3(b)). *See* SEC Adopts Dodd-Frank Act Amendments, *supra* note 73.

[193] Implementation of the Whistleblower Provisions, *supra* note 17, at 18.

[194] Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992).

[195] Weiner v. McGraw-Hill, 443 N.E.2d 441 (N.Y. 1982).

[196] *Wieder*, 609 N.E.2d at 108.

[197] *Weiner*, 443 N.E.2d at 445.

[198] *See* Sullivan v. Harnisch, 969 N.E.2d 758, 759-60 (N.Y. 2012) (outlining New York's at-will employment doctrine).

benefit both employer and employee. By erecting a legal floor upon which employees of private investment advisers can stand, New York courts can offset the incentives pulling these employees to make external disclosure. Increased internal disclosure, in turn, will improve an employer's ability to monitor its compliance with federal securities laws.

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† J.D. Candidate, Brooklyn Law School, 2014. I wish to thank my colleagues at the *Brooklyn Law Review* for their careful review and insightful edits. I also wish to thank my wife Amanda for her unconditional love and support.