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Whistleblowers & PE

Jordan Thomas, partner at Labaton Sucharow, says many GPs don't appreciate the significant impact the whistleblower provisions in Dodd-Frank will have on their businesses and what they can do to address them.

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Under Dodd-Frank the US Securities and Exchange Commission (SEC) is required to pay cash awards to whistleblowers who voluntarily supply the SEC with original information leading to a judicial or administrative action in which the SEC obtains monetary sanctions over $1 million, subject to certain limitations.

Whistleblowers who provide such information are eligible for a cash award of from 10 to 30 percent of the monetary sanctions. Employers are prohibited from retaliating against individuals who provide the SEC with information about possible federal securities law violations, and victims of retaliation are granted an independent cause of action. In addition, whistleblowers may report anonymously if they are represented by counsel. In other words, potential whistleblowers have been newly incentivised to report possible violations, and will receive previously unheard of levels of protection for doing so.

The goal of the new whistleblower regulations is to generate high quality tips that the SEC would not otherwise receive from individuals with original information about securities law violations by providing them with new and significant protections and incentives.

Although the whistleblower programme is new, both the quality and quantity of submissions have been extremely encouraging. These submissions are being handled by offices around the country and involve a wide-range of possible violations of the federal securities laws. Some of the submissions have alleged serious violations involving prominent individuals and entities.

Coupled with the new cooperation programme, which encourages individuals and entities that have violated the securities laws to self-report, the whistleblower provisions have helped to strengthen the national securities enforcement programme.

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Impact on Private Equity Funds and Managers

As many PE funds tend to make long-term investments in small to medium size companies with growth potential, the funds, and their investments generally pose a lower risk for certain types of securities fraud. Nevertheless, the possibility for aggressive accounting techniques or other conduct that might run afoul of the federal securities laws can be present at the portfolio company, fund, and manager levels.

Due to the size of the industry and that it has been largely unregulated until the passage of Dodd-Frank, it is expected that private equity firms will be subject to greater regulatory scrutiny. As a result, managers should expect and prepare for an increase in formal and informal inquiries by the SEC.

In order to remain ahead of the curve, sophisticated PE funds will conduct more extensive due diligence regarding compliance issues before acquiring new businesses and closely monitor compliance programs of the businesses in their portfolios.

While PE funds have historically helped their portfolio companies with operational issues, funds may need to become more involved in corporate governance and compliance issues to ensure that they aren't bitten by a whistleblower in one of their portfolio companies. Depending on the nature of the PE fund's investment in the portfolio company, the risk of possible securities law violations, and thus the possibility of a whistleblower action, could lie at the portfolio company or even at the fund level. For example, if a PE fund were to remain a major equity owner of a portfolio company after a public offering, perhaps with one or more affiliated officers or board members, both the portfolio company and the fund might face scrutiny over accounting practices at the portfolio company.

Summary

While the attention to PE funds and managers that may come with Dodd-Frank may be unwelcome, a few steps will help assure that the consequences of this attention are minimised. First, all funds and managers would be well served to review the compliance programmes at both the fund and portfolio company level. Second, internal reporting mechanism need to be examined and tweaked to encourage potential whistleblowers to report internally. Third, an action plan should be crafted and "put on the shelf" to be broken out in the event that a possible whistleblower complaint is lodged, internally, or with the SEC. If a firm fails to take compliance issues seriously, particularly responding appropriately to internal reports of violations, potential whistleblowers will contact the SEC or firms that represent whistleblowers concerning those violations.

Jordan Thomas chairs the Whistleblower Representation practice at Labaton Sucharow LLP. He is a former SEC Assistant Director (and Assistant Chief Litigation Counsel and had a leadership role in the development of the SEC's Whistleblower Program).