RUTGERS LAW RECORD

The Digital Journal of Rutgers Law School

lawrecord.com

Volume 46 **2018-2019**

THE WHISTLEBLOWER PROTECTION STATUTE: ITS IMPACT ON CHIEF COMPLIANCE OFFICERS

CHRISTOPHER N. SOARES[1]

INTRODUCTION

The Supreme Court of the United States ("Supreme Court") in *Digital Realty Trust Inc. v. Somers*[2] and the Court of Appeals of New York in *Sullivan v. Harnisch*[3] decided on a fundamental issue important to both chief compliance officers ("CCO") and shareholders. In *Sullivan* and *Digital Realty Trust Inc.* the courts held that the Dodd-Frank Act's prohibition on employer retaliation against whistleblowers only extends to individuals who have reported the violations of securities laws directly to the Securities and Exchange Commission ("SEC").[4] The decision by both courts was troubling. These holdings would prove detrimental to CCO's should they report any compliance concerns to management and to shareholders seeking company transparency.[5]

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[1] J.D. Candidate 2019, Rutgers Law School; B.A. Political Science, Fairleigh Dickinson University. Special thanks to my mother, Ocione Nunes, and wife, Gabriella Avelar, for their unconditional love and support.
[2] No. 16-1276, slip op. at 9 (U.S. Feb. 21, 2018).
[3] 19 N.Y.3d 259, 265 (2012).
[4] *See* Digital Realty Trust Inc. v. Somers, 138 S. Ct. 767, 781 (2018); Sullivan v. Harnisch, 19 N.Y.3d 259, 265 (2012).
[5] Luis A. Aguilar, *The Role of Chief Compliance Officers Must be Supported*, U.S. SEC. AND EXCHANGE COMMISSION (June 29, 2015), https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html ("While I respect the

This note will explore the critical question of whether public investment advisers and other entities should be given the unequivocal power to terminate the few employees who are charged with the statutorily mandated role of securing ethical and legal compliance.[6] In Section II, I will explore the inception of the SEC and the relevant legislation and historical occurrences that gave rise to this issue. I will also discuss, in Section III, the imperative role CCO's play in their respective industry as well as in the financial sector. In Sections IV, I will provide a summary of the importance of creating and maintaining a culture of compliance and briefly discuss the Dodd-Frank Act and the Sarbanes-Oxley Act's whistleblower protection statutes.[7] In Sections V, VI, and VII, I will examine the rulings in *Sullivan v. Harnisch* and *Digital Realty Trust Inc. v. Somers* and their impact on the compliance and financial industries. In Section VIII, I will argue that the rulings in *Sullivan* and *Digital Realty Trust Inc.* were in error. In addition to answering the question of whether entities should be given the unequivocal power to terminate CCO's, in Section IX, I will propose a solution which would limit an entity's incentive to terminate CCO's for unjust reasons through the use of the 8-K disclosure form.

I. BACKGROUND

A. THE FOUNDATION OF THE SEC

During the mid to late 1920s, the United States economy rapidly expanded and the prices of stocks soared to record heights in what was named the great "Hoover bull market."[8] As a result, the

views of my fellow community, the dissent, and the resulting publicity, has left the impression that the SEC is taking too harsh of an enforcement stance against CCOs, and that CCOs are needlessly under siege from the SEC.").

6 *Id.*

7 17 C.F.R § 240.21F-2 (2011); 18 U.S.C. § 1514A (2016).

8 *Stock Market Crash of 1929*, ENCYCLOPEDIA BRITANNICA, https://www.britannica.com/event/stock-market-crash-of-1929 (last updated Apr. 27, 2018); *What We Do*, U.S. SEC AND EXCHANGE COMMISSION, https://www.sec.gov/Article/whatwedo.html (last updated June 10, 2013).

public began galloping to brokers to invest their savings and wealth into stocks.[9] Billions of dollars were removed from banks and injected into Wall Street.[10] The idea of purchasing Liberty Bonds began to fade, as families started mortgaging their homes in order to finance their investments.[11] This increase in financial activity resulted in the Dow Jones Industrial Average rising to a high of 381 points.[12]

Enticed by promises of large returns and easy credit sources, most investors were unaware of the systemic risks that arose from the irresponsible abuse of margin financing.[13] Additionally, most investors gave little thought to the financial statements released by the companies they invested in.[14] This was likely attributable to the subpar standard public companies followed in providing investors with adequate and accurate financial information.[15]

On October 18, 1929, the market plummeted and the rush to purchase stocks turned into a race to wildly sell.[16] This became known as the "Great Crash".[17] It is estimated that of the $50 billion

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[9] Claire Suddath, *The Crash of 1929*, TIME (Oct. 29, 2008), http://ti.me/OHHkCY; *Broker*, INVESTOPEDIA, https://www.investopedia.com/terms/b/broker.asp (last updated June 13, 2018) (broker is defined as "an individual or firm that charges a fee or commission for executing buy and sell orders submitted by an investor").
[10] *What We Do*, *supra* note 8.
[11] *Stock Market Crash of 1929*, ENCYCLOPEDIA BRITANNICA, *supra* note 8*; Liberty Bond*, INVESTOPEDIA, https://www.investopedia.com/terms/l/liberty-bond.asp (last updated May 11, 2018) (stating that a liberty bond was issued by the U.S. government during the Second World War and was introduced as a means of financing the war).
[12] *Stock Market Crash of 1929*, ENCYCLOPEDIA BRITANNICA, *supra* note 8; *see* Troy Adkins, *Understanding And Playing The Dow Jones Industrial Average*, INVESTOPEDIA, https://www.investopedia.com/articles/financial-theory/10/introduction-to-the-dow.asp (last updated Feb. 28, 2018) (stating that the Dow Jones Industrial Average is a stock market index which is one of the most closely followed indexes consisting of 30 large-cap blue chip companies that are generally household names).
[13] *See What We Do*, *supra* note 8; *see also* Andrew Beattie, *The SEC: A Brief History of Regulation*, INVESTOPEDIA, https://www.investopedia.com/articles/07/secbeginning.asp (last updated Sept. 29, 2018); *Margin Trading: What Is Buying On Margin?*, INVESTOPEDIA, https://www.investopedia.com/university/margin/margin1.asp (last visited Dec. 1, 2018) (explaining that buying on margin is when money is borrowed from a broker to purchase a stock, which allows an investor to buy more stock and although this may result in greater returns, many times this results in greater losses).
[14] *See What We Do*, *supra* note 8.
[15] *See* Andrew Seth Bogen, *The Impact of The SEC's Shelf Regulation Rule On Underwriter's Due-Diligence Investigations*, 51 GEO. WASH. L. REV. 767, 775 (1983). *See Asset*, THE FREE DICTIONARY, https://legal-dictionary.thefreedictionary.com/Asset (last visited Dec. 1, 2018) (stating that an asset is "any item that has monetary value). *See Liability*, INVESTOPEDIA, https://www.investopedia.com/terms/l/liability.asp (last updated May 31, 2018) (defining liability as "a company's financial debt or obligations that arise during the course of its business operations" and noting that "[l]iabilities are settled over time through the transfer of economic benefits including money, goods or services").
[16] *Stock Market Crash of 1929*, ENCYCLOPEDIA BRITANNICA, *supra* note 8.

in new securities offered during this period, half became virtually valueless.[18] The average individual who owned stocks saw his or her fortune fall by almost 90%.[19] Many believe that the prominent cause of the stock market collapse was the rampant ongoing speculation by investors who had purchased stocks on margin, only to then lose their investments.[20] Those same investors, even after their substantial loss, still owed money to the entities that granted the loans for the stock purchases.[21] During this time, U.S. industrial production followed the stock market's pattern and plunged.[22] This gave rise to the highest unemployment rate the U.S. had ever seen with a quarter of the workforce being unemployed,[23] giving rise to the "The Great Depression."[24]

Congress, during the peak years of the Great Depression, passed the Securities Act of 1933, which created the SEC and the Securities Exchange Act of 1934 ("Exchange Act").[25] These laws were designed to "restore investor confidence in our capital markets[26] by providing investors . . . with more reliable information and clear rules of honest dealing."[27] As a result, the SEC was endowed with the power to oversee the financial markets as well as the conduct of financial

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[17] *Id.* The stock market crash of 1929 was spread over a two-week period in the month of October and the Dow Jones Industrial Average fell more than 20% over just two days. The stock market crash of 1929 had created pressure and fear within our markets. Beattie, *supra* note 13. Plummeting stocks resulted in a flood of sell orders that shut down the ticker-tape service that provided stock prices to traders. *Id.*

[18] *What We Do*, *supra* note 8.

[19] *Stock Market Crash of 1929,* INVESTOPEDIA, https://www.investopedia.com/terms/s/stock-market-crash-1929.asp (last updated Apr. 17, 2018).

[20] Leslie Kramer, *What Caused The Stock Market Crash Of 1929 That Led To The Great Depression?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/042115/what-caused-stock-market-crash-1929-preceded-great-depression.asp (last updated Jan. 17, 2018).

[21] *See id.*

[22] *See id.*; Christina D. Romer, *The Nation in Depression,* 7 J. ECON. PERSP. 19, 20 (1993) (stating that the peak of industrial production occurred between 1927 and 1937).

[23] *See The Great Depression (1929 – 1939)oh my* , TEACHING ELEANOR ROOSEVELT GLOSSARY, https://www2.gwu.edu/~erpapers/teachinger/glossary/great-depression.cfm (last visited Dec. 1, 2018).

[24] *Id.*

[25] *What We Do, supra* note 8; 15 U.S.C. § 77a, et. seq. (2016); 15 U.S.C. § 78a, et. seq. (2016).

[26] Capital markets are markets where investors could purchase and sell equity and debt instruments. *Capital Markets*, INVESTOPEDIA, https://www.investopedia.com/terms/c/capitalmarkets.asp (last updated Mar. 5, 2018). Capital markets are a critical to a functioning economy since it generates economic output. *Id.* Capital markets include primary markets which are where new stock and bond issuers are sold, and secondary markets, where investors trade existing securities. *Id.*

[27] *What We Do, supra* note 8.

professionals including brokers, dealers, and investment advisors.[28] Additionally, the SEC was given the task of monitoring the financial reports of publicly traded companies.[29] Although Congress initially granted the SEC power to enforce the Exchange Act, the SEC's powers has since been broadened to include the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley"), in addition to other pieces of legislation.[30]

[28] *Id.*
[29] *Id.*
[30] 15 U.S.C. § 7201, et. seq. (2016).

B. THE EXCHANGE ACT

To protect investors, Congress created the Exchange Act, which primarily regulates transactions of securities within the secondary market.[31] Most notably, the Exchange Act includes a mandatory disclosure process designed to require companies to release information that "reasonable investors" would find material in making investment decisions.[32] In addition to secondary market regulations, the Exchange Act provides for the direct regulation of the markets where securities are sold and purchased, as well as the right to oversee market participants such as the industry associations, brokers, and issuers.[33]

One of the most notable functions of the Exchange Act is the disclosure requirements mandating periodic filings with the SEC, which subsequently become available to all investors through the SEC's online filing system, known as "EDGAR."[34] The required disclosures vary depending on the registrants.[35] Companies, subject to factors including their size, must file Form 10-K for annual reports,[36] Form "10-Q for quarterly reports,[37] and Form 8-K for reports after certain

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[31] *Securities Exchange Act of 1934,* CORNELL LAW SCH., https://www.law.cornell.edu/wex/securities_exchange_act_of_1934 (last visited Dec. 1, 2018). The secondary market includes sales that take place after a security is initially offered by the issuer. *See Secondary Market*, INVESTOPEDIA, https://www.investopedia.com/terms/s/secondarymarket.asp (last updated June 24, 2018).

[32] *See Securities Exchange Act of 1934*, CORNELL LAW SCH., *supra* note 31; Amanda Rose, *The "Reasonable Investor" of Federal Securities Law*, HARV. LAW SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Oct. 13, 2016), https://corpgov.law.harvard.edu/2016/10/13/the-reasonable-investor-of-federal-securities-law/ ("The 'reasonable investor' is at best a shadowy figure, described only generically in judicial opinions and—in doctrine if not in practice—someone for the fact-finder to identify case-by-case. Public companies have long bemoaned the reasonable investor test, arguing that materiality should be judged instead by reference to quantitative or other bright-line measures, so as to simplify companies' disclosure choices and provide a basis for dismissal of securities litigation at the pleadings or summary judgment phase.").

[33] 15 U.S.C. § 78m.

[34] *Id.; Important Information About EDGAR*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/edgar/aboutedgar.htm (last visited Dec. 1, 2018) ("EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, performs automated collection, validation, indexing, acceptance, and forwarding of submissions by [public] companies and others who are required . . . to file forms with the U.S. Securities and Exchange Commission (SEC). [EDGAR]'s primary purpose is to increase efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the [SEC].").

[35] *See* 15 U.S.C. § 78m et. seq.

[36] *Id.* § 78m. A 10-K is a summary report of a company's performance which is submitted annually to the SEC. *10-K*, INVESTOPEDIA, https://www.investopedia.com/terms/1/10-k.asp (last updated May 18, 2018). The 10-K typically

events occur[38] that must be reported within four days of the event.[39] In addition to the company's audited financial statements, the required periodic reports include information about the company's management, auditors, and company officers.[40] These periodic filings would theoretically help the "reasonable investor" conclude whether a company's stock or other securities qualify as a "good" investment.[41]

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contains much more detail than the annual report compared to other required disclosures. *Id.* It includes information such as company history, organizational structure, equity, holdings, earnings per share, and subsidiaries. *Id.* The 10-K must be filed within 60 days after the end of the fiscal year. *Id. E.g.*, *Form 10-K*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/answers-form10khtm.html (last updated June 26, 2009).

[37] *SEC Form 10-Q*, INVESTOPEDIA, https://www.investopedia.com/terms/1/10q.asp (last updated Apr. 9, 2018). The SEC form 10-Q is a comprehensive report of a company's performance that must be submitted quarterly by all public companies to the Securities and Exchange Commission. *Id.* In the 10-Q, firms are required to disclose relevant information regarding their financials. *Id.* There are two parts to a 10-Q filing. *Id.* The first contains relevant financial information covering the period. *Id.* This includes financial statements; management discussion and analysis on the financial condition of the entity; disclosures regarding market risk; and internal controls. *Id.* The second part contains information such as legal proceedings; unregistered sales of equity securities; and the use of proceeds from the sale of unregistered sales of equity. *Id. E.g.*, *Form 10-Q*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/answersform10qhtm.html (last updated Sept. 2, 2011).

[38] *Form 8-K*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/answersform8khtm.html (last updated Aug. 10, 2012).

[39] STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 170-73 (Foundation Press 4th ed. 2015).

[40] 15 U.S.C. § 78m.

[41] *See Securities Exchange Act of 1934*, CORNELL LAW SCH., *supra* note 31; *see generally* Sec. Exchange Commission v. W.J. Howey & Co., 328 U.S. 293 (1946) (agreeing with the SEC's view that by including these broad catch all provisions in the statutory provision, congress intended the concept of security to have some elasticity and be interpreted flexibly and accommodate new investment types in ways congress could not even begin to anticipate). Although the Supreme Court did acknowledge, in language that would come back to haunt the high court, that the 1933 Act applied to any Instruments as a matter of law, if on its face it answered to the name or description in the statutory definition under 2(a)(1) of the 1933 Act. *Id.* at 299. In its landmark *Howey* decision, the Supreme Court established that an 'investment contract' refers to a contract, transaction or scheme whereby a person or entity (1) invests money; (2) in a common enterprise; (3) with the expectation of profits; (4) to be derived solely from the efforts of others. *Id.* The Supreme Court instructed that, in applying the *Howey* test, the emphasis is to be placed on the "economic reality" of the proposed transaction and therefore form should be disregarded with a greater emphasis on substance. *Id.*

i. Form 8-K

Congress gave the SEC authority to require public companies,[42] registered under the Exchange Act, pursuant to Section 409 of Sarbanes Oxley, to disclose material information regarding changes in the company's financial condition or operations.[43] Form 8-K is known as the closest "real time" reporting requirement.[44] Items required by this form are required to be made within four business days of the occurrence of the event.[45] This includes changes to material definitive agreements or even bankruptcy.[46] Form 8-K additionally requires the disclosure of acquisitions, changes in the "financial condition of an entity, disposal activities, and material impairments," as well as any material modifications to shareholder rights.[47] Dissimilar to the quarterly reporting of Form 10-Q, and the annual reporting of Form 10-K, public companies make use of Form 8-K as needed.[48]

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[42] A public company is a company that has issued securities through an initial public offering and is traded on at least one stock exchange or in over-the-counter markets. *Public Company*, INVESTOPEDIA, https://www.investopedia.com/terms/p/publiccompany.asp (last updated Jan. 29, 2018). Although a small portion of shares may be initially offered to the public, becoming a public company allows the market and investors to determine the value of the entire company through trading. *Id.* Public companies have certain advantages over private companies, including the ability to sell future equity stakes and increase access to debt markets. *Id.* Once a company goes public, additional revenue can be created through other offerings. *Id.* However, with these advantages comes increased regulatory scrutiny. *Id.* Public companies must meet mandatory reporting standards as regulated through government entities. *Id.* Additionally, applicable shareholders are entitled to documents and notifications regarding the activities transpiring within the business. *Id.*

[43] CHOI & PRITCHARD, *supra* note 39; *Fast Answers, Companies, Going Public,* U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/answers-comppublichtm.html (last updated Oct. 14, 2014).

[44] CHOI & PRITCHARD, *supra* note 39.

[45] *Id.*

[46] *8-K*, INVESTOPEDIA, https://www.investopedia.com/terms/1/8-k.asp (last updated May 29, 2018). *See also* TSC Industries v. Northway, 426 U.S. 438, 450 (1976) (finding that information is material if there is "a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having significantly altered the total mix of information made available"). The court in *TSC Industries v. Northway* took a balancing approach in determining materiality, which weighs competing concerns of providing investors with info they want and avoiding too broad a definition of materiality, which would bury investors under extraneous info and cost a lot for issuers. Additionally, the court focused on the reasonable investor. *See* Basic v. Levinson, 485 U.S. 224, 232-38 (1988).

[47] *8-K*, INVESTOPEDIA*, supra* note 46.

[48] *Id.*

C. THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 ("Advisers Act") was a statute designed by Congress to eliminate the abuses in the securities industry, which were believed to have contributed to the Great Crash of 1929.[49] In the 1930s, the SEC conducted multiple reports that traced the history and growth of investment advisers.[50] The SEC concluded that investment advisers were not able to perform properly their function unless all conflicts of interests between them and their clients were eliminated.[51] The SEC became increasingly concerned with the presence of conflicts of interests, which stemmed from the conscious or unconscious preconceived motives of investments advisers to favor only their own financial interests over those of their clients.[52] As a result, Congress created the Advisers Act, which states that it is unlawful for any investment adviser, unless a registered investment adviser ("RIA") or registered investment company ("RIC"), to make use of any means of instrumentality of interstate commerce in connection with its business as an investment adviser.[53]

The SEC uses a three-prong test in determining whether an entity must become an RIA.[54] An entity must be registered if the investment adviser: (1) for compensation; (2) is "engaged in the

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[49] 15 U.S.C. § 80b-1 et seq.; THOMAS P. LEMKE ET. AL., REGULATION OF INVESTMENT ADVISERS 5 (Michael Berenson, Esq. et al. eds., 2018); U.S. SEC. AND EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS 1 (2013) [hereinafter *Regulation of Investment Advisers*].
[50] Matthew Goldstein, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. INT'L BUS. & L. 111, 120 (2007).
[51] *Id.*
[52] *Regulations of Investment Advisers*, *supra* note 49. Like most industries, the asset management industry has conflicts of interest. Johnathan N. Eisenberg, *The Year in Review: SEC Enforcement Actions Against Investment Advisers*, HARV. F. ON CORP. GOVERNANCE AND FIN. REG. (Dec. 19, 2016), https://corpgov.law.harvard.edu/ 2016/12/19/the-year-in-review-sec-enforcement-actions-against-investment-advisers/. Investment advisers might benefit by selling one type of variable annuity over another or one type of variable annuity rider over another. *Id.* First, they might receive compensation from the custodians they use to hold client assets. *Id.* Second, they might receive more compensation from some clients than from others. *Id.* Third, they might advise clients to invest in funds managed by an affiliate of the adviser. *Id.* Conflicts are not prohibited under the Advisers Act, but they arouse the SEC's interest. *Id.* To the extent that material conflicts are not eliminated, they must be disclosed. While the Investment Advisers Act and the SEC label such failures to disclose "fraud," it does not need to be fraud in the commonly-understood sense. *Id.* To establish liability, the SEC does not need to show intentional, knowing, or reckless deception, or that any investor was harmed or that the respondent benefitted from the alleged disclosure violation. *Id.*
[53] 15 U.S.C. § 80b-3 (2016); 15 U.S.C. § 80b-2.
[54] *Id.* § 80b-2(a)(11).

business"; (3) of providing advice, reports, or analyses regarding securities to "others."[55] However, an entity is required to register only if it meets all three of these criteria.[56] Although there are exceptions to who must register as an investment adviser, those exempt from registration under Section 203(b) may still be subject to anti-fraud provisions in Section 206 of the Advisers Act.[57]

If registered, the RIA will owe a fiduciary duty to prospective clients.[58] The RIA must avoid conflicts of interest with clients that may breach the clients trust.[59] The RIA must also be "sensitive to the conscious and unconscious possibility of providing less than disinterested advice."[60] Justice Cardozo in *Meinhard v. Salmon* explained, "A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[61] Such a fiduciary duty requires full disclosure of material facts, and conflicts

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[55] *Id.* § 80a-3(a)(1). "A person clearly meets the third element of the test if he provides advice to others about specific securities, such stocks, bonds, mutual funds, limited partnerships, and commodity pools." *Regulations of Investment Advisers*, *supra* note 49, at 2. SEC Staff has stated that advice about real estate, coins, precious metals, or commodities is not advice about securities. *Id.* To be engaged in the business of providing advice, one does not have to be the sole or even the primary activity of the person. *Id.* "Factors used to evaluate whether a person is engaged are: (i) whether the person holds himself out as an investment adviser; (ii) whether the person receives compensation that represents a clearly definable charge for providing investment advice; and (ii) the frequency and specificity of the investment advice provided." *Id.* The SEC has broadly construed the types of benefits that may be deemed "compensation", including direct and indirect economic benefits, such as fees or benefits received from sources other than the recipient of the advice. *Id. See also* THOMAS P. LEMKE ET AL., REGULATION OF INVESTMENT ADVISERS 5 (2017); CenturyLink Investment Management Co., SEC No-Action Letter (Dec. 8, 2016) (finding that a wholly-owned subsidiary is not considered an "other" in reference to its relationship with the parent company).

[56] 15 U.S.C. § 80a-3(a)(1). *Regulation of Investment Advisors*, *supra* note 49, at 8, 2 (a person must satisfy all three elements to fall within the definition of "investment adviser," which the SEC Staff has addressed in an extensive interpretive release explaining how the Act applies to financial planners, pension consultants and other persons who, as a part of some other financially related services, provide investment advice).

[57] *General Information on the Regulation of Investment Advisers,* U.S. SEC. AND EXCHANGE COMMISSION (Mar. 11, 2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm ("Section 203(b)(4) generally exempts any investment adviser that (1) is a charitable organization, or is employed by a charitable organization, and (2) provides advice, analyses, or reports only to charitable organizations, or to funds operated for charitable purposes."). Additionally, Section 203(b)(5) exempts investment advisers to church employee pension plans. *Id.*

[58] *Regulations of Investment Advisers*, *supra* note 49*,* at 22.

[59] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-92 (1963).

[60] *Id.*

[61] 249 N.Y. 458, 464 (1928).

of interest.[62] Although this does not mandate the RIA to have a specific expertise of financial knowledge, a high burden of conduct was placed on RIAs/RICs.[63]

Additionally, being a RIA requires that the adviser provide suitable advice and a reasonable basis for recommendations.[64] The RIA must make reasonable inquiry into the client's financial situation, investment experience, and investment objectives.[65] This requires the RIA to make an inquiry into the client's personal objectives.[66] For instance, the SEC has found that an alleged investment adviser may be deemed to have lacked an independent basis for a recommendation where the investment adviser recommends a risky investment, despite a customer's conservative investment objective and older age.[67] As a result of RIAs being held to fiduciary-like standards, the SEC and Congress, through the Advisers Act, have created a more prudent environment for investors.[68]

i. Rule 206(4)-7 of the Investment Advisers Act

If a person or entity is required to register as an investment adviser under Section 203 of the Advisers Act or a RIC under Rule 38a-1 of the Investment Company Act of 1940, the adviser may not provide investment advice to clients unless the adviser: (1) adopts and implements written policies and procedures designed to prevent violation of the federal securities laws; (2) reviews the

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[62] *Regulations of Investment Advisers*, *supra* note 49 at 23.
[63] *See id.*
[64] *Id.*
[65] *Id.* at 24.
[66] *See* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (where the SEC proposed a rule under the Act's anti-fraud provisions, although never adopted, which would allow for a mechanism of extensive personal inquiry).
[67] *See* In re Philip A. Lehman, SEC Admin. Proceeding No. 3-11972 (July 5, 2005); Mark P. Cussen, *The 10 Riskiest Investments*, INVESTOPEDIA, https://www.investopedia.com/articles/forex/033015/10-riskiest-investments.asp (last updates Mar. 30, 2015). Although many investors classify investments as either "risky" or "safe," investors with experience understand that there are many ways as classifying stock. Some risky investments include, options, futures, limited partnerships, penny stocks, and junk bonds. Generally, all investments are subject to one or more type of risks, but some can carry more risk than others. Many times, the riskier investments may bare the greatest return. But by those same measures, the riskier investments are more likely to result in losses. *Id.*
[68] *Investment Advisers Act of 1940*, INVESTOPEDIA, https://www.investopedia.com/terms/i/investadvact.asp (last updated Jan. 9, 2018).

compliance procedures annually for their adequacy and the effectiveness of their implementation; and (3) designates a CCO who is responsible for administering the Compliance Procedures.[69] The SEC has stated that these compliance rules are imperative in order for RIAs/RICs to have a strong system of controls in place in order to prevent compliance violations, in addition to protecting the interests of clients and shareholders.[70]

II. THE ROLE OF CHIEF COMPLIANCE OFFICERS

As stated above, RIAs/RICs require registration with the SEC and designation of a CCO.[71] The SEC has stated that the CCO should be competent and knowledgeable regarding the federal securities laws.[72] The CCO should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures.[73] Among the CCO's duties, the CCO is tasked with anticipating new risks and conflicts of interests arising from current and changing business activities, as well as any changes in law and regulations, and any compliance matters that arise.[74] A CCO must familiarize itself with the operations of the adviser and understand the aspects of the operation that expose the adviser to potential compliance risks.[75] In addition to these roles, the CCO should anticipate new compliance risks and directly address them, and must not solely provide temporary

[69] 17 C.F.R. § 275.206(4)-7; Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. IA-2204; Investment Company Act Release No. IC-26299 (effective Feb. 5, 2004).
[70] Memorandum from Willkie Farr & Gallagher LLP on SEC Adopts Final Rules on Compliance Programs for Investment Companies and Investment Advisers to Clients 1 (Jan. 15, 2004).
[71] 17 C.F.R. § 270.38a-1(a)(4); *Id.* § 275.206(4)-7(c); Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. IA-2204; Investment Company Act Release No. IC-26299 (effective Feb. 5, 2004).
[72] *Id.*
[73] *Id.*
[74] *Id.* ("Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. A chief compliance officer is appointed in accordance with rule 206(4)-7 or Rule 38a-1 and would not necessarily be subject to a sanction by the SEC for failure to supervise other advisory personnel. Section 203(e)(6) provides that a person shall not be deemed to have failed to reasonably supervise another person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.").
[75] *Id.*

solutions.[76] The SEC has further stated that the CCO must, at minimum, review compliance annually and report violations to the CEO and board of directors.[77] The CCO must also report regularly to the adviser's Risk Management Committee, and identify potential conflicts of interests and risks.[78] Among this, Rule 38a-1 requires that the adviser's board of directors approve the removal of the adviser's CCO.[79] In voting for the CCO's removal, the SEC requires the entity's board of directors enact procedures to ensure that all requirements are met and that the CCO is adequately independent.[80]

III. A CULTURE OF COMPLIANCE

CCOs are considered vital to fostering integrity in the securities industry.[81] They are tasked with ensuring their respective employers (RIAs/RICs) comply with Federal and State rules and procedures that apply to the adviser's operations.[82] To pursue these ends, CCOs normally work in conjunction with senior corporate leadership to instill a culture of compliance in all employees.[83] This creates an environment in which employees understand the value of integrity, honesty, and the importance of compliance.[84] But an important question must be posed: how does an RIA/RIC create a culture of compliance?

The SEC staff has often stated that the primary indicator of a satisfactory culture of compliance begins at the top of the company.[85] As such, there are various methods executives may

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76 SUTHERLAND ASBILL & BRENNAN LLP, LEGAL ALERT: RULE 38A-1 AND RULE 206(4)-7 IMPLEMENTATION – PHASE 2, at 2 (2004).
77 *Id.* at 4.
78 *Id.*
79 *Id.*
80 *Id.*
81 Aguilar, *supra* note 4.
82 *Id.*
83 *Id.*; Deloitte, *Eight Ways to Move Toward a Culture*, WALL STREET J.: CFO J. (June 7, 2013), http://deloitte.wsj.com/cfo/2013/06/07/toward-a-culture-of-compliance-eight-initiatives-ccos-can-lead/.
84 Deloitte*, supra* note 83.
85 Michael C. Neus, *Creating a Culture of Compliance,* PROGRAM ON CORP. COMPLIANCE AND ENFORCEMENT AT N.Y.U.: COMPLIANCE AND ENFORCEMENT BLOG (Jan. 16, 2018), https://wp.nyu.edu/compliance_enforcement/2018/01/16/creating-a-culture-of-compliance/.

take to nurture a culture of compliance.[86] First, an investment adviser may proscribe "unitary policies and procedures."[87] Accordingly, RIAs/RICs may create policies and procedures that apply to all employees, regardless of seniority.[88] This means that the CCO should be able to "demonstrate that senior management is subject to all the same company rules." [89] In doing so, the RIA/RIC will be promoting a unilateral set of responsibilities which all employees of the company are urged to follow.[90]

Second, an investment adviser may create internal procedures that promote an "aligning of interests."[91] Accordingly, when employees positively contribute to a compliant culture, the executives and senior management should reward the employees.[92] This will promote a culture of compliance as employees are singled out.[93] In doing so, top management will communicate what values are necessary for corporate compliance.[94] Although compliance has become engraved in American corporations, the Federal government needed to address whether employees would be shielded from retaliation, should they report Federal securities law violations to the SEC.[95]

A. WHISTLEBLOWERS, DODD-FRANK AND SARBANES-OXLEY

The Dodd-Frank Act[96] ("Dodd-Frank") and Sarbanes-Oxley Act both carry provisions for whistleblowers.[97] According to Dodd-Frank, the term whistleblower means any one or more individuals acting jointly who provide information to the SEC regarding a violation of securities

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[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.* ("For example, if a firm requires preapproval of employees' securities trades, the CCO should maintain a list of trades of each senior manager with the appropriate preapproval form authorizing the trade.").
[90] *Id.*
[91] *See id.*
[92] *See id.*; Deloitte, *supra* note 83.
[93] Neus, *supra* note 85.
[94] *Id.*
[95] *Information on Whistleblower Protection Act and Whistleblower Protection Enhancement Act*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/eeoinfo/whistleblowers.htm (last updated Feb. 4, 2016).
[96] Pub. L. No. 111-203, 124 Stat. 1376 – 2223 (2010).
[97] 17 C.F.R. § 240.21F-2 (2018); 18 U.S.C. § 1514A (2010).

laws.[98] Under this law, an employer may not directly or indirectly discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower because of any lawful act done by the whistleblower: (1) in providing information to the SEC in accordance with the provisions of the Dodd-Frank Act; (2) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or (3) in making disclosures that are required or protected under the Sarbanes-Oxley Act, the Exchange Act and any other law, rule, or regulation subject to the jurisdiction of the SEC.[99]

Similarly, Section 806 of Sarbanes-Oxley states that no company registered under the Exchange Act may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee under two circumstances.[100] First, an employee may not be discharged when he or she provides information, causes information to be provided, or otherwise assists in an investigation regarding any conduct that the employee reasonably believes constitutes a violation of certain criminal statutes, any rule or regulation of the SEC, or any provision of Federal law relating to fraud against shareholders.[101] Second, an employee may not be discharged when he or she files, or causes to be filed, testifies, participates in, or otherwise assists in a proceeding filed or about to be filed relating to the same criminal statutes, SEC rules, or any provision of Federal law relating to

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[98] 17 C.F.R. § 240.21F-2(a)(1) (2018).
[99] 15 U.S.C. § 78u-6(h)(1) (2016).
[100] *Id.* § 78u-6(h)(1)(a)(2).
[101] 18 U.S.C. § 1514A (2016). *See also* Taylor v. Fannie Mae, 2014 U.S. Dist. LEXIS 119042, *7 (D.D.C. Aug. 25, 2014) (to establish that plaintiff engaged in protected activity, an employee must show that she had both a subjective and objective reasonable belief that "the conduct complained of constituted a violation of relevant law."); Feldman v. Law Enforcement Assocs. Corp., 752 F.3d 339, 344 (4th Cir. 2014); Lockheed Martin Corp. v. Admin. Review Bd., 717 F.3d 1121, 1129 (10th Cir. 2013); Bechtel v. Admin. Review Bd., 710 F.3d 443, 447 (2d Cir. 2013); Wiest v. Lynch, 710 F.3d 121, 129 (3d Cir. 2013); Sylvester v. Parexel, Int'l. LLC, No. 07-123, 19 (ARB May 25, 2011) ("[T]he critical focus is on whether the employee reported conduct that he or she reasonably believes constituted a violation of federal law. Congress chose statutory language which ensures that an employee's reasonable but mistaken belief that an employer engaged in conduct that constitutes a violation of one of the six enumerated categories is protected.") (internal citations omitted).

fraud against shareholders.[102] Damages and other remedies for breach of this section by employers can include reinstatement with back pay and compensation for any special damages incurred.[103] Section 1107 of Sarbanes-Oxley states that it is a crime to knowingly, with the intent to retaliate, take any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing any truthful information relating to the commission or possible commission of any Federal offense to a law enforcement officer.[104]

These whistleblower protection statutes are two of many laws that exist to foster an environment where employees of RIAs/RICs can report fraud and violations of securities laws without the undue fear of employer retaliation.[105] Andrew Ceresney ("Ceresney"), former Director of the SEC Division of Enforcement, has echoed the importance of these whistleblower protection statutes.[106] Ceresney has stated that current and former employees are often best positioned to observe wrongdoing and thus "hold the key" to assisting the SEC in investigations regarding fraudulent schemes.[107] Accordingly, from the inception of the whistleblower protection statutes, until 2015, about half of the whistleblower award recipients were former or current employees of the companies they reported were in violation of securities laws.[108] The SEC has received more than 14,000 tips from whistleblowers in every state in the United States, and from over 95 foreign

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[102] 18 U.S.C. § 1514A (2016). *See also* M. Meagan O'Malley, *Whistleblower Protections, Retaliation Issues, and Investigative Issues Arising Under the Sarbanes-Oxley Act and the Dodd-Frank Act*, AM. BAR. ASS'N (July 31, 2015), https://www.americanbar.org/content/dam/aba/events/labor_law/am/2015/omalley.authcheckdam.pdf; Lawson v. FMR LLC, 134 S. Ct. 1158, 1169 (2014) (recognizing that "activity protected under § 1514A is not limited to 'provid[ing] evidence of fraud'; it also includes reporting violations of SEC rules or regulations").
[103] 18 U.S.C. § 1514A (2016).
[104] *Id.* § 1513.
[105] *Information on Whistleblower Protection Act and Whistleblower Protection Enhancement Act*, *supra* note 95.
[106] Andrew Ceresney, Dir., Div. of Enf't, Speech at Sixteeneth Annual Taxpayers August Fraud Conference: The SEC's Whistleblower Program: The Successful Early Years (Sept. 14, 2016).
[107] *Id.*
[108] *Id.*

countries.[109] As such, insiders remain an important source of tips to the SEC and can be just as valuable as "first-hand" knowledge of wrongdoing by company insiders.[110]

Both statutes seem to require the whistleblowers report potential securities law violations directly to the SEC.[111] An issue arises when employees, such as CCOs, are discharged after promoting compliance with federal securities laws to their employers, rather than going first to the SEC. Both courts in *Sullivan v. Harnisch* and *Digital Realty Trust Inc. v. Somers* addressed this very issue.[112]

IV. THE PAST – SULLIVAN V. HARNISCH

The New York Court of Appeals also tackled this in a 2012 decision.[113] In *Sullivan v. Harnisch*, Joseph Sullivan ("Sullivan"), Plaintiff, was "a 15% partner in two affiliated firms, defendants Peconic Partners LLC and Peconic Asset Managers LLC."[114] Sullivan held many positions at Peconic, including Executive Vice President, Treasurer, Secretary, Chief Operating Officer, and Chief Compliance Officer ("CCO").[115] Sullivan, in his role as a CCO, raised objections to certain sales of stock by Willian Harnisch ("Harnisch"), the majority owner, Chief Executive Officer, and President.[116] Sullivan was discharged from all of his duties after this dispute between him and Harnisch.[117]

The complaint alleged Harnisch's sales amounted to "front-running,"[118] which allowed Harnisch to take advantage of opportunities which were at that moment unavailable to his clients, a

109 *Id.*
110 *Id.*
111 *See* 15 U.S.C. § 78u-6 (2016); 18 U.S.C. § 1514A (2016).
112 Digital Realty Trust Inc. v. Somers, 138 S. Ct. 767, 781 (2018); Sullivan v. Harnisch, 19 N.Y.3d 259, 265 (2012).
113 *Sullivan*, 19 N.Y.3d at 261.
114 *Id.*
115 *Id.*
116 *Id.* at 261-262.
117 *Id.* at 261.
118 *See Front-Running*, INVESTOPEDIA, https://www.investopedia.com/terms/f/frontrunning.asp (last updated Febrary, 13 2019). Front running is an unethical practice where a broker trades an equity in his or her personal account based on

violation of Federal securities laws.[119] Further, the complaint alleged that Sullivan approached Harnisch about the trades, voiced his objections, and insisted the trades be reversed.[120] Five days after Harnisch refused to comply, Sullivan was fired.[121] The issue before the court was whether the firing of Sullivan was unlawful under the public policy exception to the employment at will doctrine.[122]

Sullivan asserted nine causes of action against Harnisch and Peconic, although only one was before the court.[123] Sullivan claimed he was fired because he "spoke out" about manipulative and deceptive trading practices, and his dismissal was considered retaliation and thus, a violation of company policy.[124] Although the complaint did not specify the existence of such policy, Sullivan's claim was that the legal and ethical duties of a securities firm and its compliance officers justify recognizing a cause of action for when a CCO is fired for objecting to such misconduct.[125]

A. MAJORITY OPINION

The New York State Supreme Court held this claim to be legally sufficient, but the Appellate Division granted leave to appeal which was then affirmed by the Court of Appeals of New York.[126] In its decision, the court conformed to New York's at will employment doctrine, which states "that, absent a violation of a constitutional requirement, statute or contract, 'an employer's right at any

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his or her prior knowledge ahead of another large trade to benefit from the increase in price. *Id. See also* Susan Antilla, *Wall Street; The Murky World of Front-Running*, N.Y. TIMES (Feb. 7, 1993), http://www.nytimes.com/1993/02/07/business/wall-street-the-murky-world-of-front-running.html ("Front-running can take several forms. A secretary's brother-in-law could front-run by buying a stock that the secretary came across in the boss's notes. A printer could front-run by shorting a stock after he read in his press run that it was soon to be downgraded. Or an analyst could front-run in his own account, although that would be a tad stupid when there are perfectly good brothers-in-law around to do the trades less obviously.").

119 *Sullivan*, 19 N.Y.3d at 262.

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.*

124 *Id.*

125 *Id.*

126 *Id.*

time to terminate an employment at will remained unimpaired.'"[127] The court further declined to create a new exception to New York's at-will employment doctrine and rejected an application of the doctrine's only exception.[128]

In the court's analysis, Judge Smith further stated that neither New York's common law nor its whistleblower statute provided employees of private RIAs/RICs protection against retaliatory action for disclosing potential securities law violations.[129] The court presented two options to shield an employee who, like Sullivan, becomes aware of an employer's potential securities law violations against retaliatory action.[130] The court stated that Sullivan should have either remained silent, allowing the violation to occur, or should have reported the potential violation directly to the SEC.[131] Accordingly, the Court of Appeals of New York affirmed the Appellate Division's order and found that no exception would be made to New York's common law regarding the dismissal of at-will employees.[132]

B. DISSENT

In his dissenting opinion, Chief Judge Lippman stated that the majority "unduly narrows the scope of a purposefully and carefully crafted exception to the doctrine of at-will employment".[133] Further, the dissent asserted that this limitation "unfathomably" permits the termination of CCOs during their investigation of the alleged manipulative and deceptive trade practices.[134] Chief Judge Lippman stated that the majority "erroneously" concluded that although there are some employment relationships, such as the relationship between a lawyer and a law firm that might be

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[127] *Id.* (citing Murphy v. Am. Home Prods. Corp., 58 N.Y.2d 293, 305 (1983)).
[128] *Id.* at 262; *See* Wieder v. Skala, 80 N.Y.2d 628, 635-36 (1992) (holding that the exception pertains to attorneys within law firms and it protects attorneys who internally report the improper behavior of colleagues).
[129] *Sullivan*, 19 N.Y.3d at 264-65.
[130] *Id.* at 265.
[131] *Id.*
[132] *Id.*
[133] *Id.* at 266 (Lippman, J., dissenting).
[134] *Id.*

considered exceptions to the New York at-will employment laws, such a relationship did not exist in this case.[135] The dissent said that by excluding compliance officers from the same protection extended to lawyers in law firms, hedge fund managers are given "carte blanche" to terminate the few employees who are charged with the statutorily mandated role of ensuring ethical and legal compliance.[136] In other words, the majority concluded that CCOs may be permissibly dismissed for doing the very job they were hired to do.[137]

V. THE PRESENT – DIGITAL REALTY TRUST INC. V. SOMERS

The Supreme Court revisited the issue presented in *Digital Realty Trust Inc. v. Somers* on February 21, 2018.[138] Defendant-Appellant, Digital Realty Trust, Inc. ("Digital Realty") employed Plaintiff-Appellee, Paul Somers ("Somers") as Vice President from 2010 to 2014.[139] Somers made various reports to senior management regarding possible securities law violations by the company.[140] Soon after these reports, the company terminated Somers.[141] Somers was unable to report his objections and findings to the SEC before Digital Realty terminated his employment.[142] Somers sued Digital Realty and alleged violations of various state and federal laws, which included Section 21F of the Exchange Act (codified as 15 U.S.C. § 78u-6) regarding "Securities Whistleblower Incentives and Protection".[143] The district court denied Digital Realty's motion to dismiss based on theory of "whistleblowers protection," but granted Digital Realty's Petition for Permission to Appeal.[144]

As a result, the Supreme Court addressed the issue of whether the anti-retaliation provision of Dodd-Frank extends to an individual who has not yet reported a violation of securities laws to the

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135 *Id.*
136 *Id.*
137 *See id.*
138 Digital Realty Trust Inc. v. Somers, 138 S. Ct. 767, 772 (2018).
139 *Id.* at 776.
140 *Id.*
141 *Id.*
142 *Id.*
143 *Id.* at 774.
144 *Id.* at 776.

SEC.[145] The Court found, as it did in *Sullivan v. Harnisch*, that to sue under Dodd-Frank's anti-retaliation provision, a person must first provide to the SEC the relevant information relating to the securities law violations.[146] In the majority decision, Justice Ginsburg cited to the Exchange Act: 15 U.S.C. § 78u-6, which defines "whistleblower" as any individual who provides information relating to a violation of the securities law to the SEC.[147] As a result, the Supreme Court reversed the judgment of the Court of Appeals for the Ninth Circuit and remanded the case for further proceedings consistent with the majority's opinion.[148]

In dissent, Judge Owens stated that the statutory definition of whistleblower was clear, thus leaving no room for interpretation, and was plainly over governed.[149]

VI. WHY IT MATTERS

Since the early 1990s, compliance work has grown into a full-blown specialty with its own specific training programs, professional associations and organizations, and codes of conduct.[150] So much so that compliance is now considered a critical aspect of how organizations, institutions, and companies function.[151] As the importance of compliance increased, so did the compliance industry.[152] As a result of industry growth, a large number of attorneys began working in compliance, specifically in the financial sector, as attorneys were viewed as the most able in assessing risk and exercising good judgment.[153] SEC Commissioner Luis A. Aguilar ("Aguilar") has stated that the CCOs of RIAs play an important and crucial role in fostering integrity in the securities industry.[154]

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145 *Id.* at 772.
146 Sullivan v. Harnisch, 19 N.Y.3d 259, 265 (2012); *Digital Realty Trust Inc.*, 138 S. Ct. at 772.
147 *Digital Realty Trust Inc.*, 138 S. Ct. at 774; 15 U.S.C. § 78u-6 (2016).
148 *Digital Realty Trust Inc.*, 138 S. Ct. at 781.
149 *Id.* at 776 (Owens, J., dissenting).
150 *The Emergence of Compliance: A New Profession?*, 2 THE PRACTICE (2016), https://thepractice.law.harvard.edu/article/the-emergence-of-compliance/.
151 *Id.*
152 *Id.*
153 *Id.*
154 Aguilar, *supra* note 5; *The Emergence of Compliance: A New Profession?*, *supra* note 150.

Aguilar has also stated that some feel the SEC has been taking "too harsh" of an enforcement stance against CCO's and that the role of CCO's is under attack.[155]

Some theorize that if courts expand the Whistleblowers Act, those who are unaware of Sarbanes-Oxley's procedural requirements will be protected from retaliation, as will whistleblowers who report internally out of loyalty.[156] The same would be true for some employees, like auditors and attorneys, who are required to report misconduct to their employer before reporting the issues to the SEC.[157] However, some believe this could cause problems for employers as they might feel unable to terminate compliance officers due to the fear of being labeled a "retaliator."[158] Those who sometimes rely on the distinctions between Dodd-Frank whistleblowers and Sarbanes-Oxley whistleblowers to assess risks of liability might find that allowing internal reporters to pursue Dodd-Frank remedies might make the Sarbanes-Oxley's whistleblower protection provisions superfluous.[159]

New York courts may be able to fashion a method to protect CCOs against the retaliatory action of private investment advisers.[160] Some have posed a policy of industry-wide self-regulation such as in *Wieder v. Skala* and *Weiner v. McGraw-Hill.*[161] In *Wieder*, a law firm associate reported "false and

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155 Aguilar, *supra* note 5.
156 Brook Mullins, *Dodd-Frank Whistleblowing: Anticipating the Aftermath of Digital Realty Trust, Inc. v. Somers*, KY. L. J. (Dec. 10, 2017), http://www.kentuckylawjournal.org/index.php/2017/12/10/dodd-frank-whistleblowing-anticipating-the-aftermath-of-digital-realty-trust-inc-v-somers/.
157 *Id.*
158 *Id.*
159 *Id.* The Dodd-Frank Act and the Sarbanes-Oxley Act both have whistleblowers provisions. *See* 15 U.S.C. §78u-6 (2016); 18 U.S.C. 1514A (2016). The Dodd-Frank Act states that if a "whistleblower" provides "original information", the whistleblower may be entitled to as much as 10 percent to 30 percent of the monetary sanctions imposed. *See* 15 U.S.C. §78u-6(b). Unlike the Sarbanes-Oxley Act, the provisions of the Dodd-Frank Act do not appear to be strictly limited to public companies. *See generally* 15 U.S.C. §78u-6. Section 806 of Sarbanes-Oxley provides no company with a class of securities registered pursuant to the Exchange Act or any "officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee." 18 U.S.C. § 1514A(a).
160 John H. Runne, *The Confluence of Sullivan v. Harnisch & Dodd-Frank: Adapting New York's Common Law to Fill a Compliance Hole*, 79 BROOK. L. REV. 1265, 1267-68 (2014).
161 *Id.*

fraudulent material misrepresentations" that his fellow colleague had made to him to his supervising partners.[162] Wieder alleged he was subsequently terminated, insisting the firm report this misconduct.[163] The court found that the self-regulatory nature of the field of law warranted an exception to be carved out of the whistleblower protection statutes.[164] Similarly, in *Weiner*, the New York Court of Appeals held that plaintiff Wiener successfully persuaded the Court of Appeals. Since a provision in the McGraw-Hill's personnel handbook constituted an express promise within his employment contract that employee termination may only occur with "just and sufficient cause," Weiner's termination was improper.[165] In applying both *Wieder* and *Weiner* simultaneously, the deficiency of both cases may be resolved and still be palatable to the courts concerned of changing their respective state at-will employment doctrines, by only expanding the exception, which would not amend the scope of the overarching whistleblower protection statutes.[166]

Most critically, the current courts must continue to produce a culture of compliance. This issue is not only affecting RIAs/RICs, but also the livelihoods of the CCOs who Congress mandated to be safeguards between the average investor and corrupt securities practices.

VII. THE DISSENT V. THE MAJORITY

While the majority in *Digital Realty Trust Inc.* and *Sullivan* accurately interpreted the black letter law of the Whistleblower Protection statutes, the courts failed to follow the spirit of the statutes, and ignored the fundamental reasons for its existence.[167] The Whistleblower Protection Act was drafted to promote compliance with federal securities laws, such as Rule 206(4)-7.[168] As such, courts should prioritize that fundamental idea when considering whether exceptions to the Whistleblower

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162 Wieder v. Skala, 80 N.Y.2d 628, 631-32 (1992).
163 *Id.* at 632.
164 *Id.* at 638-39.
165 Weiner v. McGraw-Hill, Inc., 57 N.Y.2d 458, 465-67 (N.Y. 1982).
166 Runne, *supra* note 160, at 1292.
167 Digital Realty Trust Inc. v. Somers, 138 S. Ct. 767, 777-78 (2018); Sullivan v. Harnisch, 19 N.Y.3d 259, 265 (2012).
168 *See Information on Whistleblower Protection Act and Whistleblower Protection Enhancement Act*, *supra* note 95.

Protection Act should be carved out. The courts in both *Digital Realty Trust Inc.* and *Sullivan* erred in declining to create such exceptions.

In *Digital Realty Trust Inc.* and *Sullivan*, the majority found that additional exceptions should not be carved out of the Whistleblower Protection Act.[169] Although exceptions have been carved out for attorneys and auditors, the court in *Sullivan* reasoned that those industries promote self-regulation and are thus different from the compliance industry.[170] The court in *Sullivan* concluded that the legal profession had a unique function of self-regulation, and these unique qualities were missing from the financial industry.[171]

One does not need to look far to see that courts were likely misguided in finding that the compliance industry is not self-regulated. Rule 206(4)-7 and Rule 38a-1, in mandating RIAs/RICs designate a CCO who is responsible for administering the compliance procedures, essentially required that the financial industry begin taking steps towards self-regulation.[172] In doing so, both rules created proactive measures rather than reactive measures.[173] Instead of fostering an environment where the SEC would wait for securities law violations to occur, the federal government created proactive measures mandating that the industry take steps towards self-

[169] *Sullivan*, 19 N.Y.3d at 265; *Digital Realty Trust Inc.*, 138 S. Ct. at 780.

[170] *Sullivan*, 19 N.Y.3d at 263-64; Mullins, *supra* note 156; Runne, *supra* note 160, at 1278-80; *see* W. William Hodes, *Truthfulness and Honesty Among American Lawyers: Perception, Reality, and the Professional Reform Initiative*, 53 S.C. L. REV. 527, 537 (2002) ("Unless the organized bar cleans its own house, sooner or later government agencies will remove the unique measure of self-regulation granted to the legal profession"); Abraham C. Reich & Michelle T. Wirtner, *What Do You Do When Confronted with Client Fraud?*, 12 A.B.A. BUS. L. SEC. (2002), http://apps.americanbar.org/buslaw/blt/2002-09-10/reichwirtner.html ("If the profession fails to adequately police itself, our government will enact legislation that not only polices lawyers, but extends liability for corporate governance fiascos."); *Kenneth M. Rosen, Lessons on Lawyers, Democracy, and Professional Responsibility*, 19 GEO. J. LEGAL ETHICS 155, 167 (2006) ("Yet if lawyers are unwilling to recommit themselves to the regulation of their profession and their responsibilities to society, one might expect additional regulations"); Ted Schneyer, *An Interpretation of Recent Developments in the Regulation of Law Practice*, 30 OKLA. CITY U. L. REV. 559, 569 (2005) (noting that "state supreme courts and general-purpose bar associations do not consider 'self-regulation' moribund" and citing instances in which "[t]hey continue, often with ABA support, to resist federal 'intrusions.'").

[171] *Sullivan*, 19 N.Y.3d at 264.

[172] 17 C.F.R. 275.206(4)-7 (2018); 17 C.F.R. 270.38a-1 (2018).

[173] 17 C.F.R. 275.206(4)-7; 17 C.F.R. 270.38a-1.

regulation in order to prevent these violations from occurring.[174] As a result, CCOs are not only employees of the RIAs/RICs, but are also gate-keepers between their employers and the federal government.

In addition, although CCOs do not necessarily regulate other CCOs, they are a vital piece of the self-regulatory scheme of the financial industry.[175] As ethics and compliance functions become more integrated into corporations, CCOs take on a much more strategic role when managing reputational risk and compliance.[176] Many organizations have started to recognize that the risks that CCOs mitigate and proactively avoid are critical.[177] As a result, CCOs must have instincts for what can go wrong and know how their respective employers can prepare and avoid federal law violations in addition to having an understanding a full range of reputational risks.[178]

If courts continue to allow CCOs to be discharged for attempting to avoid securities law violations, as the dissent in *Sullivan* stated, "managers will be given carte blanche to terminate the very employees who are charged with the statutorily mandated role of ensuring ethical and legal obligations" in addition to halting the industry's strides towards self-regulation.[179] As a result, the holdings in *Digital Realty Trust Inc.* and *Sullivan* are a direct threat to the fundamental purpose for which CCOs were mandated by the federal government, which was to assure the compliance of Federal securities law. Thus, the majority in both cases erred in limiting the whistleblower protection statutes to only those individuals who first report federal securities law violations to the SEC.

Although the dissent in *Sullivan* was correct in reaching the conclusion that compliance officers and CCOs would be frightened of expressing their concerns of internal fraud, a supporter of the

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174 17 C.F.R. 275.206(4)-7; 17 C.F.R. 270.38a-1.
175 *Sullivan*, 19 N.Y.3d at 263-264.
176 DELOITTE, THE CHIEF COMPLIANCE OFFICE: THE FOURTH INGREDIENT IN A WORLD CLASS ETHICS AND COMPLIANCE PROGRAM 2-3 (2005).
177 *See id.*
178 *Id.*
179 *Sullivan*, 19 N.Y.3d at 266 (Lippman, J., dissenting).

majority's opinion may argue that an expansion of the Whistleblower Protection Act to internal disclosures may be an overreach by the courts.[180] As a result, I will provide a solution, which rather than expanding the whistleblower protection statutes would instead give greater latitude to the SEC to expand the required disclosure forms for public companies.

VIII. SOLUTION

A potential solution would be to employ the required 8-K disclosure form in order to protect CCOs working in public companies from being discharged due to a disagreement relating to the registrations operations, policies or practices that may violate securities law. Form 8-K is required to be filed when directors or principals depart from the company under Item 5.02.[181] For example, pursuant to Item 4.01 of the 8-K disclosure form, public companies must disclose hiring changes regarding the company's certifying accountant, which includes the reason for the change.[182]

Furthermore, the 8-K has been a tool to update investors on intercompany disagreements such as in *In the Matter of Hewlett-Packard Company*.[183] *In the Matter of Hewlett-Packard Company* involved a leak of information from Hewlett-Packard Company's ("Hewlett-Packard") Board of Directors.[184] One director, who did not leak the information, but did not agree with the procedures Hewlett-Packard used in the investigation of the board, resigned.[185] In the press release and in the company's 8-K, Hewlett Packard disclosed that the board member resigned but did not disclose the reasons for the director's resignation.[186] As a result, the SEC addressed the question of whether Hewlett-Packard was required to disclose in the 8-K, the reasons for the resignation.[187] The SEC found that this differing of opinions regarding the investigation fell under "corporate governance", and thus, a part

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180 *See id.* at 265-66.
181 Current Report (Form 8-K) 15.
182 *See id* at 13.
183 *See* Hewlett-Packard Company, Exchange Act Release No. 55801 (May 23, 2007).
184 *Id.* at 2.
185 *Id.* at 3.
186 *Id.* at 4.
187 *Id.*

of the required disclosure.[188] Pursuant to Item 5.02 of Form 8-K, if a director quits or is fired due to a disagreement with policies, operations, or practices, those disagreements must be disclosed in the 8-K.[189] As a result, the SEC found that Hewlett Packard was required to disclose that the director resigned due to the disagreement of how the "leak investigation" was being conducted.[190]

A. APPLIED

One potential solution would require public companies to disclose, through 8-K disclosures, when CCOs are discharged due to a disagreement relating to the employer's operations, policies or practices which the CCO believed violated federal securities law, as well as the reasons for the termination.

Mandating public companies to disclose these facts will likely reduce the number of companies attempting to remain in the shadows while violating federal securities laws by firing those CCOs who suggest compliance. Public companies will have to inform the investors, through the 8-K disclosure, that the CCOs suggested methods of compliance were rejected and that the RIA/RIC retaliated against them. Consequently, in applying the efficient market hypothesis, publicly-traded RICs/RIAs who retaliate would be fearful that this 8-K disclosure would quickly lead to a correction in the market, leading to a lower stock price due to possible impending regulatory action.[191] As a result, instead of risking potential litigation brought by class actions for securities violations and/or

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[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 30-31 (Foundation Press 4th ed. 2015). The efficient market hypothesis assumes that investors have rational expectations and that security prices reflect all available information. *Id.* Since share prices instantly reflect all the available information, then tomorrow's prices, independent of today's prices, will only reflect tomorrow's news. Thus, news and price changes are unpredictable. Therefore, according to this theory, both a novice and expert investor, holding a diversified portfolio, will obtain comparable returns regardless of their varying levels of expertise. *Id.*

falling share prices, more companies would likely avoid discharging the CCOs who rightfully suggest compliance.[192]

i. Burden Shift

Critics may conclude that implementing this disclosure solution may instill fear in companies and overly restrict them from firing CCOs at all. After a CCO recommends a particular path forward to bring the company into compliance with securities regulations, the company may feel barred from firing the CCO for other meritorious issues. A CCO may claim that they were retaliated against due to their recommended compliance program, which many would agree should not be a dischargeable offense. Another possible solution would be implementing an HR policy which creates a presumption that there any ensuing firing within one fiscal quarter was retaliatory. Under this system, firing a CCO after a compliance recommendation was made would carry the presumption of retaliation from the date of the compliance disagreement until the fiscal quarter ends. After the fiscal quarter ends, however, the company may discharge the CCOs without the above presumption.

Furthermore, if the CCO is discharged after that fiscal quarter and believes the termination was a retaliatory, the RIA/RIC may still be required to include the CCO's dismissal in the 8-K. A shareholder may file a complaint with the SEC against the RIA/RIC, for the RIA/RIC to include the CCO's dismissal in the 8-K. If the SEC concludes that there is "clear and convincing evidence" that the CCO's dismissal was retaliation by the employer, the RIA/RIC will be required to amend the respective 8-K to include the disagreement relating to the registrations operations, policies or practices that may violate Federal securities laws. The "clear and convincing evidence" threshold

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[192] Market sentiment is one major factor in why stock prices move up or down. *Forces That Move Stock Prices*, INVESTOPEDIA, https://www.investopedia.com/articles/basics/04/100804.asp (last updated Aug. 5, 2018). If an investor feels that a company wrongfully terminated a CCO for raising a potential securities violation, while there may be little change in the company's actual valuation, the company's stock price may be pushed down further than expected. *Id.*

would require the SEC to find there is enough evidence that a reasonable mind would conclude that it is substantially more likely than not, that the employer retaliated again the CCO.[193] Under these circumstances, both shareholders and CCOs would have an opportunity to challenge the accuracy of the 8-K, and would discourage or limit an entity's incentives to terminate a CCO for unjust reasons. Additionally, the RIA/RIC will be adequately protected through the SEC's "substantial likelihood" threshold test.

ii. Costs Associated with the Disclosure

Critics may argue that this solution would be too expensive for public companies to implement. To the contrary, there are substantial arguments in a favor of mandatory disclosures and its desirability in terms of costs.[194] First, the more information a company discloses, the more efficiently investors can evaluate how well the company and the management are taking advantage of the opportunities available.[195] In the absence of adequate required disclosures, managers may focus on improving the performance indicators that are observable by investors even when improving these measures do not improve the financial health of the company or create any real value.[196]

With increased disclosures, investors would also not have to rely on opaque signals of company health, as disclosures also improve the price accuracy of a company's securities.[197] Improved accuracy of the securities reduces agency costs by providing investors with a more reliable indicator of not only manager performance, but also the value of company.[198] In addition to reducing agency

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193 *Evidentiary Standards and Burden of Proof*, JUSTIA, https://www.justia.com/trials-litigation/evidentiary-standards-burdens-proof/ (last visited Dec. 1, 2018).
194 John H. Runne, *supra* note 160, at 133-36.
195 *Id.*
196 *Id.*
197 *Id.; See* S.E.C. v. W.J. Howey & Co., 328 U.S. 293, 301 (1946) (finding that a security is present where a person or entity: (1) invests money; (2) in a common enterprise; (3) with the expectation of profits; (3) which are derived solely form the efforts of others. This may include stocks, bonds, and partnerships in LLC's).
198 Runne, *supra* note 160.

costs, there are other benefits from increasing the accuracy of share prices, such as the reduction of uncertainties when a shareholder wants to sell shares.[199] Increased disclosure by a firm may also lower a company's cost when raising capital as well as improve the trading liquidity for the company's securities.[200]

IX. CONCLUSION

In *Sullivan* and *Digital Realty Trust Inc.*, the courts held that the Dodd-Frank Act's prohibition on employer retaliation against whistleblowers only extends to individuals who have reported the violations of securities directly to the SEC.[201] The decision by both courts was troubling. These holdings would not be detrimental to large corporations, but negatively impact shareholders and individual CCOs who may be unsure if they should report any compliance concerns to executive management.[202] If the courts will not expand the statutory interpretation of both Dodd-Frank and the Sarbanes-Oxley Whistleblowers Protection Statutes, then the SEC should be given the right to expand the required 8-K disclosure form. This solution would protect CCO's working in public companies from being discharged due to a disagreement relating to the registrations operations, policies or practices relating to Federal compliance laws, and as a result, promote compliance with Federal securities law as well as increase shareholder transparency.

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199 *Id.*

200 *Id.* Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. *Liquidity*, INVESTOPEDIA, https://www.investopedia.com/terms/l/liquidity.asp (last updated Aug. 4, 2018). Market liquidity refers to the extent to which a market, such as a country's stock market or a city's real estate market, allows assets to be bought and sold at stable prices. *Id.* Cash is considered the most liquid asset, while real estate, fine art and collectibles are all relatively illiquid asset. *Id.*

201 Sullivan v. Harnisch, 19 N.Y.3d 259, 265 (2012); Digital Realty Trust Inc. v. Somers, 138 S. Ct. 767, 782 (2018).

202 Aguilar, *supra* note 5 ("While I respect the views of my fellow Commissioners, based on what I'm hearing from the CCO community, the dissent, and the resulting publicity, has left the impression that the SEC is taking too harsh of an enforcement stance against CCOs, and that CCOs are needlessly under siege from the SEC.").