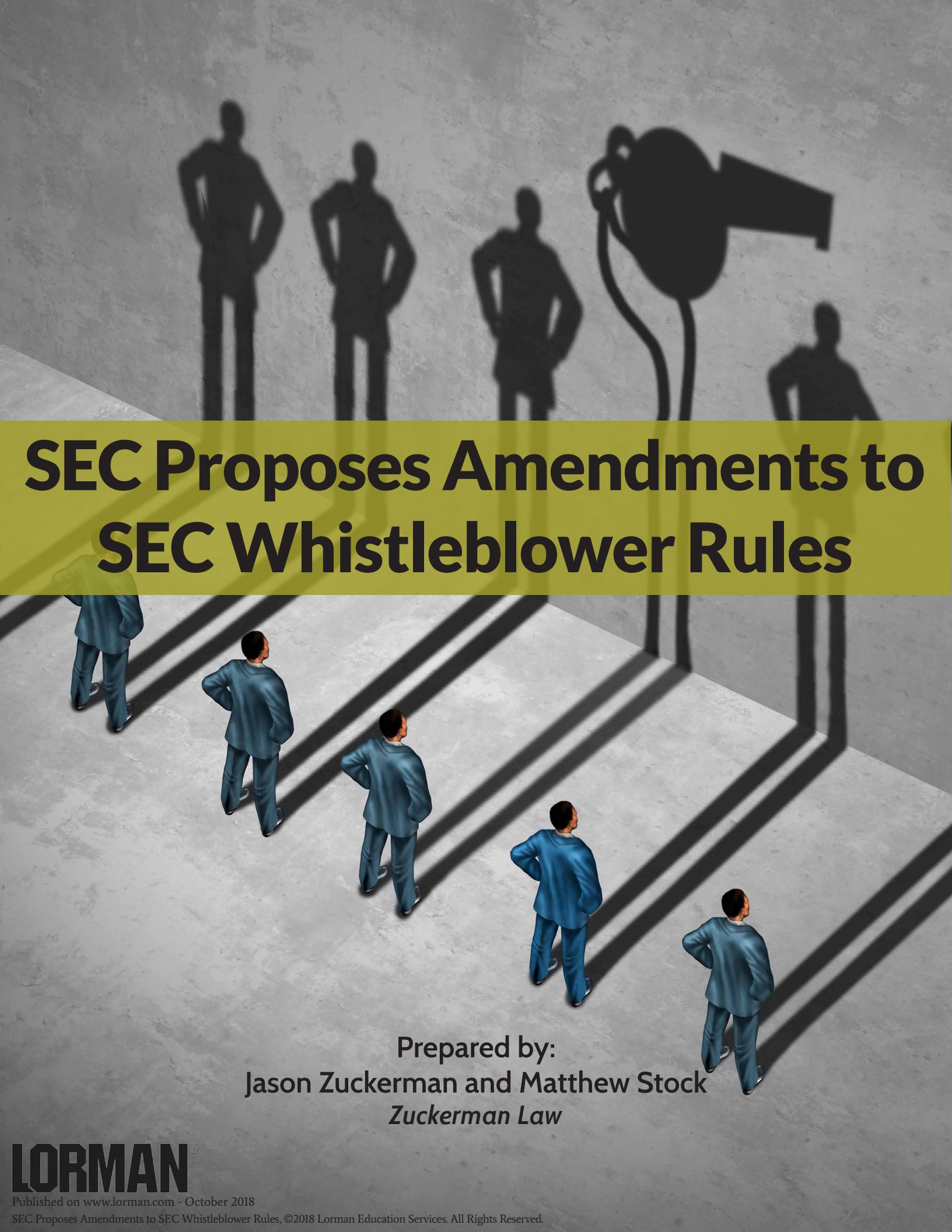

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SEC Proposes Amendments to SEC Whistleblower Rules

Written by Jason Zuckerman and Matthew Stock – 8/7/18

On June 28, 2018, the U.S. Securities and Exchange Commission (SEC) announced proposed amendments to the rules governing the SEC Whistleblower Program. Many of the proposed amendments strengthen incentives for whistleblowers to come forward, but a proposed discretionary $30 million cap on awards could deter whistleblowers from reporting the most pernicious fraud schemes.

SEC Whistleblower Program

In 2010, Congress passed the *Dodd–Frank Wall Street Reform and Consumer Protection Act* (Dodd–Frank) in response to the financial crisis of 2008. Among other things, Dodd–Frank created the SEC Whistleblower Program to encourage whistleblowers to expose violations of the U.S. federal securities laws and prevent another financial crisis. Under the program, the SEC will issue awards to eligible whistleblowers who provide original information that leads to successful enforcement actions with total monetary sanctions (penalties, disgorgement, and interest) in excess of $1 million. A whistleblower may receive an award of between 10% and 30% of the monetary sanctions collected.

In its short history, the SEC Whistleblower Program has proved to be an unmitigated success in enabling the SEC to discover fraud, protect investors, and prevent another financial crisis. Since 2011, the SEC Office of the Whistleblower has received more than 22,000 tips, some

of which led to enforcement actions resulting in more than $1.4 billion in financial remedies from wrongdoers. As of March 2018, the SEC Whistleblower Office has paid more than $266 million in awards to whistleblowers. The largest SEC whistleblower awards to date are $50 million and $33 million. Indeed, during the public meeting announcing the proposed rules, all the Commissioners commended the success of the SEC Whistleblower Program (see below).

Proposed Amendments to the SEC Whistleblower Rules

During a June 28, 2018 public meeting, the SEC voted 3-2 to propose amendments to the SEC Whistleblower Program's rules. While many of the amendments will strengthen whistleblower incentives and further the program's purpose, some of the amendments may undercut the program and deter whistleblowers from reporting the biggest frauds.

Authorizing Upward Adjustments of Whistleblower Awards

Under Rule 21F-6, the SEC considers several factors to determine the amount of an award. Based on an analysis of these factors, the SEC may increase or decrease a whistleblower's award percentage. Positive factors that can increase an award include:

1. the whistleblower's participation in internal compliance programs;
2. the degree of assistance provided by the whistleblower and their attorney;
3. the SEC's interest in deterring the specific violation; and
4. the significance of the information provided by the whistleblower.

A proposed amendment to Rule 21F-6 would authorize the Commission, in certain circumstances, to adjust a whistleblower's award upward when the potential award would yield a payout of less than $2 million for the whistleblower. The objective of this proposed amendment is to promote "the program's objectives of rewarding meritorious whistleblowers and sufficiently incentivizing future whistleblowers who might otherwise be concerned about the low dollar amount of a potential award."

As 60% of SEC whistleblower awards to date have been less than $2 million, this proposed amendment is a positive step forward in encouraging whistleblowers to report violations that could cause significant harm to retail investors but might not result in significant monetary sanctions.

Granting the SEC More Discretion to Issue Awards

Under Rule 21F-3, the SEC is only authorized to pay an award to an eligible whistleblower or whistleblowers who voluntarily provide the Commission with original information that leads to the successful enforcement action resulting in collected monetary sanctions in excess of $1 million. "Original information" does not include information that is generally known or available to the public.

The SEC is soliciting public comment on whether it should create a discretionary award mechanism for enforcement actions that result in total monetary sanctions of *less* than $1 million, are based on publicly available information, or where the monetary sanctions collected are de minimis. We favor creating such a mechanism to reward whistleblowers who assist the SEC in achieving its mission and take significant risks coming forward.

Discretionary Award Cap

A somewhat controversial proposal would give the SEC discretion to reduce an award that would exceed $30 million. Where a covered action yields collected monetary sanctions of at least $100 million, the proposed rules would give the SEC discretion to reduce the award percentage so that it would yield an award "that does not exceed an amount that is reasonably necessary to reward the whistleblower and to incentivize other similarly situated whistleblowers." The SEC would not, however, have discretion to award less than 10% of the collected sanctions (the minimum award percentage set forth in the statute). Among other factors that the SEC would take into account to determine whether to reduce an award over $30 million are "the value of the whistleblower's information and the personal and professional sacrifices made in reporting the information." It is indeed important to consider a whistleblower's professional sacrifices because a whistleblower reporting a massive fraud could suffer blacklisting in their profession, thereby losing substantial compensation that they would have earned had they not come forward. In other words, the future earnings that a whistleblower might forfeit could well exceed the value of a whistleblower award.

During the June 28, 2018 public meeting, Commissioners Jackson and Stein strenuously opposed this proposed discretionary award cap and voted against it. Commissioner Stein's written statement about the proposed rules offers several compelling reasons why the SEC should decline to impose a cap on awards:

- The broad discretion to reduce an award could be "used as a means to weaken the Whistleblower Program."

- There is no evidence that awards are too high and the SEC has not assessed how a $30 million threshold would affect the incentives or behavior of whistleblowers.

- Whistleblower awards are paid from an account funded by the monetary sanctions the Commission collects from wrongdoers, not by taxpayers. "[T]he amount of money the Commission has sent to Treasury alone as a direct result of whistleblower tips far exceeds the $266 million provided to whistleblowers for bringing wrongdoing to light. Simply put, the Whistleblower Program has more than paid for itself. There are not many government programs that can make that claim."

- The Whistleblower Program embodies good government. "It incentivizes the private marketplace to better surveil itself and has resulted in the government bringing cases against fraudsters it might not have otherwise discovered. Incentivizing market participants and others to provide information about wrongdoing has helped protect more investors, preserve the integrity of our capital formation process, and ensure that our markets are fair and efficient. In many ways it has aligned incentives so that the government is able to use its scarce resources in a more efficient manner."

Eliminating Double Recoveries

Under Rule 21F-3, the SEC will pay an award to a whistleblower who voluntarily provides original information that leads to a successful "related action" if the action is based on the same original information that the whistleblower provided to the SEC and led the SEC to recover monetary sanctions totaling more than $1 million. A "related action" is defined as a judicial or administrative action brought by:

1. the Attorney General of the United States;
2. an appropriate regulatory authority;
3. a self-regulatory organization; or

4. a state attorney general in a criminal case.

A proposed amendment to Rule 21F-3(b)(4) would modify the definition of "related action" to prevent multiple recoveries for the same information from different whistleblower programs, which would reflect the current approach of the SEC and the Claims Review Staff. If a judicial or administrative action is subject to a separate monetary award program, the SEC will deem the action a related action "only if the Commission finds (based on the unique facts and circumstances of the action) that its whistleblower program has the more direct or relevant connection to the action." That analysis would hinge on the following factors:

- The relative extent to which the misconduct charged in the potential related action implicates the public policy interests underlying the federal securities laws (such as investor protection) versus other law-enforcement or regulatory interests (such as tax collection or fraud against the Federal Government);
- The degree to which the monetary sanctions imposed in the potential related action are attributable to conduct that also underlies the federal securities law violations that were the subject of the Commission's enforcement action; and
- Whether the potential related action involves state-law claims and the extent to which the state may have a whistleblower award scheme that potentially applies to that type of law-enforcement action.

This proposed rule reduces the incentive to come forward where a whistleblower award under another whistleblower-reward program would be insufficient to justify the risk entailed in blowing the whistle. For example, if a whistleblower at a financial institution reports bank fraud that results in the U.S. Department of Justice (DOJ)

taking an enforcement action under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the SEC taking an enforcement action for securities fraud, the whistleblower's recovery would be limited by the $1.6 million FIRREA cap and the whistleblower would be ineligible to obtain a larger whistleblower award from the SEC (unless the whistleblower could show that the predominant violation that they reported is securities fraud).

Authorizing Awards Based on DPAs and NPAs

The current rules do not clarify whether a "related action" eligible for a whistleblower award includes deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) entered into by the DOJ or a state attorney general in a criminal case, or a settlement agreement entered into by the SEC outside of the context of a judicial or administrative proceeding to address violations of the securities laws. Therefore, if the DOJ or a regulatory agency elect to take enforcement action that is not a judicial or administrative action, the whistleblower could be deemed ineligible for an award. A proposed amendment to Rule 21F-4(d) would clarify that "administrative actions" encompass DPAs and NPAs, and that the money paid under such arrangements would be deemed "monetary sanctions." As DPAs and NPAs are often used in DOJ's criminal enforcement of the Foreign Corrupt Practices Act, this amendment to the rules could increase the incentive for whistleblowers to report foreign bribery.

Clarifying the Scope of Dodd-Frank Whistleblower Protection

The SEC is also updating the rules governing the whistleblower program to clarify the scope of the anti-retaliation provision of Dodd–Frank. In February 2018, the Supreme Court held in *Digital Realty*

Trust, Inc. v. Somers that Dodd–Frank whistleblower protection extends only to employees that have reported a possible securities law violation to the SEC. The proposed rule would also clarify that Dodd–Frank whistleblower protection extends to any employee reporting information about possible securities laws violations to the Commission "in writing," regardless of whether the employee submitted a whistleblower tip to the SEC Whistleblower Office using Form TCR.

Whistleblowers that disclose potential securities law violations, bank fraud, mail fraud, or wire fraud internally (e.g., to a supervisor or an internal compliance program) continue to be protected against retaliation under the whistleblower protection provision of the Sarbanes-Oxley Act.

Fostering Efficiency in the Whistleblower Claims Review Process

Due to limited resources and a high volume of award application, the SEC is proposing amendments to the Claims Review Process that would give the Whistleblower Office more discretion to avoid expending precious resources on frivolous claims.

Proposed amendments would allow the SEC to bar individuals from submitting award claims where they are found to have submitted false information to the Commission, as well as to afford the Commission the ability to permanently bar individuals who repeatedly abuse the process by submitting frivolous award claims. In addition, the proposed amendments would authorize a "summary disposition procedure" for certain types of likely denials, such as untimely award applications.

Proposed Guidance to Clarify "Independent Analysis"

To be eligible for an award, a whistleblower's tip must be original information that is derived from the whistleblower's "independent knowledge" or "independent analysis." As defined in Rule 21F-4, "independent analysis" is "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public."

The SEC proposes to modify this definition to require a whistleblower to show that their submission provided "evaluation, assessment, or insight beyond what would be reasonably apparent to the Commission from publicly available information." In reviewing an application for an award based on independent analysis, the SEC would determine "whether the violations could have been inferred from the facts available in public sources."

The ambiguity of this new standard could deter whistleblowers from reporting violations that would otherwise go undetected. As noted by Commissioner Jackson, "When whistleblowers take these risks for the benefit of all investors, what they need from us is certainty."

Success of the SEC Whistleblower Program

Although the Commissioners disagree about whether to impose a discretionary cap on awards, they all agree that the SEC Whistleblower Program is a critical tool to detect and combat fraud:

- Commissioner Clayton noted in his statement: "The Commission's whistleblower program has contributed significantly to our ability to detect wrongdoing and better protect investors and the marketplace, particularly where fraud is well-hidden or difficult to detect. As we continue our pursuit

of enforcement initiatives focused on misconduct that impacts the retail investor, the strength of our whistleblower program is a critical component in our investor protection toolbox."

- Commissioner Stein noted in her statement: "It incentivizes the private marketplace to better surveil itself and has resulted in the government bringing cases against fraudsters it might not have otherwise discovered. Incentivizing market participants and others to provide information about wrongdoing has helped protect more investors, preserve the integrity of our capital formation process, and ensure that our markets are fair and efficient. In many ways it has aligned incentives so that the government is able to use its scarce resources in a more efficient manner."

- Commissioner Jackson noted in his statement: "Whistleblowers are crucial to our enforcement efforts, and experts of all stripes have said that this program—which rewards those who make the difficult decision to come forward to help us expose fraud—is among our Staff's most successful endeavors."

- Commissioner Piwowar noted in his statement: "Each of these whistleblowers provided the Commission with valuable information and often extensive assistance that enabled us to bring successful enforcement actions in cases that we might not have uncovered on our own."

- Commissioner Peirce noted in her statement: "The SEC's Whistleblower Program is a critical part of our enforcement program . . . The most important part of our Whistleblower Program, of course, is the whistleblowers themselves, who bring to our attention securities law violations that otherwise might not come to light for years or even forever. They sometimes do so at great risk to themselves and their careers. Whistleblower awards offset some of those losses and, therefore, can help to encourage people to come forward. As of last year, information provided by whistleblowers to the SEC has resulted in wrongdoers paying over $975 million in total monetary sanctions, much of which has been paid back to victims."

The strong and unanimous consensus supporting whistleblower incentives suggests that whistleblowers will continue to play a critical role in enabling the SEC to protect investors and hold fraudsters accountable.

To learn more about the SEC Whistleblower Program, download the eBook: *SEC Whistleblower Program: Tips from SEC Whistleblower Attorneys to Maximize an SEC Whistleblower Award*.

To learn more about the SEC Whistleblower Process: https://www.youtube.com/watch?v=LL53mLT14Rc