Top 10 Things You Need to Know About the SEC’s Whistleblower Program Under Dodd-Frank

Securities Enforcement Forum 2014
October 14, 2014
Christian R. Bartholomew

Partner, Jenner & Block, LLP
Washington, D.C. Office

Christian R. Bartholomew is a member of the firm’s Securities Litigation and Enforcement Practice. As a former undefeated trial lawyer for the Securities and Exchange Commission (SEC) with more than two decades of public sector and private practice experience, Mr. Bartholomew has successfully resolved regulatory and internal investigations and litigation matters on behalf of well-known financial institutions and public companies on virtually every securities-related issue confronting these clients. Recognized by Chambers USA as a leader in the area of the SEC’s whistleblower rules, Mr. Bartholomew has represented a number of prominent financial institutions and public companies in internal and regulatory investigations regarding sensitive whistleblower allegations. He has also advised companies on strengthening their internal protocols to incentivize internal reporting, and has written and spoken extensively on these issues.
1. Almost anyone can be a whistleblower, and it is easy to qualify (for bounty purposes).

- Employees, consultants, vendors, customers, counter-parties, even competitors and their employees can be whistleblowers
  - Very first award given under the program was to an outside consultant.

- Officers, directors, lawyers, compliance personnel, internal auditors, and outside accountants generally cannot be whistleblowers absent special circumstances

- Last month, SEC made first award ($300,000) to a “compliance professional who first reported wrongdoing internally to a supervisor”
  - After company took no action within 120 days, compliance official went to SEC, which led to enforcement action with sanctions over $1 million

- Whistleblower merely needs to provide “original information” about violation of federal securities laws that has occurred, is ongoing, or is about to occur that leads to a successful enforcement action in which the SEC obtains $1 million or more in sanctions

- But note that, when it comes to retaliation issues, the situation is much less clear (See # 7)
2. There is a lot of money at stake.

- Whistleblower can be awarded between 10% to 30% of monies recovered in both an SEC action as well as in any “related” action, e.g., a joint SEC-DOJ FCPA investigation:
  - Last week, the SEC announced award of “more than $30 million” to whistleblower who provided key information in an enforcement action that appears to have been a joint SEC/DOJ effort
  - SEC made also $14 million award last September 2013
  - SEC has listed more than 400 cases and about $450 million as being available for whistleblower awards
3. The SEC is receiving thousands of tips and has made fourteen awards in nine different cases

- In most recent annual report (for FY13), SEC reported 3,238 tips, an increase of approximately 8% from 2012
  - SEC officials have indicated that the program is about on track for same amount of tips for FY14
- SEC has made 14 awards in 9 different cases totaling just over $46 million
  - Two largest awards ($14 million and $30 million) obviously account for most of this
- Dodd-Frank requires SEC to honor anonymity of whistleblower so awards have been heavily redacted: no info re name/identity/position of whistleblower or case or what info provided
- See chart summarizing awards
4. The program is undoubtedly helping the SEC’s enforcement program; the question is, how much?

- Biggest question so far is how many of the thousands of tips the SEC is getting are real and result in formal, full-fledged investigations.

- SEC Inspector General January 2013 review found that 69% of sampled tips deemed to require “No Further Action” (“NFA”) by staff after initial review. SEC officials have informally indicated this metric is about right across the board, and that only small percentage of tips end up resulting in actual settled or litigated cases.

- Given that the SEC is receiving over 3,000 whistleblower tips a year, it seems quite likely that more than 70% of these end up being deemed NFA or unmeritorious. Indeed, if even 10% result in substantial investigations, that is a significant boost to the SEC’s investigative efforts.

- SEC is also grappling with how to deal with serial tipsters providing frivolous or false information. In May 2014, SEC banned one repeat offender from the whistleblower program who had submitted close to 300 meritless tips.
5. Whistleblowers can go directly to the SEC — they are not required to raise their concerns internally first.

- Despite intense pressure from business community, SEC rules do NOT require whistleblowers to first report internally

- SEC has said publicly that, in its experience, most whistleblowers indicate—on the required SEC form—that they in fact did report internally. SEC officials have also elaborated that, anecdotally, most of these internal reports have been to management, rather than to internal audit, compliance or legal

- Despite these statements, only one award to date indicates that whistleblower first reported internally
  - July 31, 2014, $400,000 award; Head of the Whistleblower Office, Sean McKessy, quoted as saying “[t]he whistleblower did everything feasible to correct the issue internally” and justified the size of the award in part because of the initial internal reporting
6. The SEC rules provide incentives for whistleblowers to report internally, but it remains to be seen whether these incentives will be effective.

- To balance decision not to require internal reporting, SEC rules create protections and incentives for those who do so:
  - Protection:
    - 120-day grace period: so long as report to SEC within 120 days of internal report, will be considered first in line
  - Incentives:
    - in determining where on the 10-30% range the award will fall, SEC will consider whether whistleblower cooperated with internal compliance and reported internally
    - whistleblower who reports internally can be eligible for all of the sanctions resulting from the company’s internal investigation even where her initial tip was much more limited

- Given opacity of awards, very difficult to tell if these protections/incentives are working.
7. The anti-retaliation provisions are even broader than the bounty provisions, and have been the subject of significant litigation.

- Rules explicitly prohibit retaliation against anyone who makes a whistleblower complaint even where complaint does not result in SEC enforcement action and/or employee does not win award; employee must only have a “reasonable belief” that a “possible violation” has occurred, is ongoing or is about to occur in order to be protected.

- Substantial litigation as to who qualifies for this protection:
  - Most district courts hold that whistleblower who makes internal report is protected so long as information is ultimately reported to the SEC
  - Fifth Circuit held that such “second-hand” reporting is insufficient, whistleblower must report directly to the SEC
  - Both the Second and Eighth Circuits have declined to address issue
    - Second Circuit decided Siemens case on other grounds (i.e., foreign whistleblowers reporting foreign conduct not covered);
    - Eighth Circuit declined to hear an interlocutory appeal finding that whistleblower provisions applied to whistleblower who only reported misconduct internally.

- The Supreme Court, just last term, reversed a First Circuit decision finding that employees of private contractors for public companies are not covered by certain of the anti-retaliation provisions of SOX.
8. The SEC Brought Its First Anti-Retaliation Case This Year.

- Under Rules, SEC is empowered power to bring enforcement action against any entity (but not a person) that retaliates against a whistleblower.
- SEC officials pounded this drum for more than a year and brought first case in July 2014
  - *In re Paradigm Capital Management, Inc.*—involved NY investment advisor/hedge fund.
    - Head trader involved in allegedly illegal trading reported to SEC and then told firm he had done so
    - Firm immediately removed him from trading desk, relieved him of supervisory duties, put him on leave; assigned him make work (manually reviewing trading data)
    - SEC found these actions effectively “marginaliz[ed]” the whistleblower
    - Hedge fund and individual owner settled the case and paid disgorgement and penalties of $2.2 million
  - The case highlights the difficulties firms face when learn of a whistleblower (or potential whistleblower) who is also culpable in the underlying misconduct
    - Firms must tread carefully here: cannot be seen to retaliate for the whistleblowing, but must still take action to prevent future misconduct and discipline past misconduct
9. You cannot prevent people from being whistleblowers.

- SEC rules prohibit entities from binding employees, consultants, counter-parties, and others to confidentiality agreements that in any way limit the ability of such persons to report wrongdoing to the SEC. Issue has recently gotten much attention in area of severance agreements. Senior SEC enforcement officials have emphasized that they will look hard at such cases.
  - McKessy quoted as saying: “We are on the lookout for contracts, codes of conduct with this language. We are going to bring a case sooner rather than later. If you are an in-house lawyer drafting language saying you can’t come to the SEC, it’s not just the company that is in peril, you are too.”
- This summer, plaintiffs’ attorneys representing whistleblowers have asked the SEC to add additional protections for would-be whistleblowers, including making rules that protect whistleblowers who only report internally (see slide 7 for split in the courts) as well as added protections preventing employers from enforcing private agreements designed to limit the ability of current of former employees from disclosing information to the SEC.
10. Be very careful with anonymous whistleblowers.

- SEC rules permit whistleblowers to remain anonymous and SEC has gone great lengths to protect anonymity of the whistleblowers and did not identify them by position or function or provide any identifying information at all.

- Senior officials have expressed differing views on the extent to which firms can seek to communicate with such anonymous whistleblowers in efforts to understand the complaint being made, so firms should tread very carefully here.

- On related note, as indicated in prior slide, anonymity requirements have limited ability of public to understand how SEC is applying numerous nuances of the rules re, for example:
  - Internal reporting protections and incentives
  - Awards (or denials) to culpable whistleblowers
## SEC Whistleblower Awards to Date

<table>
<thead>
<tr>
<th>DATE</th>
<th>NUMBER OF CLAIMANTS</th>
<th>AMOUNT AWARDED</th>
<th>% of SANCTIONS AWARDED</th>
<th>NOTES</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/21/2012</td>
<td>1 Claimant</td>
<td>$200,000</td>
<td>30%</td>
<td>According to SEC release, WB provided “the exact kind of information and cooperation [the SEC was] hoping the whistleblower program would attract.” WSJ later reported that WB was an outside consultant. First payout was for $50,000; second payout was on April 2014 for $150,000.</td>
</tr>
<tr>
<td>6/12/2013</td>
<td>3 Claimants</td>
<td>$125,000</td>
<td>15% (5% to each Claimant)</td>
<td>Per SEC release, three WBs will receive 15% of $875,000, aggregate value of assets seized in the <em>Locust Offshore Mgmt.</em> sham hedge fund case, including sanctions recovered in a related criminal action.</td>
</tr>
<tr>
<td>9/30/2013</td>
<td>1 Claimant</td>
<td>More than $14 million</td>
<td>Unknown (10%)</td>
<td>SEC did not provide percentage amount of award but WSJ reported that award was related to scheme to defraud foreign investors seeking U.S. residency (<em>SEC v. A Chicago Convention Center, LLC, et al.</em>) in which $147M was returned to investors.</td>
</tr>
<tr>
<td>10/30/2013</td>
<td>1 Claimant</td>
<td>More than $150,000</td>
<td>30%</td>
<td>SEC release stated that WB “provided significant information that allowed the SEC to quickly open an investigation and obtain emergency relief before additional investors were harmed.”</td>
</tr>
<tr>
<td>6/3/2014</td>
<td>2 Claimants</td>
<td>$875,000</td>
<td>30% (split)</td>
<td>SEC release indicated that WB provided information enabling SEC to bring “a successful enforcement action in a complex area of the securities market.”</td>
</tr>
<tr>
<td>7/22/2014</td>
<td>3 Claimants</td>
<td>Unknown</td>
<td>30%</td>
<td>Award split 15%, 10%, and 5%; no SEC news release or articles.</td>
</tr>
<tr>
<td>7/31/2014</td>
<td>1 Claimant</td>
<td>More than $400,000</td>
<td>Unknown</td>
<td>WB’s claim was initially denied because had not come forward “voluntarily” in light of prior SRO inquiry; SEC reversed itself, determining that the whistleblower reported matter internally and “did everything feasible to correct the issue.”</td>
</tr>
<tr>
<td>8/29/2014</td>
<td>1 Claimant</td>
<td>More than $300,000</td>
<td>20%</td>
<td>First award to an audit and compliance professional. Head of SEC WB Office Sean McKessy: internal audit, compliance, and legal personnel are “on the front lines in the battle against fraud and corruption. . .these individuals may be eligible for an SEC whistleblower award if their companies fail to take appropriate, timely action on action information they first reported internally.”</td>
</tr>
<tr>
<td>9/22/2014</td>
<td>1 Claimant</td>
<td>Between $30-$35 million</td>
<td>Unknown</td>
<td>Largest award to date and the fourth award to a foreign whistleblower. McKessy: “Whistleblowers from all over the world should feel similarly incentivized to come forward with credible information about potential violations of the U.S. securities laws.”</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>14 whistleblowers in 9 cases</td>
<td>Between $46,050,000 and $51,050,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Notes:


Notes: (cont’d)


10. See Rule 21F-7.