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MEMORANUDUM

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Re: Analysis of the Amendments to the SEC Dodd-Frank Act Whistleblower Reward Regulations (Approved 9-23-2020)

On September 23, 2020, the U.S. Securities and Exchange Commission ("SEC") voted 3-2 to amend its current rules governing the Dodd-Frank Act ("DFA") whistleblower law. The DFA whistleblower law requires the Commission to pay rewards in the range of 10%-30% of any "sanctions" obtained by the SEC in administrative, civil or criminal enforcement proceedings. Sanctions also includes payments based on payments for disgorgement.

The following is an analysis of the major changes in the DFA award program approved by the Commission:

- *Limiting awards to whistleblowers in large fraud cases*. The Dodd-Frank Act mandated that rewards be paid at a minimum amount of 10% and a maximum amount of 30%. Proposed rule § 240.21F-6(d), set an arbitrary cap in large cases, directing the Commission to automatically pay awards at the lowest level (10%) when fines and penalties against fraudsters were large. The problems with this cap were explained in formal comments filed on October 21, 2019, December 10, 2019, January 16, 2020, and by Senator Charles Grassley, who also strongly opposed this change.

  The Commission voted, to eliminate this proposed rule. Thus, the proposal to reduce rewards in large cases was completely abandoned. This was a significant breakthrough for whistleblowers, as the Chamber of Commerce had strongly supported limiting rewards.

  However, during the Commission's public debate on this proposal the two Democratic Commissioners voiced strong opposition to an opinion issued by the SEC Office of General Counsel. During the discussion SEC General Counsel stated that under the current rules the Commission could take the size of an award into consideration when making a decision as to the amount of an award.

  The General Counsel's opinion is not supported by either the specific language in the Dodd-Frank Act, or in the current regulations [i.e. Rule 21F-6(b)that remain unchanged]. The DFA statute sets forth three criteria for setting an award amount (value of information provided; cooperation by the whistleblower; and the deterrent effect on potential fraudsters). The law also gives the Commission the right to create additional criteria for setting awards but requires that any applicable criteria be included in a formal "rule or regulation."

The SEC's current rules and regulations governing the DFA reward program *do not permit the Commission* to reduce the size of rewards based on the amount of compensation a whistleblower may be entitled to.

The current rules have very precise criteria for reducing the amount of a reward, and none of these criteria concern the overall size of an award. Thus, although the Commissioners debated this point in public, the controlling regulations apply, and large awards should not be reduced solely based on their size.

- *Increasing Awards in Small Cases.* The SEC approved a new rule, § 240.21F-6(c), that would result in the automatic increase of awards in small cases. Under the new rule if the amount of sanctions obtained in a case was $5 million or less, the Commission would automatically increase the size of the award and pay the award at the maximum 30% level. The Chairman of the Commission explained that most of the reward cases concern sanctions of $5 million or less, and thus this change would benefit a large number of whistleblowers. The automatic increase would not apply if a whistleblower engaged in negative factors which under the current rules would require a reduction in an award.

  Thus, if a whistleblower simply follows the rules, and does not engage in misconduct or unduly delay in reporting violations, he or she will be entitled to the maximum possible award in smaller cases. No Commissioner voiced any objection to this procedure.

  This new rule will encourage whistleblowers to come forward and will also speed up the claims decision-making process.

- *Barriers to qualifying for rewards (the TCR filing requirement)*. The proposed rule § 240.21F-9(e) created a barrier for whistleblowers to qualify for rewards. The proposed rule required whistleblowers to use a specific form when "first" informing the Commission of a violation. Aiming to codify the concept of "No form, no reward."

  In other words, if a whistleblower sent a letter to the Chairman of the Commission disclosing a fraud, and later filed the official whistleblower disclosure form, that whistleblower would be *automatically* excluded from obtaining a reward. This change would have disqualified a vast number of otherwise meritorious whistleblowers from the reward program. The problems with this proposed change were highlighted in comments filed on May 6, 2019, October 8, 2019, October 16, 2019, October 21, 2019, November 22, 2019, December 10, 2019, and December 23, 2019.

  Once identified by whistleblower advocates, the problems with this proposal became self-evident. Public policy dictates that whistleblowers should be encouraged to report violations quickly, and often informally. Requiring all whistleblowers to file a formal complaint *first* was counter-intuitive and counter to common sense practice.

The Commission modified this proposal, and in so doing clarified existing ambiguities in the current regulations.

The new rule states as follows:

A. To qualify for a reward, whistleblowers need to file the official complaint, known as a Form TCR. Filing this form not only helps qualify the whistleblower for compensation but also permits the Office of the Whistleblower to properly administer the thousands of complaints that are filed and place them into a computer system so various investigators can access the information. Thus, there was no opposition to the use of TCR forms. The opposition centered in the disqualification of whistleblowers who initially contacted the SEC outside the formal TCR process.

B. In order to obtain the statutory protections for anonymity or confidentiality provided under the DFA, whistleblowers must use the TCR form. Again, there are strong policies supporting the use of TCRs, and all clients should be strongly advised to file their information using this form.

C. Under the approved rule whistleblowers still must file TCR complaints. However, they are automatically given a 30-day grace period to file such complaints after initial contact with the SEC. This 30-day time period is subject to tolling, and only commences to run when a whistleblower obtains actual or constructive knowledge that a TCR form must be filed.

D. Importantly, the Commission specifically states that obtaining counsel in connection with an SEC submission constitutes constructive notice. In other words, from the moment one obtains counsel to report to the SEC, the clock begins to run on this 30-day grace period. *All attorneys who practice in this area must be aware of this requirement and ensure that whistleblowers file reward claim TCRs within 30-days of first contacting the lawyer. Whistleblowers must also be made aware of this requirement.*

The best practice is for counsel to ensure that whistleblowers file the form TCR either as their first communication with the SEC, or within the 30-day grace period. This will ensure that a whistleblower's filing will be fully reviewed by responsible SEC staff, that confidentiality and anonymity can be obtained, and that a whistleblower will not need to seek a waiver subject to the Commission's discretion. However, it is absolutely essential that whistleblowers file a TCR within 30-days of communicating with an attorney "in connection with an SEC submission."

- *<u>Ending protections for internal whistleblowers</u>*. Under the prior rule, the SEC could sanction a company if it retaliates against internal whistleblowers who report securities violations to corporate compliance programs, auditors, or in-house lawyers. The proposed rule, 240.21F-2(d), eliminated this authority and would permit companies to retaliate against internal whistleblowers without facing any sanction under the DFA. Detailed comments opposing the proposal were filed on July 24, 2018, October 21, 2019, December 10, 2019, and January 8, 2020.

The proposed rule was based on the Supreme Court decision in *Digital Reality v. Sommers,* where the Court fund that the definition of a "whistleblower under the DFA required direct contact with the SEC and did not include purely internal complaints. The Commission was urged to use its existing authority under the Sarbanes-Oxley Act (SOX) to maintain current protections. The Commission rejected these recommendations and stripped internal whistleblowers from all protections under the DFA.

Based on this rule change whistleblower lawyers should advise their clients to avoid internal compliance programs when raising concerns about securities law violations. Oddly, the U.S. Chamber of Commerce supported stripping internal whistleblowers of protections under the DFA and supported this rule change.

- *Restricting "related action" cases*. Under the prior rules, if a whistleblower's information results in a sanction issued by another federal law enforcement agency (such as the Justice Department) based on the whistleblower's original information that triggered the sanction. The proposed rule, § 240.21F-3(b)(4), would severely limit this authority. This is detailed in the comments filed on July 24, 2018, December 10, 2019, and September 10, 2020.

  Rule 21F-3(b)(4) was adopted without modification. This was a huge loss for whistleblowers and rewrites the related-action requirement by granting the SEC authority not to pay a related action award when it deems that the action is more "relevant" to another agency's award program.

  The original related action requirement incentivized whistleblowers to work with sister federal and state law enforcement agencies. It simply held that if a whistleblower's original information is used by one of these other agencies the whistleblower can also obtain an award of 10-30%. This recognized the fact that many securities investigations also implicate violations that other agencies have an interest in policing. It is one of the most important parts of the Dodd-Frank Act as it encouraged whistleblowers to fully cooperate with all enforcement actions.

  The Commission's new rule permits the SEC to deny related action awards when the Commission determines that another agency has a reward program. The problem with this proposal is two-fold: First, it violates the clear statutory requirements of the DFA. Second, there are numerous older award laws that have extremely low caps and or are completely discretionary. Thus, the new rule disincentivizes whistleblowers from cooperating with other law enforcement agencies.

In its decision to adopt 21F-3(b)(4), the Commission declined to recognize the statutory requirement that the agency "shall" pay 10-30% to whistleblowers when they assist in successful enforcement actions by other agencies.

The "related action" law is very clear. Practitioners should be aware that the actual discretion of the SEC to deny a related action award is very narrow and is subject to judicial review. Under the *Digital* precedent the SEC is bound by the statutory definition of a "related action" which is very broad.

- *Limiting Role of Analysts.* The current rule implements the Dodd-Frank Act requirements that "analysts" can qualify as whistleblowers. Although the SEC is not proposing to change this rule, they are recommending "guidance" to the staff that would severely limit who can qualify as an analyst. Read the letter submitted by several Senators opposing this change.

  Independent Analysis comes from whistleblowers who derive insights from publicly available information. This guidance would allow the Commission to deny a whistleblower an award if it could assert that there was any likelihood that the Commission would have arrived at the same conclusion without the analyst's assistance. Despite criticism of the obvious issues with such a subjective and hypothetical approach to determining the award worthiness of an analyst whistleblower, the Commission did not revise this guidance upon adoption of the final rule.

  While many may view the Commission's refusal to revise this guidance as a defeat, the important thing to note is that the instruction is simply guidance and not codified as a rule. Therefore, the Commission's application of the rules governing independent analysis may be disputed in the future and does not determine future outcomes. The explicit wording of the statute and the rules which were not amended will ultimately determine award eligibility for analysts. If an analyst is denied a reward under this new guidance, any such denial would be subject to judicial review.

- *Permitting Rewards in Cases where there is a Deferred Prosecution or Non-Prosecution Agreement*. The new rule, § 240.21F-4(d)(3), will explicitly support paying rewards in cases where a fraudster enters into a Deferred Prosecution Agreement or a Non-Prosecution Agreement. This amendment will clear up any ambiguity over the scope of the term "sanction" as used in the DFA.

Establishing Summary Judgment Procedures. Under the current rules any person can file a form with the SEC known as an APP application. This is the formal application for a reward. Because filing such applications is fairly simple, persons who clearly do not qualify for rewards have filed APP applications and delayed the award-granting process to fully qualified whistleblowers. The new regulations, § 240.21F-8(e) and 12F-18, provide the Commission with tools to summarily deny non-meritorious rewards. These proposals were non-controversial.