Pending Changes Pose Threat To SEC Whistleblower Program

By Stephen Kohn (September 21, 2020)

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On Sept. 23, all eyes will be on the U.S. Securities and Exchange Commission when the five commissioners vote on proposed changes to its current whistleblower program. These changes have been pending for over two years and sparked over 100,000 public comments in opposition to some of the commission's most radical changes.[1]

The stakes could not be higher. Currently, the whistleblower program has been successful well beyond what anyone could have imagined when it was enacted 10 years ago. The proof is in the pudding, as the SEC confirmed the program resulted in:

- $2.5 billion obtained from fraudsters, with many more billions on the way;
- $750 million returned to harmed investors; and
- $500 million paid to whistleblowers who risked their careers or suffered terrible retaliation to serve the public interest.[2]

But in a partisan 3-2 vote the commission decided to propose changes[3] to the rules governing the Dodd-Frank Act whistleblower law. If approved, these proposals would undermine whistleblower protections, reduce rewards and disqualify thousands of employees from the program.

Below is an outline of the five most important changes the commission will be voting on at the Sept. 23 public meeting.

1. Proposed Rule 21F-9(e): the Tips, Complaints and Referrals Issue

This proposal could result in thousands of whistleblowers being disqualified from obtaining a reward. The proposal is simple: If a whistleblower contacts anyone from the commission prior to filing a formal tip, complaint or referral, that whistleblower would be automatically disqualified from obtaining a mandatory whistleblower reward.

This rule is unprecedented and counter to the past practices of the SEC itself, and precedent under the IRS whistleblower law and the Commodity Exchange Act's whistleblower law.

Enron Corp. whistleblower Sherron Watkins, in a comment filed with the SEC on Aug. 15, 2019, explained the ramifications of this proposal. She stated:

Proposed revisions to Exchange Act Rule 21F-9(e) would create unrealistic reporting procedures that would disqualify a vast number of whistleblowers, simply because they reported their concerns to the wrong office at the SEC, rather than filling out a specific form and filing it according to specific reporting procedures.[4]

Thus, if a whistleblower sends a letter to the chairman of the commission setting forth evidence of a major fraud, but failed to first file a formal tip, complaint or referral, that individual loses all substantive rights under Dodd-Frank's reward provisions. As Watkins

explained, this would result in the disqualification of a "vast number of whistleblowers." The proposal was strenuously opposed by whistleblower advocates. The SEC will decide this issue at its Sept. 23 meeting.

2. Proposed Rule 21F-6(d): Limiting Rewards in Large Cases

The proposed rule creates a presumption that large whistleblower rewards should be reduced to the smallest amount possible under law. This proposal runs counter to the congressionally established criteria for setting awards and was strongly opposed by every knowledgeable expert in the area, including Sen. Charles Grassley, R-Iowa, and Sen. Sherrod Brown, D-Ohio, professors from Cornell and Stanford University, investor advocates, nationally recognized whistleblowers such as Watkins and Harry Markopolos, and all major whistleblower advocacy groups.[5]

It is well established that large rewards play a vital public service, in both incentivizing whistleblowers to step forward and deterring future misconduct by the regulated community. Lowering awards simply on the basis of size is inconsistent with the plain meaning of the statute.

The commission's final decision on this proposal should be carefully studied, as permitting any discretion to lower rewards simply based on the size of an award would undermine the incentives Congress established.

These incentives specifically are aimed at encouraging whistleblowers to early-report violations, cooperate fully with investigators, and deter further wrongdoing.

3. Proposed Rule 21F-3(b)(4): Related-Action Cases

The Dodd-Frank Act whistleblower law has a "related action" requirement. This provision encourages whistleblowers to fully cooperate with sister federal and state law enforcement agencies. The related-action law requires the SEC to pay rewards based on enforcement actions pursued by other agencies.

It is triggered whenever the commission issues a sanction against a wrongdoer in the amount of $1 million or more. Thereafter, if a sister federal agency or a state criminal agency also sanctions the wrongdoer based on the whistleblower's original information, the commission must pay a reward to the whistleblower as if the commission itself had issued the sanction. There are no exceptions to this rule.

Related-action proceedings are very common, as the U.S. Department of Justice often sanctions wrongdoers under various criminal laws, while the SEC sanctions the same wrongdoers under securities laws. Congress wanted whistleblowers to share their information with other law enforcement agencies and that the related-action provisions in the law effectuate this important public policy.

The proposed rule radically rewrites the related-action requirement. It grants the SEC the discretion to decide whether a case pursued by a sister agency should be excluded as a related action, therefore exempting the commission from having to pay a related-action reward.

The Dodd-Frank Act contains no such exception and does not grant the commission with this authority. If the commission enacts this rule as written it will surely be challenged in court. The illegal nature of this proposal was carefully explained by whistleblower advocates.[6]

4. Proposed Rule 21F-2(d)(4): Protection of Internal Whistleblowers

Currently SEC rules prohibit regulated companies from retaliating against employees who raise securities concerns internally (i.e., to a compliance officer, audit committee or corporate counsel). The commission is proposing to abolish this rule based on a judicial interpretation of the Dodd-Frank Act.

However, as part of the rulemaking proceeding whistleblower advocates explained that the commission had statutory authority under the Sarbanes-Oxley Act to prohibit discrimination against internal whistleblowers.[7]

The commission was provided with a copy of a letter from the authors of the Sarbanes-Oxley whistleblower law, Grassley and Sen. Patrick Leahy, D-Vt.,[8] that explained how the Sarbanes-Oxley law empowered the SEC to protect whistleblowers, including those who filed internal reports. Based on the clear statutory authority set for in the Sarbanes-Oxley law the commission was urged to affirm its current regulations prohibiting corporations from firing whistleblowers who raise concerns with internal compliance programs.

5. Interpretive Guidance Defining Analysts Eligible for Rewards

The commission is also proposing guidance that would weaken its current rules defining qualified analysts eligible for rewards. However, unlike the four proposals outlined above, the analyst revisions do not alter current rules, and thus a judicial challenge to the improper application of the guidance would be subject to judicial review in most cases.

Regardless, the proposed guidance has been vigorously opposed by whistleblower advocates. As explained in a letter to the commission by Brown, and signed by five other senators,[9] the commission's proposal "includes interpretive guidance that introduces additional hurdles that could deter whistleblowers. ... This proposal would permit the SEC to create an insurmountable hurdle for a whistleblower to establish original information based on 'independent analysis.'"

Taken together, these five proposals would radically weaken the current SEC whistleblower program. A decision on each of these five proposals will be rendered on Sept. 23. The future of the program — described by SEC Chairman Jay Clayton at a June 25 hearing before the House Subcommittee on Investor Protection as "extremely successful" — is at stake.

In whose interest is it to undermine a program that has protected whistleblowers, returned $750 million to investors, and allowed the U.S. government to collect over $2.5 billion in sanctions from fraudsters?

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Disclosure: Kohn filed 12 formal comments on the SEC's proposals discussed in this article.

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[1] SEC Comments page for Proposed Whistleblower Rule: https://www.sec.gov/comments/s7-16-18/s71618.htm.

[2] See SEC Statement (July 14, 2020): https://www.sec.gov/news/press-release/2020-155.

[3] See Proposed Whistleblower Rule: https://kkc.com/wp-content/uploads/2020/09/34-83557.pdf.

[4] Sherron Watkins Comment: https://www.sec.gov/comments/s7-16-18/s71618-190087.htm.

[5] Comments filedon September 18, 2018 by Sen. Charles Grassley, Taxpayers Against Fraud, professors from Cornell University and Stanford University, and Better Markets, comment filed by Sherron Watkins on Aug. 15, 2019, and comment filed by Kohn, Kohn and Colapinto/National Whistleblower Center dated Jan. 16, 2020.

[6] Comment filed by KKC on Sept. 10, 2020: https://kkc.com/wp-content/uploads/2020/09/KKC-ELEVENTH-SUPPLEMENTAL.pdf.

[7] Comment filed by KKC on Jan. 8, 2020: https://kkc.com/wp-content/uploads/2020/01/KKC-Ninth-Supplemental-Internal-Whistleblowers.pdf.

[8] The Grassley/Leahy Letter dated Nov. 9, 2004: https://kkc.com/wp-content/uploads/2020/01/donaldsonletter11.9.04.pdf.

[9] Sen. Brown Letter: https://www.banking.senate.gov/imo/media/doc/Ltr_to_Chair_Clayton_WB_rule_09172020.pdf.