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The First Five Years of the SEC Whistleblower Program

Part One of a Two-Part Article

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The Dodd-Frank Act directed that bounties be paid to persons bringing evidence of financial wrongdoing to the Securities and Exchange Commission (SEC). Congress hoped that by making corporate insiders and others with knowledge of securities law violations eligible to receive a reward of 10% to 30% of the SEC's recovery (in excess of $1 million), more financial frauds would be unearthed sooner. With well-publicized SEC settlements now routinely tipping into the tens of millions of dollars, the monetary rewards to a successful tipster might be huge. The Dodd-Frank Act called those tipsters "Whistleblowers," and the SEC's official Whistleblower program opened for business in August 2011.

We mark the approaching fifth anniversary of the Whistleblower program with this two-part retrospective. This month, we take a broad look at how the program intakes tips from Whistleblowers and what the SEC does with them. Next month, we will look more closely at the program's track record in issuing awards.

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Background

Dodd-Frank's SEC Whistleblower provisions, now codified as § 21F of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-6 ("§ 21F" or the "Act"), required the SEC to establish a program to administer tips from and awards to Whistleblowers. To implement the congressional mandate, the SEC adopted administrative rules to "describe the whistleblower program … and explain the procedures … to follow in order to be eligible for an award." 17 CFR § 240.21F-1 (§ 240.21F-1 *et seq.* are referred to here as "Rule 21F" or the "Rules"). As with many SEC rules, the Whistleblower Rules provide the procedural skeleton and the substantive meat of the entire program, and are, as a practical matter, "the law" governing Whistleblowers. To administer the Whistleblower program under the Rules, the SEC also established an Office of the Whistleblower (OWB).

Of course, the Whistleblower Rules must be consistent with § 21F itself, and only a federal court can decide that. So far only two aspects of Rule 21F have been challenged in court. The first does not concern *awards* to Whistleblowers, but rather whether Rule 21F correctly interprets § 21F in protecting from retaliation, as "Whistleblowers" under the Act, persons who report securities law violations internally, but *not* to the SEC. That debate has yielded conflicting district court decisions and a split between the U.S. Courts of Appeal for the Fifth and Second Circuits. *Compare Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013), and *Berman v. Neo@Ogilvy LLC*, 801 F. 3d 145 (2d Cir. 2015).

In the second challenge, the only one so far regarding awards themselves, the Second Circuit upheld the Rules' and the SEC's interpretation of § 21F that only tips received *after* the enactment of the Dodd-Frank Act (*i.e.*, July 21, 2010) are eligible for an award. *Stryker v. SEC*, 780 F.3d 163 (2d Cir. 2015). Those court challenges aside, however, the story of the Whistleblower program so far would seem to involve a simple assessment of the practical operation of the Rules.

The Lifecycle of a Whistleblower Claim

Such an assessment, however, is hardly simple. The lifecycle of a Whistleblower claim starts with a tip

and ends with an award, but what happens in between is hard to discern because of two overarching privacy concerns. For one, the Act and the Rules protect the confidentiality of Whistleblowers. Thus, although OWB publishes written decisions concerning Whistleblower bounties, in the most significant cases, those documents are redacted to make it impossible to identify the case to which a Whistleblower award relates. That privacy concern dovetails with another equally compelling: To preserve the confidentiality of ongoing investigations. This opacity, understandable though it may be, makes it difficult for outsiders to analyze how tips lead to and influence investigations and how enforcement actions inform awards. Thus, our research materials are necessarily limited to the five annual reports that OWB has so far published, the SEC Inspector General's 2013 Report on the Whistleblower program, various public statements by SEC and OWB officials, and the several hundred Whistleblower award dispositions issued through March 2016.

Tips, Complaints and Referrals

The Rules provide that a Whistleblower proceeding starts with the filing of a Tips, Complaints and Referrals Form (a TCR). TCRs can be submitted online through the OWB website, or as a paper submission to OWB. Even persons who submit information to the SEC in other ways (like directly to an office of the Enforcement Division) will be advised to file a TCR with the OWB to protect their Whistleblower status. TCRs contain the substance of the tip, the Whistleblower's substantiation and reason for thinking it violates the securities laws.

Although the TCR is intended to be self-contained, a serious Whistleblower should supplement the Form with statements, documents and analysis; it seems obvious to say that the more complete the submission, the more likely it is to be taken seriously. Experienced securities lawyers will see this as an opportunity to present to the OWB what is in effect a brief of facts and law demonstrating a violation of the securities laws.

TCRs can be submitted anonymously, but only if the Whistleblower is represented by counsel who separately affirms that he or she knows the identity of the Whistleblower and retains a copy of the TCR actually signed by the Whistleblower. In theory, a Whistleblower could remain anonymous throughout the entire process. The Whistleblower's name must be disclosed to the SEC only if he or she applies for an award, and even then the SEC will maintain the Whistleblower's confidentiality throughout the award process.

As a practical matter, though, the credibility of a TCR is enhanced if enforcement staff knows the Whistleblower to be a person with unique access to credible information, and that will often argue in favor of revealing his or her identity. The OWB has reported that only about 20% of Whistleblowers receiving awards file TCRs anonymously, and even some of those later revealed themselves to the enforcement staff. 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program, at p. 17 (tinyurl.com/p3k5gdj).

The OWB staff consists of its director and deputy director, a dozen staff attorneys, five paralegals and one administrative assistant. That staff is not large enough to do much more than intake and track the over 3,000 to 4,000 TCRs that the OWB has received over each of the past five years. Accordingly, the OWB leverages the resources of the SEC's Office of Market Intelligence (OMI) to triage TCRs, assessing their merit and referring them to appropriate offices for action. OMI was formed in January 2010 to be "responsible for the collection, analysis, and monitoring of the hundreds of thousands of tips, complaints, and referrals that the SEC receives each year." *See* SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence, SEC Press Release 2010-5 (Jan. 13, 2010) (tinyurl.com/hf5ymf2).

Substantive Review

Although the OWB says that it will communicate and even meet with Whistleblowers and/or their counsel to obtain further information or clarification, it is not at all clear that the OWB is involved in the substantive review of any TCR. In our experience, OWB acts primarily as the liaison with Whistleblowers. Even for TCRs that have resulted in investigations, OWB does not independently engage in discussions about the substance of a case without an Enforcement Division attorney or investigator present. OMI, having broader expertise in the SEC's substantive areas of jurisdiction, more likely owns the entire triage function from the very beginning, and OWB's role seems limited to ensuring that the information that it passes on to OMI is clear and complete, either on its own initiative or on a "bounce-back" from OMI.

There are really only four things that OMI can do with a TCR. In most cases, it will determine that the TCR does not merit further action. In other cases, OMI will determine that the TCR concerns primarily an injury suffered only by the Whistleblower, which in essence is just an investor complaint. Those cases are referred to the SEC's educational resources who assist the Whistleblower in seeking redress. A third category gets referred to other law enforcement agencies as the more

appropriate prosecutor. Unfortunately for the Whistleblower, that will result in no award unless the SEC also retains jurisdiction and pursues a related securities law violation. The last set are those TCRs that merit closer review as potential SEC violations, and they lead to the opening of a Matter Under Inquiry (MUI). Only those are referred to the enforcement staff for further investigation and possible prosecution.

How many TCRs have morphed into MUIs is not a published statistic. However, OMI appears to processes about 15,000 tips and complaints a year, and opens about 1,200 MUIs a year. *See* SEC FY 2017 Congressional Budget Justification at p. 62 (available at tinyurl.com/hdfvhxw). Therefore, TCRs appear to account for 20% to 25% of OMI's workload. Assuming that the ratio of MUIs to tips (8%) is the same for TCRs (which it should be, given the large share of OMI's work for which TCRs account), those statistics imply that the 14,116 TCRs that OWB received since the inception of the program have yielded about 1,100 MUIs, at a rate of about 240 to 320 per year.

Note, however, that MUIs are not even formal investigations, much less enforcement actions — this is still only a triage function. What happens to a MUI when it leaves OMI depends on what the enforcement staff finds and decides to do with those findings. We do not know how many MUI's turn into enforcement cases eligible for Whistleblower awards. But, again, the statistical evidence suggests that only a few do.

One of the OWB's main tasks is the processing of award applications and rendering preliminary determinations of awards. That process begins when OWB posts on its website, on a rolling basis, notice of cases that the SEC commences or settles where the sanction is expected to exceed $1 million. These notices — called Notices of Covered Action (NoCAs) — encompass all SEC actions, and not only those that stemmed from TCRs. Any Whistleblower wishing to claim an award must file a proper application within 90 days of the posting of the NoCA whose underlying case he or she claims to have been instrumental in generating.

The OWB's published statistics (available from its Annual Reports) say a great deal about the subject matter and geographical origin of TCRs, no doubt generated from its automated tracking system. To divine any meaning from those statistics requires more manual labor. The OWB reports that the number of TCRs filed has been steadily increasing over time, from about 3,000 in 2012 to almost 4,000 in 2015. However, the breakdown in subject matter has remained fairly stable. The largest category, generally accounting for a quarter of all TCRs, is the inscrutable "Other." But among the identified categories, tips about corporate disclosure and financial statement fraud consistently account for 17% to 18% of all TCRs, with fraud in connection with securities offerings close behind at 16% to 17%, and stock manipulation at (more variably) 12% to 16%.

Actual Postings

As against 3,000 to 4,000 TCRs a year, however, only an average of about 140 NoCAs have been posted per year. Based on our review of about 150 NoCAs posted in 2015 and 2016, they do not seem to follow the same pattern as TCRs. Those fairly labeled "Other" (mostly broker-dealer, investment adviser and market rule violations) account for 26% of the total, which is close to the same as for TCRs. But offering fraud also accounts for 26% of NoCAs, much higher than the percentage of TCRs in that category. And disclosure and financial statement fraud account for only 10%, and manipulation only 8%, both well below the corresponding percentages in TCRs. Moreover, some of the largest SEC recoveries appear to involve violations of the Foreign Corrupt Practices Act (FCPA). Those account for only about 5% of TCRs and 7% of NoCAs.

The OWB's docket of whistleblower awards shows that it has to date processed 306 discrete applications. However, 220 of those were determined to have been frivolously filed by two individuals, both of whom have now been of barred from participating in the Whistleblower program. That ban appears not to have been the result so much of the volume of applications filed, but of the fact that the applications were laced with false statements and, at least with respect to one of the individuals, that he refused to withdraw the applications when the irregularities were pointed out to him. In any event, in the past five years, only 86 substantive Whistleblower applications have been processed.

The decisions on those 86 applications are the beginnings of a "common law" of Whistleblower award criteria.

Conclusion

In Part Two of this article, we will take a closer look at those decisions, and draw some conclusions from them and how they relate to TCRs and NoCAs about the overall effectiveness of the program to date.

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