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Studying The Reactions To SEC's Whistleblower Proposals

By **Kathleen Massey**
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The numerous submissions made in response to the requests for comment by the U.S. Securities and Exchange Commission highlight that many of the proposed amendments to the whistleblower rules, if adopted, will create greater incentives for individuals to report certain violations of the securities laws to the SEC and to do so more quickly than they do now. Notwithstanding the foregoing, the proposed rules would decrease the financial incentives for individuals to report the most significant violations to the commission and make it more difficult for individuals to qualify for awards based upon public information.

Ultimately, legislative action will likely be necessary to provide anti-retaliation protection for individuals who report possible violations internally before going to the SEC. Additional rule-making will be required to resolve whether the SEC will continue to reward participation in internal reporting and compliance. Further guidance from the commission will be necessary to clarify how regulated entities can avoid being charged with impeding communications with the SEC when drafting employment agreements and to prohibit wrongdoers from receiving incentive awards.

Background

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which, among other things, established the SEC's current whistleblower incentive and protection program.[1] The SEC adopted implementing rules in May 2011 and they became effective in August 2011.[2]

Pursuant to the statute and rules, qualified whistleblowers are entitled to incentive rewards of between 10 and 30 percent of the sanctions collected on matters where the whistleblower voluntarily provides original information to the SEC about a violation of the securities laws, which information is derived through independent knowledge or analysis, and leads to an enforcement action by the SEC requiring the payment of more than $1 million.[3]

The existing rules state that individuals are protected from retaliation for reporting information about possible violations of the securities laws, whether the report is made to the SEC or through an internal reporting program.[4] In 2015, the SEC issued interpretive guidance, stating that for purposes of employment retaliation protection, an individual's status as a whistleblower does not depend on whether he or she reported information to the SEC.[5] In February 2018, the U.S. Supreme

Court rejected the SEC's interpretation of the act's anti-retaliation provisions and held in Digital Realty Trust Inc. v. Somers that the act only protects individuals who provide information to the SEC and does not protect those who just report such information internally.[6]

On June 28, 2018, the SEC voted to propose amendments to the rules governing its whistleblower incentive and protection program.[7] The commission requested comment on: numerous aspects of the proposed amendments; proposed guidance concerning how the staff might construe various terms in the existing rules; and potential future interpretive guidance, rule-making and legislative action. The proposed rules were open for comment through Sept. 18, 2018. More than 100 individual comments were filed before the deadline, not including form letters, and several more comments were filed after the deadline had passed.

Key Takeaways

Set forth below is a summary of the issues raised by the proposed amendments, requests for comment and comments that are of greatest significance to regulated entities.[8]

- Regarding who is entitled to anti-retaliation protection, the rules will be revised to require individuals to provide information to the commission before qualifying as a whistleblower entitled to such protection.[9] Although the proposed rules seek to clarify that protected activity would include reporting internally, even if it is done before a report is made to the SEC, anti-retaliation protection would not attach until a report to the commission is made.[10] To ensure that individuals are appropriately incentivized to report internally, it is likely that further legislation will be required to ensure that individuals who report information internally before going to the SEC will be protected from retaliation that occurs prior to the SEC report. In the meantime, individuals concerned about retaliation are more likely to report information to the commission before or contemporaneously with reporting internally.

- It is likely the rules will be amended to allow the SEC to count money required to be paid pursuant to deferred prosecution agreements and nonprosecution agreements entered into with the U.S. Department of Justice and state attorneys general, and settlement agreements entered into with the commission, when determining whether recoveries meet the $1 million threshold for making an award.[11] As a result, more individuals will likely be able to meet the threshold for award eligibility, which could increase the number of tips and enforcement activity on smaller matters.

- With regard to potential awards below $2 million, the rules will likely be amended to allow the SEC to consider award amounts in determining whether to increase them (to an amount no higher than $2 million and the statutory cap of 30 percent of the sanctions collected).[12] Although commenters associated with business interests object to this proposed amendment on the ground that it will encourage individuals to come forward with more tips on less important and potentially frivolous matters, the whistleblowers' position that the amendment will encourage more reporting on securities violations is likely to carry the day, resulting in more tips and enforcement activity on relatively small matters.

- Given recent decisions by the U.S. Supreme Court, which has held the SEC is time-barred from seeking disgorgement and penalties if it fails to bring an enforcement action within five years of the date of the underlying violation,[13] the commission will likely issue guidance stating that unreasonable reporting delay for purposes of determining the amount of an award will be presumed at 180 days from knowledge of the possible violation.[14] If such guidance is issued,

individuals will be incentivized to report information to the commission sooner than they do currently.

- The rules will likely be amended to allow the SEC to reject applications summarily when, for example, they fail to comply with procedural requirements, and to bar certain individuals from receiving awards if they submit false information or repeatedly submit frivolous applications for awards.[15] Although some whistleblowers expressed concern that this proposal could violate individuals' due process rights, the majority of commenters support the SEC's taking steps to improve efficiency. If adopted, this amendment would enable the commission to act on tips, commence enforcement actions and grant awards on meritorious matters more quickly than it does currently.

- With regard to large matters with monetary sanctions equal to or exceeding $100 million, the rules will likely be amended to allow the SEC to consider the dollar values of potential awards in determining whether to cap or decrease them (to an amount no lower than $30 million and the statutory minimum of 10 percent of the sanctions collected).[16] Whistleblowers object to this proposal on the ground that it will result in decreased incentives for individuals, including high-level executives, to come forward with information on substantial wrongdoing. If the amendment is adopted, there will likely be fewer tips from high-level executives and decreased enforcement activity on larger matters.

- The commission will likely amend the rules to eliminate the possibility that a whistleblower might recover under two different whistleblower programs based on the same information.[17] Although whistleblowers object to this proposal on the ground that it would reduce incentives for individuals to report wrongdoing to the SEC, any reduction would likely be offset by incentives to report wrongdoing to other whistleblower programs.

- The SEC will likely issue guidance narrowing the scope of information that can form the basis of an award. Although the commission proposes to limit the use of public information to that which provides evaluation, assessment or insight beyond what would be "reasonably apparent" to the commission from publicly available information,[18] many of the comments submitted reflected concern that this standard is vague, subjective and susceptible to unfair application based on 20/20 hindsight. Assuming the SEC issues guidance limiting the use of public information as a basis for an award, it will likely become more difficult for individuals to satisfy the requirements for obtaining incentive awards.

- The SEC may engage in future rule-making to eliminate consideration of a whistleblower's participation in an internal reporting program when determining whether to increase an award.[19] Whistleblowers expressed concern in their comments that it is unfair to consider such participation since it is not necessarily protected. Commenters associated with business interests assert that it is necessary to consider participation, regardless of whether it is protected, since that incentivizes individuals to use established internal reporting programs. If legislation is not adopted to expand whistleblower protections, it is likely the commission will proceed with additional rule-making with regard to whether and the extent to which participation in internal reporting will be taken into account in determining awards.

- Although the SEC seeks comment on whether it should propose a rule that would afford the commission discretion to give awards in situations where a claimant would not otherwise qualify for an award,[20] it is not likely the SEC will move forward on such a proposal anytime soon. Whistleblowers favor adoption of such a rule as a means of incentivizing more reporting to the

SEC. However, in light of the constraints imposed by the existing legislative framework, it is likely that amendments thereto will be required to allow the commission to grant awards in situations where the existing requirements have not been met.

- With regard to how regulated entities are to go about protecting their confidential information when preparing employment and severance agreements, the proposed rules are silent. Unless the commission issues additional proposed rules or guidance, it is likely that there will be no clarification on how to balance the need to protect confidentiality with the desire to avoid enforcement action for impeding communications with the SEC.[21]

- Similarly, unless the commission amends the existing rules, it is likely that wrongdoers will continue to be eligible for awards. Although many commenters associated with regulated entities expressed the view that wrongdoers should not be allowed to recover, the proposed rules do not go that far in restricting the ability of wrongdoers to recover.[22]

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[1] Section 922 of the Act amended the Securities Exchange Act of 1934 to add a new Section 21F entitled Securities Whistleblower Incentives and Protection. 15 U.S.C. § 78u-6.

[2] 17 C.F.R. § 240.21F-1, et seq.

[3] For additional information on the SEC's whistleblower program, please see SEC's Whistleblower Program Is Alive and Well, Dechert OnPoint (Nov. 2016); The New Dodd-Frank Whistleblower Program Takes Shape as the Securities and Exchange Commission Releases Proposed Rules, Dechert OnPoint (Nov. 2010).

[4] 17 C.F.R. § 240.21F-2(b)(1).

[5] 80 Fed. Reg. 47,829 (Aug. 10, 2015).

[6] 138 S. Ct. 767 (2018).

[7] See https://www.sec.gov/news/press-release/2018-120; see also https://www.sec.gov/rules/proposed/2018/34-83557.pdf ("Proposed Rules").

[8] For additional detail, please see Comments on Proposed Changes to SEC Whistleblower Rules Highlight Challenges, Dechert OnPoint (Oct. 2018).

[9] See Proposed Rule 21F-2(d)(1)(i).

[10] See Proposed Rules at 70.

[11] See Proposed Rule 21F-4(d)(3).

[12] See Proposed Rule 21F-6(c).

[13] Kokesh v. SEC, 137 S. Ct. 1635 (2017); Gabelli v. SEC, 568 U.S. 442 (2013); see also https://www.sec.gov/news/speech/speech-avakian-092018 (noting that the SEC Enforcement Division has already had to forego recovery of hundreds of millions of dollars in disgorgement following the decision in Kokesh).

[14] See Proposed Rules at 56-57, 60.

[15] See Proposed Rules 21F-18(a), 21F-8(e).

[16] See Proposed Rule 21F-6(d).

[17] See Proposed Rule 21F-3(b)(4).

[18] See Proposed Rules at 97.

[19] See Proposed Rules at 73.

[20] See Proposed Rules at 110.

[21] See 17 C.F.R. § 240.21F-17(a).

[22] See, e.g., Proposed Rule 21F-6(c)(2).