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SEC Has Begun Paying Whistleblower Bounties

Its rulings so far suggest the pace and scope of awards may be more limited than the business community feared.

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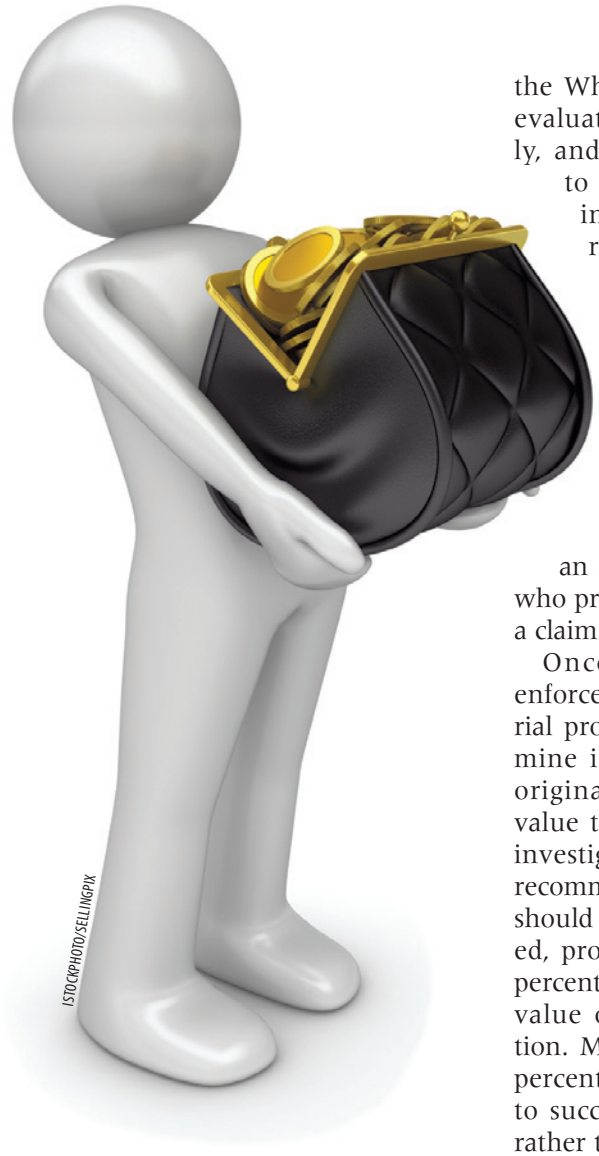
Since the creation of the U.S. Securities and Exchange Commission's whistleblower program in August 2011, thousands of whistleblowers have submitted complaints about corporate wrongdoing, in hopes of receiving a monetary award. Corporations have long expressed concern that the program provides strong financial incentives for informers to bypass internal reporting and compliance systems and instead raise potential securities law violations directly with the SEC. The program—established as part of the 2010 Dodd-Frank Act financial reforms—offers monetary awards to whistleblowers who voluntarily provide the SEC with information leading to a successful enforcement action. Informers receive up to 30 percent of any money collected as a result of the action, provided the violation resulted in sanctions of at least $1 million. The specter of such large bounty awards for whistleblowers prompted fears within the business community of unwarranted SEC investigations based on frivolous claims. Worse yet, in bypassing the internal reporting controls, there is the concern that whistleblowers will deprive the company of a means to address wrongful conduct internally, as many companies have gone to great lengths to try to do in the decade since the passage of the Sarbanes-Oxley Act.



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THE PRACTICE
Commentary and advice on developments in the law

The SEC is now starting to make payments to whistleblowers, including within the past few weeks. This column briefly describes the SEC's procedure for evaluating whistleblower claims, and examines the two cases in which informants have successfully sought and obtained awards. It then evaluates lessons that can be learned from these early payment decisions by the SEC under the whistleblower program.

According to the SEC's 2012 Annual Report on the Whistleblower Program, complaints submitted to the Office of the Whistleblower receive a preliminary evaluation, after which "specific, timely, and credible" reports are forwarded to enforcement officers for further investigation. If an investigation results in a final judgment or order imposing sanctions of more than $1 million, or if it can be combined with prior judgments in the same action to exceed $1 million, the Office of the Whistleblower will post a notice indicating that informants who voluntarily provided tips may be eligible to collect an award. The onus is on individuals who provided information to then submit a claim within 90 days of the posting.

Once a claim is submitted, SEC enforcement officers evaluate the material provided by the informant to determine if the submission provided new, original information and to assess its value to the successful resolution of the investigation. The officers then make a recommendation as to whether the claim should be granted or denied and, if granted, propose an award amount up to 30 percent based on their assessment of the value of the whistleblower's contribution. Moreover, claimants receive only a percentage of the funds the SEC is able to successfully collect after a judgment, rather than a percentage of the total penalties assessed.

A TALE OF TWO BOUNTIES

Now that the program has been in effect for two years, the SEC has begun to render final determinations on whistleblower award claims. The onset of bounty payments gives us our first opportunity to assess the extent to which initial concerns about the bounty program may be realized. The SEC received 3,001 submissions

to its Tips, Complaints, and Referrals System during the 2012 fiscal year. During the two months in which the program was active in fiscal year 2011, the system received 344 submissions.

To date, however, awards have been granted to whistleblowers in only two instances. The first-ever award was issued in August 2012, when an anonymous whistleblower received $50,000—30 percent—of the total penalties the SEC collected from an unidentified firm. Explaining its decision to provide the whistleblower with the maximum award allowed under the program, the SEC noted in a press release that the informant had "provided documents and other significant information that allowed the SEC's investigation to move at an accelerated pace and prevent the fraud from ensnaring additional victims." The press release indicated that a second individual's claim had been denied because the information provided did not "lead to or significantly contribute to" the enforcement action.

A second whistleblower payment was recently announced on June 12, 2013. In that case, the SEC determined that three claimants would evenly split 15 percent of the sanctions collected from Locust Offshore Management LLC, a fraudulent investment fund. The SEC levied approximately $7.5 million in penalties against Locust and its officers. However, the size of the claimants' award is unclear, as no money has yet been recovered from the company. A fourth individual's claim was denied because the SEC concluded the information he provided "did not lead to the successful enforcement of the Locust Matter" as it was not the impetus for the SEC's opening of an investigation, nor did it "significantly contribute…to the success" of the case. The window to submit a claim for the Locust case closed in July 2012.

LESSONS LEARNED

The role that robust internal reporting and compliance systems continue to play in shielding companies from regulatory actions remains an important lesson in this area. A strong internal reporting structure, whistleblower policy and anonymous complaint line can reduce the risk that a whistleblower will raise an issue for the first time with the SEC rather than internally at the company.

The low ratio of granted awards to claims, the small size of the awards to date, and the denial of some claims in both cases suggests the pace and scope of awards may be more limited than initially believed. However, it is important to note that an average SEC action takes approximately two years to investigate and bring an enforcement action, and therefore it is premature to assess what percentage of the thousands of complaints made within the past year or two will result in successful actions and bounty payments.

The speed with which the SEC issues any additional awards from claims that have closed within the past year will provide further guidance here. The relatively slow pace of whistleblower awards, the small size of the awards, and the difficulty of collecting penalties from companies after sanctions have been issued could make the whistleblower program less attractive to whistleblowers and their lawyers than initially expected.

The disincentive to whistleblowers caused by perceived difficulties in prompt SEC action and recovery may be exacerbated by the recent announcement by the SEC that it will seek in some cases to force defendants to admit to improper conduct as a prerequisite to settlement. Refusing to allow defendants to enter into the standard "neither admit nor deny" settlement terms may result in some defendants refusing to simply resolve matters early and instead engaging in protracted litigation and trials. The SEC, like all agencies, has a limited budget, and this new policy may, at the margin, lead to fewer available resources to devote to bringing cases and longer resolution times.

There may already be some rising awareness of the difficulties inherent in the whistleblower bounty system. Indeed, recent press articles report that a former SEC lawyer-turned-financial industry watchdog tried but failed to use crowdsource funding to raise capital for a professional whistleblowing firm. The attorney reportedly had planned to use his expertise in fraud investigation and his familiarity with SEC processes to help guide informants through the whistleblower program in exchange for a percentage of the award.

However, if—as SEC Division of Enforcement Associate Director Stephen Cohen recently suggested may be the case—the magnitude of the awards or the pace at which they are granted increases, the program may become a more appealing prospect for professional whistleblowers. The trajectory of the program should become clearer in the near future. Since August 2011, the Office of the Whistleblower has posted 411 notices of covered action, and of those only 58 remain open for whistleblowers to submit claims. If the award adjudication period for the Locust case is any indication, award determinations—providing any claims were submitted—for a number of cases may be finalized over the next several months.


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