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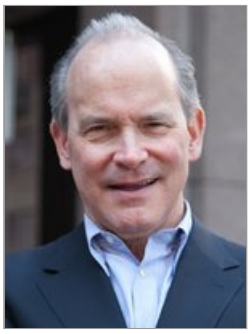
SEC's Whistleblower Amendments Are A Step Backward

By **Kevin O'Brien** (October 1, 2020, 2:57 PM EDT)



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On Sept. 23, the U.S. Securities and Exchange Commission voted to adopt amendments to its whistleblower program in order to, in its words, "provide greater clarity to whistleblowers and increase the program's efficiency and transparency."

The real result is likely to be less, not more, clarity and transparency. The amendments raise new doubts about the commission's commitment to whistleblowers, at a time when the federal government's lagging prosecution of white collar crime makes the assistance of knowledgeable insiders and employees more valuable than ever in exposing business misconduct.

The SEC whistleblower program has steadily grown since it was established in 2011 as part of the Sarbanes-Oxley Act reforms. Between fiscal years 2012 and 2019, the program received more than 33,000 tips, including more than 5,200 tips for each of 2018 and 2019.

Through 2019 the SEC has ordered wrongdoers implicated by whistleblowers to pay over $2 billion in total monetary sanctions, including more than $1 billion in disgorgements plus interest, of which almost $500 million has been, or is scheduled to be, returned to injured investors. In return, the SEC has awarded roughly $387 million to 67 individuals, including $168 million in 2018 alone, of which $122 million went to three whistleblowers.

Despite these numbers — or rather because of them — the whistleblower program is often considered a poor relation of the SEC, lacking the leadership and resources it needs.

John Coffee, a professor at Columbia Law School, noting the disparity between the number of tips and the number of award recipients, suggests that "the SEC seems reluctant to pay awards" and "is unable or unwilling to process or verify all the material and credible information it receives."

The commission is least likely to pursue whistleblower tips when they call its own conclusions into question, as when analyst Harry Markopolos could not interest the staff in one Bernie Madoff.

The amendments, taken as a whole, do not address this perception. A number of them, to be sure, are positive. Under the whistleblower statute, awards must be made in an amount equal to not less than 10%, but not more than 30%, of the total monetary sanctions collected in the covered SEC action and certain related actions.

One salutary amendment provides a mechanism for whistleblowers with potential awards under $5 million — the vast majority of the awards — to qualify for a presumption that they will receive the maximum statutory amount. Other amendments will help the commission weed out false or frivolous whistleblower applications.

Two other developments, however, jeopardize the main purpose of the whistleblower statute, by

creating uncertainty that could discourage whistleblowers from coming forward with incriminating information in significant cases. One amendment falls under the heading of commission interpretive guidance.

Under the Sarbanes-Oxley Act, a whistleblower must provide either original factual information or independent analysis, which is defined by the prior rule as an "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public."

The new amendment muddies this relatively straightforward test, familiar in securities cases, by making SEC knowledge the touchstone. Now, in order to qualify as independent analysis, the whistleblower must provide analysis "beyond what would be reasonably apparent to the Commission from publicly available information."

In other words, before a whistleblowing analyst can qualify for an award, commission staff must accept his or her analysis as superior. We saw how that process fared in the case of Markopolos.

The second development does not involve a new amendment at all. When amendments were first proposed in July 2018, they included a controversial proposal that would have given the commission discretion to adjust downward the award amounts in the largest cases, those that involved more than $100 million in total sanctions and at least a $30 million bounty. There have been five such awards through 2019.

The proposed amendment stated that award limits would allow SEC staff "to make such common-sense adjustments to extraordinarily large awards to ensure that they do not exceed an amount that is appropriate to achieve the goals and interests of the program."

Critics detected in these bureaucratic euphemisms a retrenchment "contrary to Congressional intent, public policy and the goal of investor protection," in the words of six Democratic senators in a letter to SEC Chairman Jay Clayton.

At the end of the day, the proposed amendment enabling downward adjustments was not included in the final rule. The SEC explained: "We have concluded that it is not necessary to adopt the formalized mechanism for the commission to exercise its discretion" on award amounts, because the commission already has sufficient authority to determine award amounts through existing "awards factors" criteria.

This explanation raises more questions than it answers. If the SEC already has the authority to reduce large awards, why did it court controversy by proposing the amendment and lobbying for it for over a year? Will the SEC now seek to act on its supposed authority? Or is the uncertainty engendered by these questions the real point of the amendment?

The result is far from the added clarity, efficiency and transparency promised by Clayton in his rollout of the amendments.

Whistleblowers, given the right incentives, could play an important role in ferreting out corporate fraud and other misconduct. Many observers have concluded that our laws against white collar violations are becoming dangerously underenforced, partly because federal agencies — including the U.S. Department of Justice and the SEC — have neither the budgets, the manpower nor the patience to investigate many types of corporate misconduct, particularly in the largest cases.

Coffee, in his new book "Corporate Crime and Punishment: The Crisis of Underenforcement," has recommended that whistleblower programs, which uncover evidence virtually cost-free to the government but are used by only a handful of agencies, be greatly expanded to man the breach.

According to Coffee: "The one new law enforcement tactic that appears to work in white-collar cases is paying bounties to whistleblowers for information." He writes that "[l]aw enforcement agencies could make far greater use of the whistleblower as a means of economizing on investigation costs than they do today."

It's unfortunate that the SEC, our principal enforcer of the federal securities laws, hasn't gotten the message.

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