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## What's Next for the Year-Old SEC Whistleblower Program?

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### COMMENTARY

For years, the Securities and Exchange Commission had a whistleblower program in place that accepted information about securities violations in exchange for the possibility of a financial award if funds were recovered.

Nonetheless, over the 20 years that program existed, only six whistleblower claims were ever paid. The reason appears clear. The program was administered entirely at the discretion of the SEC with little congressional oversight. In fact, the SEC paid out just over \$1.15 million dollars to those six claimants. One of the claimants received a \$1 million reward, which was announced only after the new SEC whistleblower program was enacted under Dodd-Frank. The other five claimant awards totaled \$159,537.

One example of the failure of the prior program is Harry Markopolos, a former investment officer for a company that competed with Bernie Madoff's investment firm. Markopolos's investment firm assigned him to analyze the basis for Madoff's unbelievable returns to see if they could be duplicated. His analysis concluded that Madoff was either involved in front running — a form of illegal insider trading that occurs when a broker executes orders on a security for its own account while taking advantage of advance knowledge of pending orders from its customers — or a giant Ponzi scheme. Markopolos tried in vain for years to persuade the SEC to investigate Madoff. The SEC completely ignored his warnings. Surprisingly, Madoff's fraud was only revealed when his own children learned the truth and turned him in.

On July 15, 2010, in response to the Madoff crisis, Congress enacted sweeping new whistleblower

provisions for securities law violations as part of the Dodd-Frank Act. The program is a "bounty" program that provides a whistleblower the chance for an award without filing a lawsuit. The law also addresses shortcoming in the SEC's prior program and provides sweeping incentives for insiders to report securities law violations.

It took almost a year to pass regulations to allow the SEC to administer the program. On May 25, 2011, the SEC finalized rules for the program that adopt a pragmatic approach to whistleblower claims. Dodd-Frank provides similar plenary whistleblower provisions for violations of commodity future laws. The Commodity Futures Trading Commission has also issued its own final rules that mirror the SEC rules regarding its whistleblower program.

The new SEC rules legally went into effect on Aug. 12. Moreover, despite earlier indications that it would defer doing so, the SEC established the Office of the Whistleblower Program with its first director, Sean McKessy, along with seven staff.

Based on his public statements to date, McKessy seems enthused and ready to prove to the taxpayers that the SEC is poised for a new era of enforcement using its recently-enacted powers. In addition, the commission has funded the Investor Protection Fund created to pay whistleblower claims. The SEC's whistleblower office opened its new website, which is a portal for making whistleblower claims and obtaining recoveries. All of these steps are encouraging because they show a renewed commitment to treating whistleblower claims seriously.

To fully understand the whistleblower program, it is important to understand the statutory framework that underlies the current SEC whistleblower program. Section 21F of Dodd-Frank establishes a SEC Investor Protection Fund to pay whistleblower claims. The Investor Protection Fund is to be funded with monetary sanctions that the commission collects in a judicial or administrative action, or through certain disgorgements under the Sarbanes-Oxley Act of 2002. As of today, the SEC has initially funded the Investor Protection Fund with \$430 million. The fund is used to pay awards to whistleblowers and activities of the investigator general.

#### **Who May Be a Whistleblower Under Dodd-Frank?**

Dodd-Frank defines a whistleblower very broadly to include any individual or two or more individuals who voluntarily submit original information to the SEC. Unlike the False Claims Act, other entities, such as corporations, partnerships and associations, may not be SEC whistleblowers. Thus, any individual with insider information concerning securities law violations can make a claim to the SEC. This includes a diverse array of individuals. For example, a staff accountant who knows of corporate payments made to foreign governmental entities for the purpose of securing contracts and other business — which constitutes a violation of the Foreign Corrupt Practices Act — may be a SEC whistleblower.

A competitor that knows that a company is providing false financial information to investors in its disclosures may be a SEC whistleblower. A janitor who overhears conversations of senior officials engaging in insider trading may also be a SEC whistleblower. The only qualification to becoming a whistleblower is having original information about securities law violations that the SEC does not already have.

#### **Who is Ineligible**

##### **for an Award?**

While those individuals who may make a claim are innumerable, the SEC has imposed restrictions on certain classes of individuals who have compliance and reporting obligations independent of Dodd-Frank.

Thus, a whistleblower who is, or was at the time he or she acquired original information, a member, officer or employee of an appropriate regulatory agency, the Department of Justice, a self-regulatory organization, the Public Company Accounting Oversight Board or a law enforcement organization; convicted of a criminal violation related to the judicial or administrative action for which he is seeking, or would be seeking, an

award; an individual that gained information through the performance of a required SEC audit; or an individual who fails to submit information that the SEC requires is ineligible to receive an award. A whistleblower may also be disqualified from an award if it is judicially determined that he or she violated federal or state law in order to obtain the information that was reported to the SEC.

The final rules also exclude certain individuals from recovering an award by deeming them to be individuals without "independent knowledge" or "independent analysis." These individuals include attorneys with confidential information or information subject to the attorney-client privilege, accountants that perform engagements required by the securities laws, other compliance personnel who are expected to report securities laws violations and those individuals who are retained to conduct an inquiry or investigation into possible violations of the law. Limited exceptions exist if disclosure of the information is necessary to prevent the entity from causing substantial injury to the financial interest or property of the entity or investors, to keep the entity from impeding an investigation of misconduct or if the violation was reported internally but not remediated.

Attorneys, therefore, may not violate their duty of confidentiality or the attorney-client privilege to report violations. The only exception is to prevent substantial injury to the corporation or investors, or if state law allows the disclosure to prevent a client from committing a crime or fraud. External auditors may report only when the retained audit company — the auditor's employer, for example — fails to disclose the client's wrongdoing. McKessy described these limited exceptions not as a means for professionals to skirt their obligations to a corporation, but rather as a means to reward these professionals for taking their obligations seriously. The exceptions only apply when the professionals reported wrongdoing internally but the violation was not addressed.

#### **What Does the SEC**

##### **Owe a Whistleblower?**

Section 21F(b) provides that the SEC "shall pay" a whistleblower who voluntarily provides original information to the SEC that leads to the successful enforcement of a covered judicial or administrative action and results in monetary sanctions exceeding \$1 million. The SEC may also permit an award if multiple actions involving the same facts cause an aggregate sanction greater than \$1 million.

Under the law, the whistleblower is entitled to an award of between 10 and 30 percent of what the SEC collects in monetary sanctions. A whistleblower is defined as "any individual or two or more individuals acting together who provide 'original information' to the SEC relating to a violation of the securities law." A submission is "voluntary" only when provided before a request, inquiry or demand from the SEC, a federal government agency, the Public Company Accounting Oversight Board or a state securities agency that relates to the subject of the submission.

In a manner similar to other whistleblower laws, "original information" is further defined as information derived from the independent knowledge or analysis of the whistleblower; not known to the SEC from any other source unless the whistleblower is the original source of the information and the information is not derived exclusively from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit or investigation, or from the news media, unless the whistleblower is a source of the allegation.

The concept of "original information" is derived in part from the public disclosure doctrine and original source exceptions found in the federal False Claims Act and its state counterparts, and its purpose is to preclude opportunists from profiting from whistleblowing.

Under the new rules, to be eligible for an award, the whistleblower must voluntarily provide to the SEC "original information," which is defined as information derived from the "independent knowledge" — defined as "factual information in the whistleblower's possession that is not derived from publicly available sources" — or independent analysis of the whistleblower; not already known to the SEC from any other source, unless the whistleblower is the original source of that information; and not exclusively derived from an

allegation made in a judicial or administrative hearing, audit or investigation, or from the news media, unless the whistleblower is the source of that information. (Rule 240.21F-4(b))

The definition of "original information" is fairly precise. For example, the statute allows for a whistleblower to provide new information to supplement information already in the possession of the SEC. It also expands on the concept of "original source" by allowing claims to be based in part on allegations already publicly available so long as they are not exclusively based upon such allegations. On the other hand, a whistleblower may be barred under Dodd-Frank if he or she is not the source of independent knowledge concerning nonpublic allegations. All information provided ought to be specific, credible and timely. (Rule 240.21F-4(b)(2))

In order to be eligible for a whistleblower award, the SEC also requires that any new information be provided to the SEC after July 21, 2010, the effective date of Dodd-Frank. The final rules permit a whistleblower to make a claim based upon information that "materially adds" to information the SEC already possessed. The rules also allow a whistleblower to collect an award if the violation is reported internally and then the company voluntarily reports the violation to the commission, or if the whistleblower subsequently passes along original information that contributes to the success of the commission's action. According to the commission, the regulations are designed to "motivate those with inside knowledge to come forward and assist the government ..."

However, it will take a majority of the commission to approve an enforcement action based on a whistleblower claim.

A whistleblower may make a claim anonymously, but may do so only through legal counsel. His or her identity must be disclosed, however, prior to the payment of an award.

### **Stronger Whistleblower**

#### **Retaliation Remedies**

Dodd-Frank also provides beefed-up protections against retaliation for whistleblowers. Under prior law, whistleblowers that faced retaliation could only pursue a claim through administrative procedures within the Department of Labor, and were entitled only to a remedy of reinstatement. Under Dodd-Frank, whistleblowers are permitted to bring claims directly in a U.S. District Court, and are entitled to multiple remedies including reinstatement to their position, damages equal to twice the amount of lost wages, attorney fees and costs. One district court has ruled, however, that in order to be eligible for protection against retaliation, the whistleblower or someone acting on his or her behalf must actually submit information to the SEC.

#### **No Internal**

#### **Reporting Required**

One of the most controversial provisions in the proposed rules the SEC published in November 2010 would have required a whistleblower to report securities violation internally through a corporation's compliance program, prior to submitting a whistleblower claim to the SEC. After the collapse of Enron in 2001, Congress passed the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley requires publicly-traded companies to establish internal compliance programs that allow employees to advise the company of any wrongdoing that violates the securities laws. Corporations argued that allowing whistleblower claims under Dodd-Frank to bypass internal compliance programs, which took a substantial amount of time and effort to implement, would eviscerate those programs because whistleblowers would make their claims directly with the SEC for monetary gain. Whistleblower advocates took the position that internal compliance had not been effective since it became required under Sarbanes-Oxley and that, in any event, Dodd-Frank made no provision for internal reporting as a condition for submitting a whistleblower claim.

The SEC took a Solomonic approach to the dispute by declining to adopt an internal reporting requirement while providing whistleblowers with incentive to utilize internal reporting mechanisms. The final rule provides

that whistleblower awards may be enhanced if the violation is reported internally first. This enhancement may also apply when a whistleblower reports internally, and the company subsequently self-reports based on the internally reported information. The rule also provides that a whistleblower who reports internally may subsequently report to the SEC within 120 days and the SEC will backdate the claim to the date of internal reporting.

In response to corporate complaints that the whistleblower program would eviscerate established internal compliance programs, McKessy characterized the final rule as a good motivator for companies to refine and enhance their compliance programs to provide their own incentives for whistleblowers to report internally first. The end result could be more transparent compliance programs that no longer target and isolate the whistleblower as a wrongdoer in his or her own right.

How is an

Award Determined?

Dodd-Frank provides the SEC with a number of criteria to determine, in its discretion, the amount of an award. By statute, the award must be between 10 and 30 percent of the amount recovered if the amount recovered exceeds \$1 million. The factors to be considered include the significance of the information provided; the degree of assistance provided by the whistleblower and his counsel; the interest of the SEC in deterring violations of the securities award; participation of the whistleblower in internal compliance systems; the culpability of the whistleblower; unreasonable delay in reporting the violations; whistleblower interference with internal compliance and reporting systems by the whistleblower.

The SEC publishes notice of those cases that may qualify for a whistleblower award on its website as "Notice of a Covered Action" once a judicial or administrative action results in the imposition of monetary sanctions exceeding \$1 million. Once a case is listed on the SEC's website, the whistleblower must file a claim for an award within 90 days of the notice. The claim must be submitted on the SEC's approved form, which is available on its website. In some instances, whistleblowers with whom the commission has worked closely may receive direct notice of the covered action. The better practice is to regularly monitor the notices of covered actions for new additions.

Because it is a "bounty" program, the SEC maintains broad discretion in the amount of the whistleblower award, as well as whether to make an award and to whom. Nonetheless, any award must be between 10 and 30 percent of the monetary sanctions imposed on the wrongdoer. Whistleblowers may appeal any determination that does not comply with Dodd-Frank, or that considers factors other than those enumerated. However, whistleblowers may not appeal the amount of the award so long as it falls between 10 and 30 percent of the amount recovered.

**What Does the Future Hold?**

The next stage in the growth of SEC whistleblower claims may be to determine what types of claims the SEC is likely to focus on and how aggressive the SEC will be in pursuing any enforcement actions to a favorable conclusion. The securities laws proscribe a wide range of conduct in the areas of illegal trading, false reporting of financial condition and events that may impact financial performance of publicly-traded companies. Similarly, the SEC enforces the Foreign Corrupt Practices Act as it applies to financial reporting. For additional information on the FCPA, conduct that violates the FCPA and effective FCPA compliance programs, see "The FCPA: Can Your Company Survive the Wave?" by Joseph D. Mancano and Ethan J. Barlieb in the July 21 issue of *The Legal*.

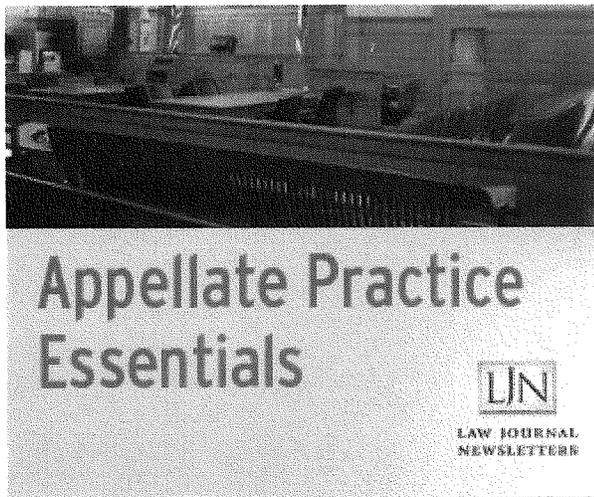
While illegal trading constitutes a large part of the commission's enforcement activities, a great deal of the information used to uncover such conduct is already available to the commission in the form of market and trade reports from brokerages and clearing houses. In the context of illegal trading, the type of information that a whistleblower can provide may be limited to information that the SEC cannot readily obtain on its own, such as information concerning the connection between a trade, a trader and an individual supplying insider knowledge. Conduct more amenable to whistleblower claims is likely to come from insiders, and may

also involve improper financial reporting (e.g., Enron off-books reporting, Madoff-style Ponzi schemes) that the SEC cannot readily monitor.

The creation of the Office of the Whistleblower Program with its director and staff, along with the establishment of the fund used to pay whistleblowers, is a positive development in and of itself for taxpayers. The success of the program will only be known once the SEC begins enforcement proceedings in response to whistleblower claims and then makes payment to the whistleblower for the information provided.

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