

Pending SEC Rules Could Dampen Whistleblower Activity

By George Talarico (August 3, 2020)

The U.S. Securities and Exchange Commission's whistleblower program has been very successful, and the SEC considers it "to be an invaluable component of" its enforcement efforts.[1] Since its inception in 2012, the SEC whistleblower program has awarded over \$500 million to whistleblowers.[2]

Lately, the program is operating at a record-setting pace as the SEC recently awarded its largest whistleblower award ever.[3] Moreover, the number of tips, complaints and referrals has seen a 35% increase over last year.[4]



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The whistleblower program is, however, about to be impacted by the expected enactment of the SEC's proposed new rules that govern its whistleblower program.[5] Other factors, such as the U.S. Supreme Court's recent ruling in *Liu v. SEC*[6] and the expected post-COVID-19 economic rebound may also have an effect.

SEC's Proposed Regulation 21F

While it is not clear what form the proposed Regulation 21F will take, the SEC is expected to enact a revised rule this year. If the enacted rule is substantially like proposed Regulation 21F, it could affect the number of whistleblowers willing to come forward.

The original whistleblower program was created in 2010 under Section 922 of the Dodd-Frank Act, which added Section 21F to the Securities Exchange Act,[7] titled "Securities Whistleblower Incentives and Protection."

Section 21F of the Exchange Act provides that to receive a cash award a whistleblower must voluntarily provide the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than \$1 million.[8] The amount of the award is left to the discretion of the SEC but must be at least 10% and no more than 30% of the monetary sanctions that the commission and the other authorities collect.[9]

The SEC's discretion in setting the award amount is, however, tempered by the requirement that the SEC "shall" consider:

- The significance of the information provided by the whistleblower to the success of the covered judicial or administrative action;
- The degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;
- The programmatic interest of the commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws;
- Such additional relevant factors as the commission may establish by rule or regulation; and

- Shall not take into consideration the balance of the fund.[10]

To implement its responsibilities under Section 21F of the Exchange Act, the SEC promulgated Regulation 21F, which became effective in 2011.[11] In addition to establishing procedures, Reg 21F follows the dictates of Section 21F of the Exchange Act.

In June 2018, the SEC proposed new rules to the whistleblower program.[12] Notable among the changes is an increase in the SEC's authority to establish awards. In situations where the whistleblower award is likely to be under \$2 million, the SEC would have the discretion to upwardly adjust the amount of the award.

Conversely, in situations where the award is likely to exceed \$30 million, the SEC would have the discretion to limit the award — to the mandated minimum of 10%. The SEC's proposed new power to adjust solely based on the award amount seems to ignore the express statutory language.

Section 21F of the Exchange Act instructs the SEC to consider, among other things, the: (1) actions of the whistleblower, such as degree of assistance; and (2) significance of the information. The law does not reference the amount of the award as a factor to consider. Moreover, there is substantial disagreement concerning whether the SEC should amend Reg 21F to permit the reduction of awards in large cases, many focused on the concern that it will discourage whistleblowers from coming forward.[13]

Sen. Chuck Grassley, R-Iowa, has echoed these disagreements noting that by allowing the reduction of large awards the proposed Reg 21F "underestimate[s] the impact of very large awards on a potential whistleblower's decision whether to report and does not adequately consider the deterrent effect of very large sanctions and awards on future potential violators." [14]

Proposed Reg 21F would also limit the amount of whistleblower awards by eliminating double recoveries. Under Reg 21F, the whistleblower award would also be based upon amounts collected in related actions brought by (1) the attorney general of the U.S.; (2) an appropriate regulatory authority; (3) a self-regulatory organization; or (4) a state attorney general in a criminal case.[15]

Proposed Reg 21F prevents double recovery from different whistleblower programs for the same whistleblower information by deeming the action related "only if the Commission finds (based on the unique facts and circumstances of the action) that its whistleblower program has the more direct or relevant connection to the action."

This provision could also discourage whistleblowers from coming forward where an applicable non-SEC whistleblower award program would allow for a much lower award. Thus, if a whistleblower reports bank fraud that results in one action under Financial Institutions Reform, Recovery, and Enforcement Act [16] and another under the Exchange Act, the whistleblower's award may be subject to FIRREA's \$1.6 million cap unless the SEC decides that the predominant reported violation is securities fraud.

Section 21F of the Exchange Act defines "original information" as information derived from either the whistleblower's independent knowledge or analysis.

Reg 21F emphasized that the original information should not include public information noting that "Congress primarily intended our program 'to motivate those with inside

knowledge to come forward and assist the Government to identify and prosecute persons who have violated the securities laws." [17]

Rule 21F, however, defines "independent analysis" to include publicly available information if the "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public."

Proposed Reg 21F changes this definition to require a whistleblower to show that their submission provided "evaluation, assessment, or insight beyond what would be reasonably apparent to the Commission from publicly available information."

Before it accepts that the independent analysis standard is met, the SEC would determine "whether the violations could have been inferred from the facts available in public sources." This introduces a level of ambiguity that could deter whistleblowers from reporting.

Other Impacts on Whistleblower Activity

Liu v. SEC

On June 22, the U.S. Supreme Court held that the SEC's practice of seeking discouragement under Section 21(d) of the Exchange Act can continue, subject to certain restrictions. The court held that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is equitable relief permissible under §78u(d)(5)." [18]

Thus, a disgorgement award: (1) must not exceed the wrongdoer's profit, taking into account legitimate business expenses; and, (2) should go back to the wrongdoer's victims.

This decision will likely cause a decrease in the total amount of monetary penalties recovered by the SEC and thereby decrease the number of whistleblower awards. Also, the determination and calculation of legitimate business expenses are likely to be complicated and time-consuming and will likely delay the payment of any whistleblower award.

Limiting the amount available for and delaying the payment of a whistleblower award may discourage whistleblowers from coming forward.

The COVID-19 Crisis Leads to Increased Whistleblower Activity

From March to May of this year, during a major portion of the COVID-19 crisis, the SEC has received 4,000 whistleblower tips. [19] The increased rate of whistleblower tips, complaints and referrals seems to be tied to the fallout from the COVID-19 pandemic for three reasons:

1. The economic devastation caused by COVID-19 may not have been fully understood by companies causing missteps in reporting things like earnings; [20]
2. Misrepresentations in the Coronavirus Aid, Relief and Economic Security, or CARES, Act process; [21] and
3. The increased number of employees who were laid off, furloughed or working remotely, disgruntled former employees, and employees working from home. [22]

As the economy rebounds and employees get rehired or return to the office, the first and third reasons will be abated and as such, the increased pace of whistleblower activity will likely slow.

Conclusion

Proposed Reg 21F has been scrutinized for over two years and has garnered considerable criticism. Over 100,000 mostly negative comments have been submitted to the SEC concerning proposed Reg 21F.

It remains to be seen what form of Reg 21F will be enacted and if it does dampen the whistleblower program's success as many suggest it will. Also, whistleblower activity may be negatively impacted by both *Liu v. SEC* and COVID-19. In any event, the SEC's whistleblower program is not going to disappear, and firms should still take measures to address whistleblower liability, particularly during this time of COVID-19.[23]

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[1] Jay Clayton, Statement on Whistleblower Program 2109 Annual Report to Congress, November 15, 2019. <https://www.sec.gov/news/public-statement/statement-clayton-2019-11-15-whistleblower>.

[2] SEC Awards Record Payout of Nearly \$50 Million to Whistleblower, SEC Press Release dated June 4, 2020. <https://www.sec.gov/news/press-release/2020-126>.

[3] *Id.*

[4] From mid-March to mid-May 2020, the SEC has received over 4000 tips. S. Peiken, Keynote Address: Securities Enforcement Forum West 2020, May 12, 2020. https://www.sec.gov/news/speech/keynote-securities-enforcement-forum-west-2020#_ftn20.

[5] Whistleblower Program Rules, Release No. 34-83557; File No. S7-16-18 ("Proposed Reg. 21F"). <https://www.sec.gov/rules/proposed/2018/34-83557.pdf>.

[6] *Liu v. Securities and Exchange Commission*, No. 18-1501 (June 22, 2020).

[7] The "Exchange Act", 15 U.S.C. 78u-6.

[8] *Id.*

[9] *Id.*

[10] 15 USC §78u-6(c)(1)(B). The Fund refers to the Investor Protection Fund ("IPF") which was established for payment of whistleblower awards by the SEC. 15 USC §78u-6(g).

[11] 17 CFR § 240.21F.

[12] Proposed Reg. 21F.

[13] There have been over 100,000 comments submitted to the SEC concerning proposed Reg. 21F. Comments on Proposed Rule: Amendments to the Commission's Whistleblower Program Rules. <https://www.sec.gov/comments/s7-16-18/s71618.htm>.

[14] <https://www.sec.gov/comments/s7-16-18/s71618-4373264-175545.pdf>.

[15] Reg. 21F.

[16] 18 USC § 3293, et seq.

[17] 3 76 FR 34300, 34311/3.

[18] Liu v. Securities and Exchange Commission, No. 18-1501 (June 22, 2020).

[19] See FN 2,

[20] See e.g. Coronavirus (COVID-19), Division of Corporate Finance, Securities and Exchange Commission, CF Guidance: Topic No. 9, March 25, 2020. <https://www.sec.gov/corpfin/coronavirus-covid-19>.

[21] See e.g. SEC Conducts Review of PPP Borrowers, Alaric Alert, May 29, 2020.

[22] See, e.g. K. Johnson, Armed with whistleblower tips, U.S. SEC cracks down on coronavirus misconduct, May 26, 2020, Reuters. <https://www.reuters.com/article/us-health-coronavirus-sec-whistleblowers/armed-with-whistleblower-tips-u-s-sec-cracks-down-on-coronavirus-misconduct-idUSKBN2321FI> Tips to SEC Surge as Working From Home Emboldens Whistleblowers. The Wall Street Journal, June 1, 2020.

[23] See e.g. Arian June, Andrew Ceresney, 5 Ways To Mitigate Whistleblower Risk During COVID-19, Law360. <https://www.law360.com/articles/1284905/5-ways-to-mitigate-whistleblower-risk-during-covid-19>.