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Should Culpable Whistleblowers Be Eligible for SEC Awards?

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By promising anti-retaliation protection and offering the prospect of significant monetary awards, the U.S. Securities and Exchange Commission whistleblower program[1] incentivizes individuals to come forward in an effort to ferret out securities law violations. While the SEC has touted the program as a success,[2] certain aspects have sparked ongoing debate within the legal and business communities. Whether whistleblowers who engaged in culpable conduct should be eligible for monetary awards, as they are now, is one area of contention.

The core arguments on both sides of this debate are fairly straightforward. On the one hand, if culpable whistleblowers are not eligible for monetary awards, the pool of potential whistleblowers best positioned to report wrongdoing may be diminished and discovery of misconduct may be delayed or never occur.[3] Others argue that the program should not reward—or worse, incentivize—wrongdoers by allowing them to cash in by reporting their own misconduct.[4]

The first round of this debate ended in 2011 when the SEC, in adopting final rules implementing the program, limited culpable whistleblowers' eligibility for monetary awards, but declined to implement a per se exclusion of culpable whistleblowers.[5] The SEC currently only bars whistleblowers convicted criminally from recovering. All others, including culpable whistleblowers, can collect between 10 percent and 30 percent of the monetary sanctions. The exact amount in that range is subject to the SEC's discretion, which includes an assessment of the whistleblower's culpability in the underlying wrongdoing. Now, six years later, Congressman Jeb Hensarling (R-Tx.), Chairman of the House Financial Services Committee, has reignited the debate by introducing legislation that would prohibit culpable whistleblowers from receiving any monetary award under the program.

This column surveys and analyzes current SEC regulations concerning culpable whistleblowers, SEC orders providing monetary awards to whistleblowers under the program, Chairman Hensarling's proposed legislation—the Financial CHOICE Act of 2017 (the CHOICE Act 2.0)[6]—and the potential implications of eliminating monetary awards to culpable whistleblowers. It also presents a potential path forward in the form of a compromise: prohibiting a narrowly-defined group of culpable whistleblowers—those who directed, planned, or initiated the misconduct—from receiving monetary awards.

Current Eligibility

Section 21F of the Exchange Act, as amended by Dodd-Frank, directs the SEC to pay a whistleblower 10 percent to 30 percent of the monetary sanctions collected if the whistleblower voluntarily provides "original information" to the SEC about violations of the securities laws and that information leads to a successful enforcement action in which the monetary sanctions exceed $1 million. Section 21F(c)(2)(B) explicitly precludes monetary awards "to any whistleblower who is convicted of a criminal violation related to the judicial or administrative action for which the whistleblower otherwise could receive an award." Section 21F is silent on whether culpable whistleblowers who have not been

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criminally convicted are eligible for monetary awards.

The Commission addressed this issue by adopting rules designed to strike a balance: "appropriately incentiviz[ing] culpable whistleblowers to report securities violations while preventing culpable whistleblowers from financially benefiting from their own misconduct or misconduct for which they are substantially responsible."[7] It accordingly limited the award to culpable whistleblowers in two ways. First, the program omits "any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated" in determining whether the $1 million sanctions threshold had been met or in the total amount that the whistleblower is eligible to be awarded.[8] Second, the program provides that the Commission may decrease the amount of a whistleblower's award based on the whistleblower's culpability or involvement in matters related to the enforcement action.[9]

In February 2017, the Commission exercised that discretion when it awarded a whistleblower 20 percent of the sanctions collected. In its order, the Commission explicitly noted that the award was reduced "because of both the Claimant's culpability in connection with the securities law violations at issue … and the Claimant's unreasonable delay in reporting the wrongdoing to the Commission."[10] Of the 43 whistleblowers who have received monetary awards to date, this represents the second occasion in which the Commission has indicated some culpability on the part of the whistleblower and appears to be only the first time the amount of the award was decreased as a result.[11]

CHOICE Act 2.0

In April 2017, Chairman Hensarling proposed legislation, the CHOICE Act 2.0, that would amend §21F(c) of the Exchange Act to prohibit "any whistleblower who is responsible for, or complicit in, the violation of the securities laws for which the whistleblower provided information to the Commission" from receiving a whistleblower award.[12] It provides that "[a] person is responsible for, or complicit in, a violation of the securities laws if, with the intent to promote or assist the violation, the person—(A) procures, induces, or causes another person to commit the offense; (B) aids or abets another person in committing the offense; or (C) having a duty to prevent the violation, fails to make an effort the person is required to make."[13] In practice, the CHOICE Act 2.0 would appear to bar all "culpable" whistleblowers, no matter their level of involvement, from receiving monetary awards.

> While the SEC has touted the whistleblower program as a success, certain aspects have sparked on-going debate within the legal and business communities.

Implications

As a general matter, monetary awards constitute a meaningful incentive for culpable individuals considering whether to come forward as whistleblowers. Less apparent is the impact that eliminating such an incentive would have on the program at large.

There is little doubt that the prospect of monetary awards helped drive the SEC-touted success of its whistleblower program. Accordingly, it is reasonable to assume that the SEC leadership responsible for stewarding the program for its first six years would be concerned that additional limitations on culpable whistleblower awards might do more harm than good by decreasing the number of high-quality tips.[14] As recently as September 2016, the then-Director of Enforcement made clear that "[i]t is important for participants in misconduct to understand that, in many circumstances, they are eligible for awards and we would like to hear from them."[15]

Nevertheless, it is impossible to know how a prohibition on culpable whistleblower awards would have impacted—or will impact—the SEC's enforcement program. The impact could be minimal: We are only aware of two culpable whistleblowers who have received monetary awards. Then again, the impact could be much greater: Of the remaining 41 whistleblowers who received monetary awards, some may have been involved with the misconduct but not considered sufficiently culpable for amount determination purposes. Additionally, other culpable whistleblowers may have reported securities law violations that resulted in no sanctions or sanctions that did not exceed $1 million (and therefore, no monetary award was ordered). Such individuals may not have blown the whistle absent at least the prospect of a financial reward.

Ultimately, impact on the program will depend largely on how culpability

is defined. The CHOICE Act 2.0 standard illustrates several of the problematic issues that could arise when attempting to define who is (and who is not) a culpable whistleblower.

First, the proposed legislation injects significant uncertainty into the entire process. To determine whether a whistleblower should be prohibited from receiving a monetary award, the Commission would need to decide whether the whistleblower is essentially civilly liable (or not) for the underlying violation. This would require the Commission to grapple with and decide on a case-by-case basis issues of intent, involvement, whether or not the whistleblower had a duty to prevent the securities law violation, and what, if any effort the whistleblower should have made to prevent the violation. Reading the tea leaves with respect to how the SEC might decide such issues in a given case is, at best, a dicey proposition, and one made even dicier by the fact that details of a whistleblower's involvement are never disclosed by the Commission. Such uncertainty might well deter potential whistleblowers who are concerned, whether justified or not, about the possible implications of their conduct.[16]

This uncertainty is amplified because the Commission's decision under the CHOICE Act 2.0 is determinative as to eligibility. The Commission may already take into account "[t]he whistleblower's role in the securities violations" and "whether the whistleblower acted with scienter."[17] But, under the current regulations, these are only permissible considerations that come into play when deciding the amount of the monetary award, not the threshold issue of whether a whistleblower is eligible for an award in the first place.

There is always some uncertainty as to whether a whistleblower will earn a monetary award and, if so, the appropriate award amount. But, under the CHOICE Act 2.0, a whistleblower could be in the dark as to their eligibility to receive an award until the investigation is complete (or close to it) or even until the Commission issues its order, which might further disincentivize potential whistleblowers from coming forward. And, if a whistleblower is ultimately determined ineligible for a monetary award, an appeal to the U.S. Court of Appeals might feel more like a criminal trial or civil enforcement action against the whistleblower than an award dispute.[18] This, too, might serve to deter potential whistleblowers.[19]

Prohibiting whistleblowers who directed, planned, or initiated the violative conduct from receiving awards presents a potential compromise position.

A Potential Path Forward

Prohibiting whistleblowers who directed, planned, or initiated the violative conduct from receiving awards presents a potential compromise position. This would not resolve all of the uncertainty created by placing the onus on the Commission for determining whether a whistleblower is eligible to receive a monetary award. However, the SEC already uses this "directed, planned, or initiated" standard to exclude certain monetary sanctions from whistleblower calculations and, as compared to the CHOICE Act 2.0, it would exclude a narrower universe of culpable whistleblowers from eligibility. It would, therefore, be less of a deterrent to potential culpable whistleblowers and still achieve the objective of preventing wrongdoers from benefiting from their own misconduct. It would also comport with the common sense notion of balancing the need to encourage less culpable whistleblowers (i.e., aiders and abettors) to come forward, while barring those most culpable and/or involved in leading the misconduct from cashing in on their wrongdoing.

There are no easy solutions or parameters for determining a culpability bar. And, when Congress and the Commission begin to consider potential changes to the whistleblower program, we expect the debate concerning culpable whistleblower awards to be as heated as it was at the program's inception.

1. The whistleblower program was established on July 21, 2010 by §922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Pub. L. No. 111-203, §922(a), 124 Stat 1376, 1841-49 (2010). Dodd-Frank added new §21F, "Securities Whistleblower Incentives and Protection," to the Securities Exchange Act of 1934 (the Exchange Act).

2. In August 2016, then-SEC Chair Mary Jo White characterized the SEC's whistleblower program as a "game changer for the agency[.]" Press Release, U.S. Sec. and Exch. Comm'n, SEC Whistleblower Program Surpasses $100 Million in Awards (Aug. 30, 2016), available at https://www.sec.gov/news/pressrelease/2016-173.html. Since the program's inception in 2011, enforcement actions from whistleblower tips have resulted in over $953 million in financial remedies; the SEC has awarded more than $142 million to 43 whistleblowers; and it has received over 18,000 whistleblower tips. See U.S. SEC. AND EXCH. COMM'N, 2016 ANNUAL REPORT TO CONGRESS ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 1, 23 (2016) [hereinafter 2016 ANNUAL REPORT],

available at https://www.sec.gov/files/owb-annual-report-2016.pdf; Order Determining Whistleblower Award Claim, Exchange Act Release No. 80521 (April 25, 2017) (one claimant awarded); Order Determining Whistleblower Award Claim, Exchange Act Release No. 80115 (Feb. 28, 2017) (one claimant awarded); Order Determining Whistleblower Award Claim, Exchange Act Release No. 79853 (Jan. 23, 2017) (three claimants awarded); Order Determining Whistleblower Award Claim, Exchange Act Release No. 79747 (Jan. 6, 2017) (one claimant awarded); Order Determining Whistleblower Award Claim, Exchange Act Release No. 79517 (Dec. 9, 2016) (one claimant awarded); Order Determining Whistleblower Award Claim, Exchange Act Release No. 79294 (Nov. 14, 2016) (one claimant awarded); WHISTLEBLOWER AWARDS, https://www.sec.gov/page/whistleblower-100million (modified as of Jan. 23, 2017) (last visited May 1, 2017).

3. See, e.g., Robert S. Khuzami, Director, U.S. Sec. and Exch. Comm'n Division of Enforcement, Remarks at Opening Meeting—Whistleblower Program (May 25, 2011), available at https://www.sec.gov/news/speech/2011/spch052511rk.htm (noting that the final rules "simply recognize[] the established reality in law enforcement that often only those who are part of the fraud can provide evidence of unlawful conduct, and equally importantly can make the case against the biggest threats to investors—the organizers and leaders of a scheme who, if not pursued, will resurface in the future to commit new frauds"); Implementation of the Whistleblower Provisions of §21F of the Securities Exchange Act of 1934, Exchange Act Release No. 24-64545 191-94 (May 25, 2011) [Adopting Release], available at https://www.sec.gov/rules/final/2011/34-64545.pdf (citing numerous letters submitted to the SEC providing comment on the proposed whistleblower rules).

4. See Adopting Release at 191-94.

5. See 17 C.F.R. §§240.21F-6(b)(1), 240.21F-16 (2015).

6. H. COMM. ON FIN. SERVICES, 115th CONG, Discussion Draft The Financial CHOICE Act of 2017 449-50 (2017) [CHOICE Act 2.0], available at https://financialservices.house.gov/uploadedfiles/choice_2.0_discussion_draft.pdf.

7. Adopting Release at 194.

8. 17 C.F.R. §240.21F-16.

9. Id. at §240.21F-6(b)(1). The SEC has discretion in determining the amount of an award, within the mandated 10 percent to 30 percent of monetary sanctions collected, based on the particular facts and circumstances of each case. Culpability is one of three factors—along with unreasonable reporting delay and interference with internal compliance and reporting systems—enumerated in Rule 21F that may warrant decreasing the amount of a whistleblower award.

10. Order Determining Whistleblower Award Claim, Exchange Act Release No. 80115, 1 & n.1 (Feb. 28, 2017).

11. See Order Determining Whistleblower Award Claim, Exchange Act Release No. 78719 (Aug. 30, 2016) (noting that "[s]everal other factoring mitigating the Claimant's culpability" were considered in arriving at the $22 million award). Based on the information in the heavily redacted order, it appears that whistleblower's culpability was sufficiently mitigated by other factors and had little, if any, impact on the amount of the award. Id.

12. CHOICE ACT 2.0 §828(1)(C). Non-monetary incentives, like cooperation credit and the whistleblower anti-retaliation protections, would remain.

13. Id. at §828(2). If the CHOICE Act 2.0 whistleblower amendment passes as proposed, the SEC whistleblower program would face stricter limits on awards to culpable whistleblowers than any other federal whistleblower programs. The U.S. Commodity Futures Trading Commission (CFTC) whistleblower regulations place the same limitations on culpable whistleblowers and criminally convicted whistleblowers as the SEC whistleblower regulations. See 7 U.S.C. §26 (c)(2)(b) (2010); 17 C.F.R. §§165.9(c)(1), 165.17 (2015). Similarly, the False Claims Act whistleblower regulations do not entitle a whistleblower to any recovery if they are "convicted of criminal conduct arising from his or her role in the violation." 31 U.S.C. 3730(d)(3) (2011). However, in the absence of a criminal conviction, if the court finds that the whistleblower "planned and initiated" the false claim, it may take that into consideration and reduce the amount of the award accordingly. Id. The Internal Revenue Service whistleblower provisions are even more lenient. A whistleblower's criminal conviction for conduct relating to the information s/he provided is not a bar to receiving a whistleblower award; the IRS rules only prohibit awards to whistleblowers criminally convicted for conduct "arising from his or her role in planning or initiating the actions." U.S. INTERNAL REVENUE SERV., MANUAL 25.2.2.1.1; see 26 U.S.C. §7623(b)(3) (2006). If there is no criminal conviction but the IRS Whistleblower office determines that the whistleblower "planned and initiated the actions" that led to the violation, the IRS Whistleblower office may take this into consideration and reduce the award. U.S. INTERNAL REVENUE SERV., MANUAL 25.2.2.1.1 (2015), available at https://www.irs.gov/irm/part25/irm_25-002-002.html; see 26 U.S.C. §7623(b)(3).

14. The SEC has made clear that it is focused on protecting its whistleblowers and removing obstacles that could inhibit an individual's ability to be a whistleblower. Over the past two years, the SEC has cracked down on confidentiality agreements and separation agreements that it viewed as impeding whistleblowers from reporting potential violations to the SEC. See, e.g., *In re BlueLinx Holdings*, Exchange Act Release No. 78528, 2 (Aug. 10, 2016) (concerning separation agreement provisions); *In re KBR*, Exchange Act Release No. 74619, 2 (April 1, 2015) (concerning confidentiality agreement provisions). It has also continued to pursue whistleblower retaliation cases, bringing its first stand-alone whistleblower retaliation case in September 2016. See *In re Int'l Gaming Tech.*, Exchange Act Release No. 78991, 2-4 (Sept. 29, 2016) (concerning whistleblower retaliation).

15. Andrew Ceresney, Director, U.S. Sec. and Exch. Comm'n Division of Enforcement, Speech at the Sixteenth Annual Taxpayers Against Fraud Conference, The SEC's Whistleblower Program: The Successful Early Years (Sept. 14, 2016), available at https://www.sec.gov/news/speech/ceresney-sec-whistleblower-program.html.

16. If the Commission determines that a whistleblower is not eligible for a monetary award under the CHOICE Act 2.0 standard, it could also raise questions concerning why the SEC did not bring an action against that whistleblower. See 17 C.F.R. 240.21F-15 (making clear that the SEC can bring an action against a whistleblower based on his/her own connection with the violations).

17. 17 C.F.R. 240.21F-6(b)(1).

18. See 17 C.F.R. 240.21F-13(a) (setting forth that "[a] determination of whether or to whom to make an award may be appealed" after the Commission issues its final decision to a United States Court of Appeals).

19. In addition, de facto determinations of liability would essentially guarantee that potential whistleblowers retain counsel, who generally work for a contingency fee and may be less likely to represent a potentially culpable whistleblower in the face of a lengthier process and a more uncertain outcome, which could further inhibit the process. Another (and perhaps less obvious) consequence of adopting the CHOICE Act 2.0 is the burden it would likely place on the SEC professionals with responsibility in the current whistleblower award process: the SEC Office of the Whistleblower (OWB), the Claims Review Staff, which includes the Director of Enforcement and four additional senior officers in the Division of Enforcement designated by the Director of Enforcement, and the Commission. See 17 C.F.R. §240.21F-10; 2016 Annual Report at 14-16. The CHOICE Act 2.0 standard could result in increased debate—and time spent—on issues like intent and aiding and abetting liability when making a determinative eligibility decision that is not necessary when considering the current, more general culpability factor, which only impacts the amount of a monetary award.