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COMMENTARY

Fuel to the fire: Whistle-blower incentives in the Dodd-Frank Act

By James Parkinson, Esq., and Lauren Randell, Esq.

A new era of whistle-blower regulation commenced July 21, when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1]

The Dodd-Frank Act directs the Securities and Exchange Commission to develop a whistle-blower incentive program seemingly certain to increase the number of whistle-blower reports and, in response, the level of SEC enforcement activity. More whistle-blowing adds fuel to the fire for companies concerned about compliance programs and enforcement actions.

The new law adds Section 21F to the Securities Exchange Act of 1934, titled "Securities Whistle-blower Incentives and Protection." The SEC is now *required* to award qualifying whistle-blowers between 10 percent and 30 percent of certain monetary sanctions imposed by the agency, as well as in related actions as described below. Whistle-blowers now have powerful financial incentives in the form of potentially huge payouts.

A back-of-the-envelope analysis shows the magnitude of the incentive created by this program. In February 2009, the oil field services company Halliburton settled a Foreign Corrupt Practices Act enforcement action with the SEC for $177 million, and a Halliburton subsidiary settled a parallel action with the Department of Justice for $402 million. Had a whistle-blower's information led to the SEC settlement and DOJ action, the minimum award under the new whistle-blower incentive program would have been nearly $58 million, and the maximum award possible would have been $173.7 million.

HOW THE WHISTLE-BLOWER INCENTIVE PROGRAM WORKS

How a whistle-blower qualifies

To qualify under the program, a whistle-blower must voluntarily provide original information to the SEC that leads "to the successful enforcement of [a] covered judicial or administrative action, or [a] related action."

Covered judicial or administrative action means any judicial or administrative action brought by the agency under the securities laws that results in monetary sanctions exceeding $1 million. More than 150 SEC actions exceeded this threshold in 2008 and 2009, a not-insignificant universe of potential whistle-blower claims.

A "related action" is "any judicial or administrative action ... based on the original information provided by a whistle-blower ... that led to the successful enforcement of the commission action" and is brought by any of the following entities: "the attorney general of the United States; an appropriate regulatory authority; a self-regulatory organization [or] a state attorney general in connection with any criminal investigation."

Unlike the requirement for an SEC enforcement action, there is no monetary threshold for a "related action."

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Importantly, there is no subject matter limitation on the underlying basis for the judicial or administrative action. Eligibility for the whistle-blower incentive program may be triggered by "any judicial or administrative action brought by the commission under the securities laws," including the FCPA, actions under Exchange Act Section 10(b) or Rule 10(b)(5), Section 17(a) of the Securities Act of 1933, or any other enforcement action pertaining to the securities laws. In the pre-Dodd-Frank Act era, under the SEC's bounty program, whistle-blowers were eligible for awards only in insider trading cases.

Finally, under Section 21 F, the information provided by the whistle-blower must be "original":

> The term "original information" means information that ... is derived from the independent knowledge or analysis of a whistle-blower; ... is not known to the commission from any other source, unless the whistle-blower is the original source of the information; and ... is not exclusively derived 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 whistle-blower is a source of the information.

Determining the value of awards

The whistle-blower may qualify for awards ranging between "not less than 10 percent [and] not more than 30 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions."[2]

This stands in stark contrast to the 10 percent maximum award available under the SEC's prior bounty program, where the largest amount ever awarded was $1 million.[3] Whether the whistle-blower receives 10 percent or 30 percent of the monetary sanctions will be a case-by-case determination under Section 21 F:

> The determination of the amount of an award ... shall be in the discretion of the commission[, which] shall take into consideration ... the significance of the information provided by the whistle-blower to the success of the covered judicial or administrative action; ... the degree of assistance provided by the whistle-blower and any legal representative of the whistle-blower in a covered judicial or administrative action; ... the programmatic interest of the commission in deterring violations of the securities laws by making awards to whistle-blowers who provide information that lead to the successful

enforcement of such laws; and ... such additional relevant factors as the commission may establish by rule or regulation.

Monetary sanctions include "any monies, including penalties, disgorgement, and interest, ordered to be paid; and ... any monies deposited into a disgorgement fund or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act [], as a result of such action or any settlement of such action."[4]

Source of funding for the awards

The Dodd-Frank Act created a new fund to be used for paying whistle-blower awards, the Securities and Exchange Commission Investor Protection Fund. There is no distinction made between awards based on SEC enforcement actions and awards based on related actions — *all* whistle-blower awards are to be paid from the fund.[5] Thus, if the SEC settles an action for $1 million, but a related action is settled for $50 million, the fund could be the source of a whistle-blower award for both.

Shielding the whistle-blower

Exchange Act Section 21F(h)(1)(A) contains significant new protections for whistle-blowers, including a private right of action:

> No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, a whistle-blower in the terms and conditions of employment because of any lawful act done by the whistle-blower ... in providing information to the commission in accordance with this section; ... in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the commission based upon or related to such information; or ... in making disclosures that are required or protected under the Sarbanes-Oxley Act [], the Securities Exchange Act, Section 1513(a) of title 18, United States Code, and any other law, rule, or regulation subject to the jurisdiction of the commission.

If a whistle-blower believes this protection has been violated, the whistle-blower may bring an action in federal district court alleging "discharge or other discrimination," seeking "reinstatement with the same seniority," "two times the amount of the back pay otherwise owed to the individual, with interest," and "compensation for litigation costs, expert witness fees, and reasonable attorneys' fees."[6]

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ADMINISTERING THE WHISTLE-BLOWER INCENTIVE PROGRAM

Dedicated SEC whistle-blower office

The SEC must establish a separate office within the agency to administer and enforce the provisions of Section 21F. This office is required to report annually to Congress "on its activities, whistle-blower complaints, and the response of the commission to such complaints."

Regulations

The SEC is authorized to issue rules and regulations necessary or appropriate to implement the provisions of Section 21F not later than 270 days after the date of enactment of the Dodd-Frank Act. If this schedule for final rules holds, requiring final action by mid-April 2011, the SEC will have to propose rules early this fall.

Appeals

Under Exchange Act Section 21F, a determination concerning whether, to whom or in what amount to make whistle-blower awards shall be in the discretion of the SEC. A determination, except the determination of the *amount* of an award if the award was made in accordance with subsection (b), may be appealed to the appropriate court of appeals not more than 30 days after the determination is issued.

Excepting from appellate review "the determination of the amount of an award" appears to insulate that element of decision-making from litigation. If the award falls within the 10 percent to 30 percent range, the SEC's determination appears to stand outside review. The appellate court will review other elements of the determination under the judicial review provisions of the Administrative Procedures Act, 5 U.S.C. § 706(2)(A)-(F).

Inspector general study

The Dodd-Frank Act modifies the whistle-blower provisions of the Sarbanes-Oxley Act, 18 U.S.C. § 1514A, to require the SEC's inspector general to study the whistle-blower protection program and publish the results within 30 months of the enactment date, which falls in January 2013.

Among the areas to be examined by the inspector general are whether

- The regulations are "clearly defined and user-friendly."
- The program has been widely publicized.
- The commission promptly responds to information provided by whistle-blowers.
- The reward levels are adequate to entice whistle-blowers to come forward.[7]

Perhaps the most interesting element the inspector general is to study is:

> [W]hether, in the interest of protecting investors and identifying and preventing fraud, it would be useful for Congress to consider empowering whistle-blowers or other individuals, who have already attempted to pursue the case through the commission, to have a private right of action to bring suit based on the facts of the same case, on behalf of the government and themselves, against persons who have committed securities fraud.[8]

This line of inquiry calls upon the SEC inspector general to evaluate whether it would be useful for the whistle-blower incentive program to permit a private right of action similar to the False Claims Act.

DEVELOPMENTS TO WATCH

What is the scope of related actions?

The incentive program allows whistle-blowers to receive awards based on SEC enforcement actions and on so-called "related actions," vastly increasing the universe of potential awards. A "related action" may include any action brought by the Justice Department or an "appropriate regulatory authority" when the action "is based on the original

information provided by a whistle-blower [and] that led to the successful enforcement of the commission action."

This could be interpreted to suggest that the whistle-blower may benefit from any sanction obtained by the Justice Department or the "appropriate regulatory authority," only when the same "original information" is used by the other agency in an enforcement action.

But what if the "original information" included information leading the Justice Department to obtain an environmental crimes conviction and fine? Is the factual nexus the critical aspect qualifying another action as being a "related action?" Or is it the source of the information, so that any action can be a "related action" if the underlying information came from the whistle-blower? What if the whistle-blower provides a huge data set to the SEC, the SEC acts on only a portion of it but obtains a "successful enforcement" action and the whistle-blower separately provides the data to the Internal Revenue Service? Should the IRS action be considered a "related action"?

Another open issue concerns non-U.S. actions. An important enforcement trend in recent FCPA actions involves collaboration by U.S. agencies with foreign law enforcement agencies. It will be interesting to observe whether a whistle-blower award may be based on monetary sanctions imposed by a foreign law enforcement agency. The language of the whistle-blower incentive program does not appear to bar such claims by whistle-blowers. Given the current level of international enforcement cooperation, it may be difficult for the SEC to argue that other nations' law enforcement agencies are not "appropriate regulatory authorities."

Adequacy of the fund

The success of the whistle-blower incentive program may depend on the adequacy of the fund to pay awards. If a whistle-blower qualifies for an award, and the SEC's report to other law enforcement agencies and/or self-regulatory agencies results in qualified "related actions" involving monetary sanctions, the whistle-blower's potential award may greatly increase. Indeed, it is plausible that the awards from "related actions" may be much higher than awards from the SEC's enforcement actions.

Because the fund is the exclusive source of funding for whistle-blower awards, it will be required to pay bounties associated with actions over which the SEC has no control. The agency is expressly prohibited from taking the "balance of the fund" into account when determining the size of a whistle-blower's award. One effect may be funding shortfalls down the line to pay whistle-blower awards.

Sanction inflation

No observer of the SEC's enforcement program has missed the increase in the value of monetary sanctions over the past few years, particularly for FCPA-related actions. The whistle-blower incentive program seems certain to add fuel to the fire of sanction inflation. The knowledge that up to 30 percent of every covered enforcement action will no longer remain in government coffers may cause the SEC to "gross up" sanctions to compensate for awards to whistle-blowers.

Dynamics with plaintiffs' counsel

Under the incentive program, significant financial incentives are provided not only to whistle-blowers. Financial incentives for counsel to the whistle-blower are also attractive. Exchange Act Section 21F(d)(1) expressly permits counsel to represent a whistle-blower who makes a claim for an award. If counsel to the whistle-blower expects a contingent fee, often 30 percent or more of the award, he or she has powerful financial incentives to represent whistle-blowers.

Canny whistle-blower counsel may be able to advocate for their client to receive a 30 percent bounty on an enforcement action and any related actions (counsel, of course, receiving a contingent fee on that recovery) and at the same time represent a plaintiff in a parallel shareholder action against the company based on the same facts.

Award litigation and the future

Whistle-blowers may disagree with the SEC about aspects of the whistle-blower incentive program, including whether information reported qualifies as "original," the relative proportion of an award to individual whistle-blowers in the case of multiple whistle-blower reports, and whether an enforcement action by another entity qualifies as a "related action" for purposes of increasing the potential size of an award. These issues seem certain to lead to litigation between whistle-blowers and the SEC.

Despite some unresolved issues, the whistle-blower provisions of the Dodd-Frank Act will undoubtedly increase the frequency and possibly the quality of information reported to the SEC by whistle-blowers, fueling an increase in the number of SEC enforcement actions and possibly the size of resulting settlements. WJ

NOTES

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Exchange Act § 21F(b)(1)(A)-(B).

[3] *See* Litigation Release 21601, Sec. & Exch. Comm'n, SEC Awards $1 Million for Information Provided in Insider Trading Case (July 23, 2010) (describing award of $1 million to two people who provided information leading to civil penalties in an insider trading case).

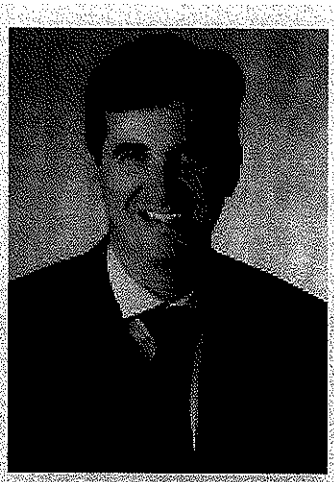
[4] Exchange Act § 21F(a)(4).

[5] Exchange Act §§ 21F(b)(2), (g)(1).

[6] Exchange Act §§ 21F(h)(1)(B), (C).

[7] Dodd-Frank Act § 922(d)(1)(A)-(D).

[8] Dodd-Frank Act § 922(d)(1)(G).



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