



# Whistleblowers granted bounties and protection from SEC and CFTC in US financial reform law

This briefing highlights the increased risk of investigations and enforcement under the US securities and commodities trading laws by the SEC and CFTC against financial institutions and other companies doing business in the United States. This results from the significant expansion of financial incentives for whistleblowers under the newly enacted US financial reform act.

With the signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act into law this week, the US government quietly introduced two parallel whistleblower programs that will provide powerful financial incentives for individuals to report suspected securities or commodities trading violations to the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). US issuers and others subject to SEC and CFTC regulations, including new regulations relating to the trading of derivatives, will be directly affected. It is likely that these two programs will lead to an increase in government investigations and enforcement actions brought under the US securities and commodities trading laws, similar to the sharp increase in enforcement activity that accompanied the strengthening of a comparable whistleblower reward structure under the US False Claims Act.<sup>1</sup> Under the new legislation, private individuals such as current or former employees are given significant financial incentives of up to 30 percent of the proceeds of any judgment or settlement to disclose potentially confidential company information to federal regulatory authorities.

To mitigate this increased risk, issuers, financial institutions and other companies doing business in the United States can take several precautionary steps to review and revamp their compliance, training, risk

assessment and internal whistleblower policies and procedures, as discussed in greater detail below.

## Powerful incentives and protections

Stripped down to its fundamental purpose, the new legislation calls for the mandatory award to one or more whistleblowers of between 10 percent and 30 percent of any “monetary sanctions” recovered under the securities laws by the SEC or certain other government agencies or organizations in “related proceedings” that are made possible by the voluntary provision of “original information” by the relevant whistleblowers. The new SEC whistleblower program is set forth in section 922 of the Dodd-Frank Act, while the analogous CFTC program is established by section 748. As the provisions are nearly identical in all meaningful respects, this briefing will analyze only the SEC program.

SEC actions subject to a possible whistleblower award include any judicial or administrative action brought by the SEC under the securities laws that results in monetary sanctions exceeding \$1m. The Act also covers any “related proceedings” brought by the Attorney General of the United States (DOJ), an appropriate regulatory authority, a self-regulatory organization or a state attorney general in connection with any criminal investigation.

The “monetary sanctions” on which a potential whistleblower’s share will be based include all penalties,

<sup>1</sup> For more information on the US False Claims Act, please consult our recent briefing, available at [www.freshfields.com/publications/pdfs/2010/May10/28080.pdf](http://www.freshfields.com/publications/pdfs/2010/May10/28080.pdf).

disgorgement amounts and interest payments in any actions brought by the SEC or in a related proceeding, as defined above. This includes monetary sanctions recovered in parallel actions by the DOJ under the US Foreign Corrupt Practices Act (FCPA). Under the Dodd-Frank Act, if the information on which a joint SEC and DOJ settlement is based derives from a qualified whistleblower as defined by the Act, the whistleblower may be entitled to an award of between 10 and 30 percent of the cumulative value of the joint settlement.

In addition, although the amount of a whistleblower's share is determined by the SEC in its sole discretion, and apparently is not subject to judicial review, a mandatory 10 percent floor ensures that a whistleblower otherwise meeting all specified requirements will share in a portion of any monetary sanction recovered.<sup>2</sup>

The new provisions also contain a number of strong legal protections for prospective whistleblowers. Most notably, employers are prohibited from taking retaliatory action against any employees who qualify as whistleblowers under the Act. The legislation also creates a private right of action for any such employees who are the subject of retaliatory actions to bring lawsuits in federal district court. In addition, the legislation contains confidentiality protections intended to safeguard against the disclosure of any information that "could reasonably be expected to reveal the identity of a whistleblower," subject to certain limited exceptions.

The Act, however, does place several restrictions on the eligibility of individuals seeking whistleblower status that closely mirror similar restrictions placed on *qui tam* plaintiffs under the US False Claims Act. For example, as with the US False Claims Act's "original source" requirement, whistleblowers under the new SEC whistleblower program must voluntarily provide "original information" to the SEC that leads to a successful enforcement result in a covered proceeding. Original information is defined as being "derived from the independent knowledge or analysis of a whistleblower"

that is "not known to the SEC from any other source unless the whistleblower is the original source" and cannot be derived exclusively from allegations made in another proceeding or from a government report, hearing, audit, investigation or news source unless the whistleblower is the original source.

Other individuals explicitly prohibited from qualifying as a whistleblower under the Act include those who are convicted of a crime related to the action for which the whistleblower provided original information as well as employees of certain government, law enforcement and self-regulatory agencies and organizations.

## **Background regarding the proposal and implementation of the new whistleblower provisions**

The new SEC whistleblower program established by the Dodd-Frank Act is not the first such program to be established by the federal securities laws. In 1989, Congress enacted Section 21A(e) of the Securities Exchange Act of 1934, 15 USC, section 78u-1(e), to authorize the payment of a bounty to whistleblowers who provided information to the SEC regarding suspected insider trading activities that lead to civil monetary penalties. On March 29, 2010, the SEC's Office of Inspector General (OIG) issued a scathing report on this underutilized program. Specifically, the OIG found that the program was "not designed to be successful" because few investors were aware of the program and it applied only to a narrow range of possible securities violations. According to the report, from the inception of the program through January 2010, the SEC paid a total of only \$159,537 to five claimants and outright denied five additional bounty applications. The OIG also found that the criteria for judging applications were "broad" and "somewhat vague," that there was a lack of communication between the SEC and prospective whistleblowers, and that the overall process was neither transparent nor user-friendly.

The OIG's report echoed earlier concerns raised by both the SEC and industry experts regarding the need to revamp and expand the existing program. For example, in a June 30, 2009 letter from SEC Inspector General H. David

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<sup>2</sup> Although the *amount* of any award is not subject to judicial review under the Act, other aspects such as the disqualification of a claimant or the respective apportionment of an award among several whistleblowers are appealable within 30 days of the SEC's award determination.

Kotz to Congressman Paul Kanjorski, the SEC touted the success of similar DOJ and IRS whistleblower programs and advocated analogous reforms to the SEC's program.

## What to expect and how to identify and mitigate increased enforcement risks

In light of the significant financial incentives provided to prospective whistleblowers with knowledge of possible violations of federal securities or commodities trading laws, there is likely to be a significant expansion of enforcement activity by the SEC and CFTC. The Association of Certified Fraud Examiners found in a 2008 report that over 54 percent of all securities fraud cases prosecuted by the SEC derive from tips. By contrast, the report found that only 4 percent of cases were discovered by external audits such as those conducted by the SEC. Accordingly, it is likely that additional tips from whistleblowers will beget an increase in the number of investigations and resultant enforcement actions. Moreover, one need only look to similar federal whistleblower legislation such as the US False Claims Act – which has resulted in over \$24bn in recoveries from settlements and judgments since 1986 – to recognize the success of such incentive programs. In addition, the Dodd-Frank Act has built in provisions that are likely to increase participation by the active *qui tam* plaintiffs' attorney bar. For example, the Act explicitly provides that whistleblowers may be represented by counsel and those who choose to provide information on an anonymous basis are *required* to have legal representation.

Despite the obvious challenges presented by the new SEC and CFTC whistleblower provisions, there are meaningful steps that issuers, financial institutions and other companies doing business in the United States can take to mitigate increased enforcement risks.

First, companies must respond quickly to and take seriously any whistleblower allegations and carefully manage any investigations into whistleblowers' concerns. This is particularly true given the expanded scope of monetary sanctions subject to the calculation of a whistleblower award. Companies should also be wary of overlapping or more stringent whistleblower protections

available to employees who are resident in jurisdictions outside the United States. For example, UK whistleblowing legislation (sections 43A and 103A of the Employment Rights Act of 1996) imposes obligations on employers to protect both whistleblowers and other employees implicated in reports of wrongdoing.<sup>3</sup> Accordingly, the interaction among the company's compliance, legal and human resources functions is critical when navigating the issues arising in a whistleblower investigation, especially if it involves multiple jurisdictions.

Second, companies should reassess internal compliance and training policies and procedures to prevent improper retaliation against company whistleblowers, and to encourage employees to pursue internal channels to report and remedy suspected violations. Strengthening compliance and internal reporting controls is even more important given the new financial incentives for employees to bypass internal company mechanisms such as anti-fraud hotlines in favor of reporting suspected violations directly to the SEC or CFTC. In addition, as a result of the new legislation, companies may feel additional pressure to self report possible violations of securities statutes such as the FCPA, providing another reason to strengthen internal compliance and employee training programs to immediately and effectively detect and address any possible wrongdoing.

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<sup>3</sup> For information on UK whistleblowing laws and effective compliance, please consult our recent briefing, available at [www.freshfields.com/publications/pdfs/2009/apr09/25766.pdf](http://www.freshfields.com/publications/pdfs/2009/apr09/25766.pdf).

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