THE NEW SEC WHISTLEBLOWER PROPOSAL: MAKE IT FAIR, MAKE IT PAY, AND THEY WILL COME

Daniel J. Hurson*

Buried deep within President Obama's historic new proposals to oversee and regulate the financial markets ("Financial Regulatory Reform, A New Foundation") is the outline of a provision that garnered no headlines but might well become the most effective new anti-fraud regulation of all: rewarding whistleblowers who disclose fraud cases to the United States Securities & Exchange Commission ("SEC"). It is surely the only part of the massive proposal that gives insiders with knowledge of wrongdoing a chance to speak up against, and even profit from, the types of financial and securities fraud that has infected the financial markets in recent years. This may be the beginning of the golden age of whistleblowing. Protecting whistleblowers and making their jobs easier is getting increased attention in Congress. While federal *qui tam* actions initiated by whistleblowers who report fraud against the government have been around for many years, the concept of rewarding those who report on securities fraud (other than insider trading) is new, and revolutionary.

The potential for such a statute, covering all of the growing jurisdiction of the SEC, is vast. While current law provides for rewards for whistleblowers who report insider trading (a very limited class of fraud which generally does not have significant market impacts, and few whistleblowers), the recent Treasury Department announcement makes clear this provision would be much broader in scope:

> The SEC should gain the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. Currently, the SEC has the authority to compensate sources in insider trading cases; that authority should be extended to compensate whistleblowers

> that bring well-documented evidence of fraudulent activity. We support the creation of this fund using monies that the SEC collects from enforcement actions that are not otherwise distributed to investors.

SEC Commissioner Mary Schapiro has been speaking out for this enforcement tool for some time. According to *TheStreet.com,* she told a conference of business writers last April:

> We need to leverage third parties where we can at the SEC, given our short staffing… [i]f we can prosecute the case and get a sanction or a fine, then pay the whistleblower the way the IRS does for [cases involving] tax cheats, then I am pretty happy to do that."
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> It will help us focus on the [cases] where there's the highest probability that there's a really big problem that we can tackle. My goal is to try to increase the probability that we don't miss the next Bernie Madoff.

Commissioner Schapiro noted that the agency, which has 3,600 staff members, can receive anything from 750,000 to 1.5 million tips and complaints a year, hence the potential for whistleblower payments. She said the SEC has hired an outside firm to manage tips, complaints and referrals. Of course, the SEC will have to listen to its whistleblowers, not just offer to pay them. Bernie Madoff could have been nailed years, and billions, earlier had the SEC paid attention to a very vocal whistleblower who bugged the agency for years. It is fair to say that in today's SEC every whistleblower who is not a raving lunatic will get a fair hearing from some staffer who is paranoid about missing another Madoff.

The IRS model is a good one to follow. Section 7623(b) of the Internal Revenue Code sets out the whistleblower provisions, which apply to amounts in dispute over $2 million and provide for payments to the whistleblower of 15 to 30% of the amounts recovered. The whistleblower must "substantially contribute to a decision to take administrative or judicial review." If the matter was already known to the IRS, or the

whistleblower himself "planned and initiated the actions that led to the underpayment of tax" the award can be scaled back to no more than 10% (one would surely hope so). The IRS has set up its own Whistleblower Office, with a Director and small staff, and reports a growing number of submissions since the act took effect in December 2006.

One suspects the SEC will soon get its whistleblower authority (Sen. Grassley, recent scourge of the SEC, considers himself the father of whistleblowing and continues to improve their lot through legislation; Sen. McCaskill is a newer but just as ardent pro-whistleblower legislator). When it does get the authority to reward whistleblowers, the SEC should consider a structure similar to that of the IRS, i.e. a clear intake point for tips that does not require whistleblowers initially to approach enforcement attorneys. These lawyers are much more interested in making the case, not rewarding the whistleblower, who they may suspect at the outset to be a participant in the fraud and trying to cut a deal for immunity (I know, I used to work there). Indeed, the careful minuet that may have to be played at the outset to make sure the whistleblower does not blow himself away with incriminating disclosures suggests that the SEC should have some form of Miranda warnings for whistleblowers who come in without counsel.

The new SEC Whistleblower Office, after filtering out the usual run of meritless tips, allegations and accusations by disgruntled investors, should sympathetically shepherd those with real information through the process, and, in the appropriate case, support them to some degree if the SEC staff summarily denies compensation because the SEC was "already on the case", or after taking the position the information did not ultimately make a "substantial contribution" to the case.

Whistleblowing is no picnic. It has historically been a bad career move for most employees, although a number have hit it big financially after years of litigation. They invariably move on to other jobs, and carry something akin to a Scarlet W. Many never regain a place in their industries. There are very few Sharon Watkins-like (Enron) heroes who land on the cover of Time Magazine. But whistleblowing, SEC style, should not pose the legal hurdles confronting false-claims act whistleblowers. There will be no need to get the government to sue, or to wait years to find out if one has to sue on one's own.

At the SEC, now under pressure to speed up investigations, there should be a fairly expedited process to determine if there is a fraud case, followed by a resolution (hopefully a settlement) which could, in a big case, produce millions in fines, penalties and disgorgement. Whether the case was already on the radar, and how much help the whistleblower has given, should not be hard to determine. If there is disagreement, it should be decided by the full Commission, with resort to court if necessary for the disappointed whistleblower.

How large a percentage of recovered funds any SEC whistleblower should recover remains to be seen. Since the Treasury Department release suggests that the whistleblower may only be able to be paid from a fund consisting of what remains after distributions to investors, the whistleblower may have to settle for part of a smaller pot. 30% off the top, the upper IRS level, seems unrealistic given the priority mission of the SEC to recover value lost by investors. Still, recent SEC settlements against major entities routinely climb into the millions, not all of which ends up being distributed to shareholders. Fines and penalties might also be available to fund the rewards as well. To make the risk worthwhile, the SEC needs to incentivize potential whistleblowers and put

as few bureaucratic hurdles in their way as possible. The true insider whistleblower types, especially at the higher managerial levels, carefully consider their positions before taking the plunge. They must be made to feel confident that they are not entering into a Quixotic endeavor for which virtue is their only reward, with considerable downside risks.

In the coming weeks, the SEC should work closely with Congress to get this provision up and running, and do so in a way that will truly encourage, not intimidate, what could well be a treasure-trove of potential whistleblowers to come forward. Once they do so, the law should work to their benefit, not be used to discourage and ultimately disappoint them. For example, employees who come forward internally, for example approaching an in house compliance officer, and first reveal fraud should be considered whistleblowers, even if the information is ultimately given to the SEC by the company following an internal investigation. If the informers qualify, they should see their reward and others should see it too. A few large and well publicized early awards for SEC whistleblowers could make this law worth more to law enforcement than hundreds of new staff lawyers, while costing the government nothing. Creating a viable method to uncover corporate fraud from the inside out is well worth the effort.

Daniel J. Hurson is senior partner in The Hurson Law Firm LLP, in Washington, D.C. He is a former federal prosecutor and SEC enforcement trial lawyer. His law firm represents individuals, including whistleblowers, and smaller corporations in government investigations and proceedings. His website is www.hursonlaw.com; email dan@hursonlaw.com; phone 202-530-1230.