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The S.E.C.'s New Whistleblower Program, Which Takes Effect August 12th, Should Help it Get Ahead of Scandals Rather than Playing Catch-up. But Will Budget Cuts Impair its Ability to Follow up on Tips?

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Law enforcement authorities have long relied on cash rewards to induce tipsters to report wrongdoing. The S.E.C. is finally trying to get in on the act.

The S.E.C.'s new whistleblower rules, recently adopted pursuant to the Dodd-Frank Wall Street Reform Act, take effect August 12th. Under them, the S.E.C. is required to pay whistleblowers bounty awards for information leading to enforcement actions that result in monetary recoveries of over $1 million. Awards will range from 10-30% of the recovered amount, with no dollar cap, and whistleblowers are entitled to keep their identities secret if they're represented by a lawyer. Companies are prohibited from requiring their employees to waive their rights under the whistleblower rules, or to report only internally and forego the whistleblower route. Companies are also prohibited from retaliating against any employees who exercise their whistleblower rights.

The S.E.C. hopes to ferret out violations of the federal securities laws, whether committed by reporting issuers or participants in the securities industry itself, *i.e.*, big banks, traders, broker-dealers or investment advisors or companies.

Already, most S.E.C. enforcement actions develop from outside tips, and almost half (excluding actions against individual brokers) result in monetary sanctions of $1 million or more, *i.e.*, in excess of the bounty threshold. Under the new program, the number and quality of tips are expected to increase dramatically.

Bounty payouts could be significant. The rules authorize the staff to consider certain "factors" to determine appropriate awards in the 10-30% range. An award somewhere in the range, however, is required – even to whistleblowers who culpably participated in the misconduct. And bounties are not limited to a percentage of the S.E.C.'s recovery. They also include a percentage of the recoveries of any other authorities such as the increasingly activist states attorneys general in related or parallel actions.

Nevertheless, resource constraints could impair the S.E.C.'s ability to follow up on tips. As business columnist James Stewart recently pointed out in The New York Times, the Republican-controlled House Appropriations Committee recently cut the agency's fiscal 2012 budget request by $222.5 million, to $1.19 billion (the same as this year's), even though Dodd-Frank vastly expanded its responsibilities. (See Stewart's column here: www.nytimes.com/2011/07/16/business/budg....)

The committee cynically cited deficit reduction as its rationale. But the S.E.C. pays for itself, by imposing fees on those it regulates – principally the large banks, *i.e.*, significant Republican campaign donors. So, while cutting the

S.E.C.'s budget saves money for Wall Street, it has "no effect on the budget deficit, won't save taxpayers a dime and could cost the Treasury millions in lost fees and penalties," Stewart noted.

To compensate for the inadequacy of its resources, the S.E.C. plans to deputize corporations to provide it assistance. In "appropriate cases," the S.E.C. release states, "our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back." Big law firms are beefing up their internal investigation practices to handle this work.

This is worrying. Internal investigations are famously unreliable. Typically, they are conducted by law firms with close relationships to the company. They also seem to nearly always pin responsibility on supposedly "rogue" low-level employees, while exculpating senior managers, or find any wrongdoing "isolated." The famed Vinson & Elkins investigation of Enron, triggered by a whistleblower's letter to Ken Lay, comes to mind. The law firm concluded that certain transactions merely had "bad cosmetics . . . ."

There is also the danger that internal investigations requested by the S.E.C. devolve into improper witchhunts to identify the whistleblower. This would violate the whistleblower anonymity and anti-retaliation provisions.

Then there is the question is why it took 77 years for the S.E.C. to adopt the incentive award approach (the S.E.C. was established in 1934).

It is no secret that cash is an effective inducement for potential tipsters. This is exemplified by the success of the Justice Department's Rewards for Justice program, established in 1984 and "one of the most valuable U.S. Government assets in the fight against international terrorism," according to its website. U.S. authorities paid $30 million in reward money to a tipster who pointed American forces toward the hideout of Saddam Hussein's two sons, Uday and Qusay. The effectiveness of bounties in the civil arena is shown by the success of the I.R.S.'s tax-cheat bounty program and the 1986 amendments to the federal False Claims Act. The latter enhanced the rewards for "qui tam" plaintiffs – whistleblowers of fraud against the government – resulting in a surge in False Claims Act claims and recoveries.

Offering bounties would seem particularly logical in the financial sphere. Securities industry employees are accustomed to arrangements involving incentive compensation.

The delay in taking up the bounty strategy might be the result of the influence of the securities industry, which prefers a weak S.E.C. and lax enforcement. The industry fought to water-down the whistleblower rules. For instance, it argued that employees should be required to report potential securities violations through their companies' internal compliance and reporting processes first, before being allowed to file whistleblower complaints with the S.E.C. The industry expressed purported concern that internal compliance functions would otherwise be "undermined."

Fortunately, the S.E.C. didn't buy the industry's argument. It recognized in its whistleblower release that, while many corporations have compliance processes that are "robust" and properly assure whistleblowers confidentiality, "others do not." It left to whistleblowers to decide whether to use corporate procedures.

So, is the financial institution you're working for using improper assumptions to inflate the value of its Level 3 assets? Are customers being misled or front-run, or concentration limits being disregarded? If so, you'll find an appropriate

box to check off on the S.E.C.'s whistleblower complaint form, which is located on the S.E.C.'s new Tips, Complaints and Referrals Portal. Filers are asked to "Choose the option that you believe best describes the nature of your complaint," and given a list that reads like a litany of misconduct that the S.E.C. failed to detect in the past – "Ponzi/pyramid scheme," for example, and "after hours trading."

Only whistleblowers who want to keep their identities secret are required to have an attorney represent them. Regardless, the rules contain complex requirements and deadlines, so having an attorney is advisable.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

Comments (1)

The Mad Hedge Fund Trader
Contributor

Buried in the recently passed Dodd-Frank financial reform bill are massive financial rewards for turning in your crooked boss. The SEC is hoping that multimillion dollar rewards amounting to 10%-30% of sanction amounts will drive a stampede of whistleblowers to their doors with evidence of malfeasance and fraud by their employers.

If such rules were in place at the time of the settlement with Goldman Sachs (GS), the bonus, in theory, could have been worth up to $500 million. Wall Street firms are bracing themselves for an onslaught of claims, legitimate and otherwise, by droves of hungry gold diggers looking for an early retirement.

Don't count on this as a get rich quick scheme. Government hurdles to meet the requirement of a true stoolie can be daunting. The standard of evidence demanded is high, and must be matched with the violation of specific federal laws. Idle chit chat at the water cooler won't do. Litigation can stretch out over five years, involve substantial legal costs, and often lead to a non-financial settlement with no reward. For those who do deliver the goods, death threats from defendants are not unheard of.

Having 'rat' on your resume doesn't exactly look inviting either. Just ask Sherron Watkins, the in-house CPA who turned in energy giant Enron's Ken Lay, Andy Fastow, and Jeffrey Skilling just before it crashed in flames. Nearly a decade later, Sherron earns a modest living on the lecture circuit warning of the risks of false accounting, and whistleblowing. There have been no job offers.

The Mad Hedge Fund Trader

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