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SEC Issues Annual Report on New Whistleblower Program

Highlights

- **SEC reports receiving 334 tips in the first seven weeks of its whistleblower program**
- **Tips report a broad array of potential securities laws violations, but the most common allegations relate to market manipulation and offering fraud**
- **Report does not identify if whistleblowers also use internal reporting systems or whether tips provide actionable information to the SEC**

On November 15, 2011, the US Securities and Exchange Commission (the "SEC" or "Commission") issued its Annual Report on the Dodd-Frank Whistleblower Program for Fiscal Year 2011 ("Report"). The Report outlines the establishment and activities of the Whistleblower Office during the past fiscal year, describes the tips received by the Office from August 12, 2011, through September 30, 2011, and includes the first set of data released by the SEC concerning its new whistleblower program. Despite the short time period covered by the Report, it provides information concerning various characteristics of tips received by the Office and the level of activity related to the new whistleblower program. Nonetheless, because the Report provides only limited information and covers a short time period, it does little to answer questions about the whistleblower program's impact on existing internal reporting systems and compliance programs.

SEC Whistleblower Program, a Feature of Dodd-Frank, Subject to Business Criticism for Adverse Impact on Internal Reporting

The new SEC whistleblower program was created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended the Securities Exchange Act of 1934 and created Section 21F, titled "Securities Whistleblower Incentives and Protection." Section 21F directs the SEC to pay eligible individuals an award of 10 to 30 percent of the monetary sanctions imposed in a successful enforcement action. To qualify for an award, an individual must voluntarily provide the SEC with original information that leads to a successful enforcement action in which monetary sanctions exceed US$1 million. Awards will be paid from the Commission's Investor Protection Fund based on a fact-specific determination of the appropriate amount of the award by the SEC.[1]

1 A previous White & Case Client Advisory providing an analysis of the Dodd-Frank Whistleblower Program and the SEC's rules implementing the new program may be found here.

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The SEC received 240 comment letters and approximately 1,300 form letters during the robust comment period for the rules to implement the new whistleblower program. During this period, the business community raised concerns that the financial incentive of a potentially large whistleblower award and related eligibility requirements encourage individuals with knowledge of misconduct to bypass internal reporting systems. The SEC responded to these concerns by identifying incentives that the Commission believed would encourage individuals to report potential misconduct to internal systems. Nonetheless, the business community has repeatedly objected to these rules because they fail to mandate internal reporting, thus raising concerns that the new program would damage their ability to monitor their own compliance, investigate possible misconduct, and swiftly remediate instances of non-compliance, as they are required to do to meet duties to shareholders and to comply with provisions of Sarbanes-Oxley.

Report Contains Little Detail Useful to Assess Impact on Compliance Programs

As stated in the Report, the SEC received 334 whistleblower tips from the effective date of the Rules, August 12, 2011, through September 30, 2011. The Report also compiles the number of calls to the SEC whistleblower hotline, which was established in May 2011, and has to date received more than 900 phone calls. Of the 334 tips received by the SEC, nearly one-quarter are listed as falling into a catchall "other" category, and the Report provides no information about the subjects of those tips. The second most common allegation type cited in the Report was for "market manipulation," which accounted for 16.2 percent of all tips. Tips pertaining to "offering fraud" accounted for 15.6 percent, while "corporate disclosure and financials" made up 15.3 percent. Other notable allegations were "insider trading" tips, which totaled 5.1 percent, and tips pertaining to possible Foreign Corrupt Practices Act violations, which comprised 3.9 percent of the tips received by the SEC. Lastly, of the 32 foreign allegations reported to the SEC, ten tips came from sources in China and nine originated in the United Kingdom.

Perhaps more noteworthy than the information in the Report is the SEC's failure to provide information about several important aspects of the Commission's new whistleblower program. SEC officials have recently stated that the Commission has seen an increase in the quality of the tips received since the passage of the Dodd-Frank Act in July 2010,[2] but the Report contains no information to substantiate this claim and does not specify whether the tips covered by the Report produced actionable information. The Report also fails to identify the percentage of tips provided by "insiders" or the positions held by the reporting individuals within the subject entities, an important issue to businesses as expressed in its comments on the Rule's exceptions that allow certain individuals with compliance-related responsibilities to obtain whistleblower awards in certain circumstances. Furthermore, the Report fails to give any indication of whether whistleblowers were primarily individuals, organizations or acting on first-hand knowledge. The Report provides no information on the types of businesses that are identified in tips and does not even generally describe the industry sectors in which the businesses that are the subject of the complaints operate. The Report also contains no information on the SEC's receipt of tips containing privileged information or how the Commission processes and evaluates such information.

Finally, the Report contains no evaluation or analysis of the whistleblower program's impact on existing internal reporting systems and corporate compliance programs and provides virtually no information to facilitate such an evaluation by corporations. For example, the Report does not identify whether the individuals who reported information to the SEC also reported the information internally. Similarly, the Report nowhere mentions whether the Commission has initiated inquiries—whether formal or informal—or otherwise contacted corporations on account of the whistleblower information it has received. The Report also fails to discuss whether self-reporting by corporations has been affected by the whistleblower program, which would provide valuable insight on whether information is being diverted from internal reporting systems. The absence of meaningful information on the new whistleblower program's impact on internal reporting systems and corporate compliance programs is also noteworthy given the legislation currently pending in Congress that would revise the whistleblower program to, among other changes, mandate internal reporting as a condition of award eligibility.[3] The lack of data on several important issues related to the whistleblower program in the Report may be particularly salient since after the Report's release, it was announced that on December 14, the House Capital Markets and Government Sponsored Enterprises Subcommittee is scheduled to mark up this pending legislation.

2 *See, e.g.*, Sean X. McKessy, Chief, Office of the Whistleblower, US Sec. & Exch. Comm'n, Remarks at Georgetown University (Aug. 11, 2011) *available at* http://www.sec.gov/news/speech/2011/spch081111sxm.htm (last visited Nov. 18, 2011).

3 Whistleblower Improvement Act of 2011, H.R. 2483 (2011).

In sum, while the Report provides some information on the number, allegation type and geographic origin of complaints to the SEC during the whistleblower program's first seven weeks, it provides no information to address or allay concerns that the new program is undermining internal reporting systems and corporate compliance programs. The full impact of the SEC whistleblower program therefore remains to be seen, but corporations need not wait to address the potential impact of the whistleblower program on internal controls and compliance programs. In general, companies should consider reinforcing to their employees the importance of complying with securities and other applicable laws and using internal reporting systems when they become aware of potential misconduct. This may include evaluating whether internal reporting systems are effectively collecting information for the company. Businesses must make sure that employees are aware of internal hotlines and other mechanisms to report potential misconduct, as well as the company's compliance function and its role in investigating reports of improper conduct. Such proactive efforts can help mitigate the potential negative impact the whistleblower program may have on compliance programs even though the new whistleblower program's aggregate impact on compliance systems may not yet be clear.