Institute for Enterprise Ethics: SEC Final Whistle Blowing Bounty Regulations

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Welcome to the Office of the Whistleblower

Assistance and information from a whistleblower who knows of possible securities law violations can be among the most powerful weapons in the law enforcement arsenal of the Securities and Exchange Commission. Through their knowledge of the circumstances and individuals involved, whistleblowers can help the Commission identify possible fraud and other violations much earlier than might otherwise have been possible. That allows the Commission to minimize the harm to investors, better preserve the integrity of the United States’ capital markets, and more swiftly hold accountable those responsible for unlawful conduct.

The Commission is authorized by Congress to provide monetary awards to eligible individuals who come forward with high-quality original information that leads to a Commission enforcement action in which over $1,000,000 in sanctions is ordered. The range for awards is between 10% and 30% of the money collected.

The Office of the Whistleblower was established to administer the SEC’s whistleblower program. We greatly appreciate your interest, and we hope that this website answers any questions you may have.

We understand that the decision to come forward with information about securities fraud or other violations is a significant one. Our office is here to answer any questions you may have about the process and to help guide you through it. Thank you for your interest and support.
Dodd-Frank Wall Street reform and Consumer Protection Act of 2010

• Legislative History:
  – Congress’ intent “to motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated securities laws and recover money for victims of financial fraud.”
  – New Section 21F of the Securities Exchange Act of 1934
FINREG WB Provisions

• Bounty (10 to 30% under False Claims Act)
• Voluntary
• Based upon original information or analysis
• Involve an SEC violation
• Must be material > $1,000,000
• Employee waivers of rights not allowed
Entitled to Bounty?

• In his new book, "No One Would Listen"
  – A former securities industry executive, Markopolos discovered that Madoff was running a Ponzi scheme "within five minutes" of seeing his business plan in 2000. He spent the next eight years trying to warn the SEC, who refused to listen to him.
New WB Protections

• Right to a jury trial three years after retaliation by company
• Double back pay
• Award of attorney fees and court costs
• Job back
  – One condition: you had a reasonable belief that there was a violation of SEC rules.
  – Don’t need to qualify for the actual award.
Pump & Dump?

- $226,000,000 in gains made after pumping up the financials?
- Said analysts that questioned accounting were not the sharpest knives in the drawer.
Cross hairs on Nacchio

• In her 16-page **plea agreement** in July, Szeliga said she and other unnamed "senior Qwest executives" knew by at least April 24, 2001, that Qwest was meeting its revenue targets only through **"gap fillers"** such as questionable one-time sales of network capacity.

• On that day to Wall Street, Szeliga and -Nacchio **highlighted Qwest's double-digit revenue growth** amid a weakening industry and reaffirmed double-digit growth projections. **No detail was provided on the capacity sales**, which accounted for more than $400 million of Qwest's first-quarter revenue of $5 billion.

• **Two days later, Nacchio** started a three-week flurry of exercising stock options that would net him about $42 million in profits that spring. Those stock sales accounted for more than 20 percent of his total sales during his five years at Qwest.

Trying to avoid prison
Teamwork Counts in Corporate Fraud

• “Fraud too pervasive to roll back SarbOx”

• 374 accused of securities fraud—1997-2002
  – Average 7 indicted in each
  – CEOs 90%; CFOs 78%
  – Directors 40%; VPs 36%
  – COOs 20%; Controllers 19%
  – General Counsel 7%

Al Lewis
Why Should the Company be told first:

• Justice and Organizational Federal Sentencing Guidelines Factors in mitigation of the fine:
  – 1. **self reporting by the company**
SARBOX Sec. 301: Establishment of Complaint Procedures

• Must establish whistle blowing procedures

• *Allowed policy*: require whistle blowing internally first before go to Congress or SEC
  – Consistent with professional whistle blowing rules
Management’s Internal Controls
Representations

• Knowledge of fraud or suspected fraud affecting the entity involving

  – (1) management,
  – (2) employees who have significant roles in internal control, or
  – (3) others where the fraud could have a **Material effect** on the financial statements.
Bounty Arguments Against

• Could undermine corporate internal reporting and compliance mechanisms that are designed to identify and correct improper conduct before it rises to the level of enforcement activity.

• Could flood the SEC with unfounded misconduct
Final Rules: Incentivizing Reporting Internally First-Extension of Time

Proposed rule had a 90 day look-back rule

• Final rule has a 120 day look-back rule
  – Extends the time for a WB to report to the SEC after first reporting internally and still be treated as if he or she had reported to the SEC at the earlier reporting date.
  – Ex. Reports internally on 12/1/2012, then is deemed to have reported it on that day if the entity or the WB reported it to the SEC by 3/29/2013
Final Rules: Incentivizing Reporting Internally First-Size of Award

• A WB’s voluntary participation in the entity’s internal compliance and reporting systems is a factor that increases the amount of the reward;
• A WB’s interference with internal compliance is a factor that decreases the award
Final Rules: Incentivizing Reporting Internally First-Size of Award

• A WB’s voluntary participation in the entity’s internal compliance and reporting systems is allowed to receive the award when the entity reports to the SEC.

• Any new information found by the entity after investigation will be creditable to the WB and thus the amount of the award should go up.
Factors Increasing WB’s Award

• Significance of the information provided by the WB (saved SEC resources; contributed to successful enforcement action)

• Assistance provided by the WB (timeliness of report to SEC or entity; assistance in explaining complex transactions or evidence)

• Law Enforcement Interest (helps SEC enforce rules; helps incentivize WB even on small violations or where the entity reduced liability by self-reporting; fiduciaries of regulated entities; exposed industry wide practice)

• Participation in internal compliance systems
Factors Decreasing the Award

• Culpability
• Unreasonable reporting delay
• Interference with internal compliance and reporting systems
List of Exclusions

• Those who have a contractual or legal duty to report already
• Those who obtain the information by means or in a manner determined to violate federal or state criminal law
• Those in compliance, internal whistle blowing, internal audit personnel
• Those covered under the attorney client privilege unless disclosure the SEC is permitted under state rules.
Prohibited Employees Become Eligible for Bounty

• After 120 days of the WB report internally
• Or earlier if:
  – Concern that the investigation is being impeded
  – Concern that their will be substantial injury to the entity
Original Information—Unallowable Sources due to Unethical Professional Practice (External)

• Communication subject to attorney client privilege
• Outside counsel of company uses the client information for personal benefit of bounty
• Through the performance of an external audit
Sec. 307: Outside Attorneys: “Up the Ladder Rule”

• Required to whistle blow inside the client company if a SEC violation
• To corporate counsel or CEO
• Then, to audit committee or Board of Directors
• ABA Rule: then may consider disclosing to SEC
  – Known as the “Noisy Withdrawal” rule.
Rest of States Permit Disclosure to SEC—Example Colorado

• Rule 1.6 External Lawyer:
  – Allows disclosure “to permit, mitigate, or rectify substantial injury to the financial interest of another due to fraud or a crime,”
  – Or if practical, seek to persuade client to change action
Rest of States Permit Disclosure to SEC—Example Colorado

• Rule 1.13 Internal Lawyer:
  – If a lawyer for an organization knows that his employer’s officer or another employee is engaged in an illegal act that reasonably is likely to cause substantial injury to the company, then need to W/B internally to the highest sources within the company, unless
  – The attorney reasonably believes it is not in the best interest to the company to go internal, but rather external immediately whether or not Rule 1.6 allows for WB externally for fraud causing substantial financial harm to others.
Entity has Protection in Five States

• Five states don’t permit the lawyer to whistle blow to the SEC—only if the lawyer reasonably believes the client actions “will likely end in death or substantial bodily harm”
  – California
  – Alabama
  – Rhode Island
  – Kentucky
  – Missouri
  – Montana
Sherron Watkins Guidance

• Texas Board Rule like all 50 states--Don’t subordinate your judgment
• No whistle blowing provision similar to the ethical interpretation by the AICPA or Colorado
• Only 13 states have adopted the AICPA, PCAOB, Colorado WB rule
AICPA/PCABOB/13 States Rule

• Does 7.3?
  • Material Departure from GAAP
  • Notification of Supervisor
  • Exhaust Internal Channels
– Obligatory
  • Documentation/ Evidence
  • Consider external whistle blowing to government
Colorado/AICPA/PCAOB WB Rule

- CPAs “also must assess any responsibility that may exist to communicate to third parties, such as regulatory authorities or external auditor”
Congressman Mike Grimm Proposed Amendments

• Must report internally first!
• No contingent fee legal representation
• All contract waivers, whistle blowing clauses, policies could be enforced
  – Current regulations do not allow for contractual waivers on WB to SEC since would be contrary to public policy
  – Prohibition should also apply to WB awards by the entity internally contingent on a contractual waiver of right to WB to SEC