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A 501(c)(3) Non-Profit Foundation
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July 17, 2018

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Comments on RIN 3235-AM11 (Amendments to the Commission's Whistleblower Program Rules)

To Whom It May Concern:

Think Computer Foundation is a 501(c)(3) non-profit organization that focuses in large part on transparency issues, including issues that affect public markets. Through our PlainSite public access website (<https://www.plainsite.org>) that we jointly run with Think Computer Corporation, we have now published two in-depth "Reality Check" reports on publicly traded corporations Credit Acceptance Corporation (NASDAQ: CACC) and Herbalife Nutrition, Ltd. (NYSE: HLF). In producing these reports, we frequently come across individuals wishing to act as whistleblowers, find information that could constitute a "tip" to the Securities and Exchange Commission (SEC), and produce finished content that may inspire others to act as whistleblowers. Accordingly, we offer the following comments on the proposed amendments to the Commission's Whistleblower Program Rules.

I. Overview

The SEC's whistleblower program has arguably been one of the most effective (and least controversial) aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which emerged from the wreckage of the 2008 financial crisis. While most of the legislative efforts to rein in reckless and harmful financial practices have arguably failed as regulatory measures, in a nutshell, the SEC whistleblower program works. While the SEC's proposed rulemaking release for RIN 3235-AM11 focuses to a large extent on the program's expenses and distributions to whistleblowers, it is worth explicitly noting that the whistleblower program is still widely regarded as successful despite its obvious and necessary costs.¹ Accordingly, any changes to the program should seek to preserve its fundamental structure as intended by Congress, while streamlining any glaring inefficiencies. We believe some of the SEC's proposed changes go too far.

¹ *Forbes*, July 18, 2017, "One Billion Reasons Why The SEC Whistleblower-Reward Program Is Effective."

II. Proposed Amendment to Exchange Act Rule 21F-4(d) defining an “action”

Think Computer Foundation does not object to defining a deferred prosecution agreement (DPA) or a non-prosecution agreement (NPA) as an “action” for the purpose of allowing whistleblowers to receive reward payments. However, we do object to the high frequency with which the SEC and United States Department of Justice (DOJ) appear to use DPAs and NPAs to resolve cases of wrongdoing where *actual admissions of guilt and/or criminal prosecutions are necessary* to ensure the proper functioning of markets.

If and when a DPA or NPA *must* be used for lack of any other option, we believe it is proper for the SEC to treat these agreements as the result of administrative actions, and monetary payments obtained therefrom could reasonably be called monetary sanctions. This logic could also apply to other kinds of settlement agreements obtained by the Commission, but again, DPAs, NPAs and settlement agreements should only be entered into as an absolute last resort. The SEC is not a mere mediator acting on behalf of the American public. The SEC is a financial regulator, and the entities it regulates are almost without exception legally savvy. If violation of securities law is widely thought to involve nothing more than an automatic settlement with the federal government—which is already the case thanks to years to lax enforcement efforts—then the SEC has failed to do its job.

To the extent that DPA, NPA and other settlements are classified as administrative actions for the purposes of the whistleblower program, detailed statistics on their frequency of use must be made available on an annual basis to the general public.

Generally, the SEC should give the broadest possible interpretation to any statutory language that would allow a whistleblower to be rewarded for providing valuable, original or especially insightful information to the government for the benefit of the public. It would follow that any monetary payment to the SEC by an entity accused of wrongdoing, after and because of the commencement of an SEC inquiry, could be fairly classified as the result of an administrative action, even if the matter does not proceed to be heard by an administrative judge.

III. Proposed Amendment to Exchange Act Rule 21F-4(e) defining “monetary sanctions”

We do not believe that receivership fees and costs, taxes, and attorney’s fees should count under the definition of “monetary sanctions” used to calculate SEC whistleblower payments, unless a whistleblower has simultaneously filed a separate whistleblower claim with the Internal Revenue Service (IRS), in which case federal taxes collected may be relevant for those calculations.

The phrase “as relief” may be too narrow to classify the kinds of payments that should be taken into consideration for computation of whistleblower payments. If a court orders a defendant in a hypothetical securities action to pay \$1 million in restitution payments and \$1 million in punitive damages, the SEC could justifiably argue that only \$1 million, as opposed to \$2 million, was paid “as relief” (the restitution portion). In fact, the whistleblower would have been responsible for \$2 million of total disgorgements. The SEC should accordingly use broader terminology, without substantially changing the way it calculates qualifying payments from the way it does now.

IV. Proposed Amendment to Exchange Act Rule 21F-3(b)(1) defining “related action”

In any case where two whistleblower claims under separate state or federal programs are related, a whistleblower should be entitled to choose which program to proceed under (presumably, whichever program pays the highest award) once each program’s reward total has been calculated. Or, if the law permits and circumstances merit it—meaning that monetary collections do ultimately take place across multiple agencies—a whistleblower in this situation should be able to proceed under multiple programs. The SEC’s stated view on page 34 of its rulemaking brief that Congress intended a 30% cap for whistleblower programs *across multiple agencies* and over time is totally without merit.

Similarly, the SEC’s fear about whistleblowers taking “multiple bites at the apple” is overblown and also moot. If a hypothetical drug cartel uses a publicly traded company to launder money through the United States *and* is evading taxes, and a whistleblower presents information about all of the cartel’s wrongdoing to the SEC, obvious jurisdictional issues would prevent the SEC from investigating the tax aspects of the case. The same obvious jurisdictional issues would prevent the IRS from looking into securities law violations. Our federal government is deliberately structured such that absolute authority is never vested in one single office or location, but fraudulent activity rarely respects the boundaries of statutory slicing and dicing. Disincentivizing whistleblowers from addressing various parts of the federal government simultaneously if and when large, complex frauds arise would harm the public. Reward should be commensurate with risk, and exposing extremely large and complex frauds might reasonably involve extreme risks, as more money is at stake. The government should enthusiastically welcome cases where multiple awards from different agencies might be merited.

We do believe that the SEC’s exception for dual SEC and CFTC claims is sensible given that the SEC and CFTC regulate very similar and at times overlapping markets. It is worth noting, however, that the 30% figure used in the SEC rulemaking briefing is a discretionary *maximum*, and typical IRS whistleblower rewards are often much closer to 15%.

A repeal of Exchange Act Rule 21F-3(b)(3) seems sensible in the interest of simplifying a Rule that is likely to be invoked rarely.

V. Proposed Amendment to Exchange Act Rule 21F-6 regarding awards to a single whistleblower below \$2 million or in cases yielding at least \$100 million in collected monetary sanctions and guidance on the meaning of “unreasonable delay” under Rule 21F-6

The SEC proposes using a variety of discretionary factors to adjust upward or downward the amount of a whistleblower reward such that the amount falls within a target range. To be blunt, this is a terrible proposed change that could destroy what has been thus far a successful program.

While Think Computer Foundation generally supports initiatives that can reward whistleblowers for information that ensures the efficient functioning of markets, the SEC’s proposed changes to Rule 21F-6 introduce a thick fog of uncertainty that would strongly disincentivize individuals with important infor-

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mation from coming forward. Generally, the more opaque criteria that the SEC factors into its reward computations, the less clear it will be to whistleblowers that they have a reasonable chance of success when taking the risks involved with coming forward. The best signal the SEC can send to potential whistleblowers is that 30% really means 30% (or that $x\%$ really means $x\%$), and that the Commission will not endeavor to reduce awards based on arbitrary factors that may or may not even be disclosed to the whistleblower.

If the SEC wishes to impose a cap of \$100 million—or some other large amount—on awards, it should seek to do so in a separate proposed rulemaking and in terms as clear as possible. Manipulating reward percentages based on fuzzy terms, such as “reasonably necessary,” should be avoided at all costs. The program’s goal is to provide whistleblowers a guarantee of an award in exchange for information that by definition is worth considerably more. Altering, qualifying and retreating from that guarantee will harm the program more than anything else short of imperiling the safety of participants. The additional wiggle room for the SEC also makes the program vulnerable to abuse by potentially overly political Commission staff, some of whom are political appointees.

The Commission’s proposed floors, thresholds and other modifications to this section are inappropriate, overly complex, and will assuredly harm the program.

The SEC should evaluate “unreasonable delay” on a case-by-case basis. It may, in some circumstances, be completely reasonable to avoid burdening SEC staff with confusing or peripheral information that could take two quarters (180 days) or more to materialize and manifest as material to a case. This proposed change especially seems vulnerable to abuse.

VI. Proposed Amendment to Exchange Act Rule 21F-2 addressing whistleblower status and certain threshold criteria related to award eligibility, heightened confidentiality from identity disclosure, and employment anti-retaliation protection

It is reasonable to require information provided to the SEC to be in writing, and the SEC’s Form TCR portal provides a good channel for information—provided that the SEC adequately protects the contents of the associated database. Testifying under oath in an investigation or judicial or administrative action of the Commission should count as an additional “manner” of providing information to the Commission, given that such testimony would necessarily produce a written transcript.

VII. Proposed Amendment to Rule 21F-8 to add new paragraph (d) to provide the Commission with additional flexibility regarding the forms used in connection with the whistleblower program (and corresponding amendments to Rule 21F-10, Rule 21F-11, and Rule 21F-12)

These proposed changes appear to be reasonable. Preferably, the Commission should amend its forms at most once per year.

VIII. Proposed Amendment to Rule 21F-8 to add new paragraph (e) to clarify and enhance the Commission's authority to address claimants who submit false information to the Commission or who abuse the award application process

It is definitely appropriate for the Office of the Whistleblower to advise a claimant of the Office's assessment that the claimant's award application for a Commission action is frivolous, and to offer the claimant the opportunity to withdraw his or her award application(s), such that the application(s) would not be considered by the Commission in determining whether to impose a bar. This process should take no more than 15 days; applicants should not have to wait prolonged periods of time to find out that the SEC considers their input frivolous, since in some cases the Commission's determination may be wrong.

It is similarly appropriate for the Commission to adopt a rule that would permanently bar any applicant after he or she has been found by either the Commission to have submitted at least three frivolous award applications *within one year*, provided that the above notification procedure is followed.

IX. Proposed Amendments to Rule 21F-9 to provide additional flexibility and clarity regarding Form TCR (and corresponding technical amendments to Rule 21F-10, Rule 21F-11, and Rule 21F-12)

The proposed changes to Rule 21F-9(a) are reasonable so long as the SEC has a process in place to address technical security issues with the TCR portal that may be identified by a member of the public. A dedicated e-mail address and phone number should be allocated and made clearly visible for the receipt of information that could help the Commission rectify urgent security issues that could jeopardize whistleblower safety and/or information.

X. Proposed Amendment to Rule 21F-12 regarding the materials that may form the basis of the Commission's award determination

These proposed amendments appear to be reasonable, except that the full administrative record for purposes of appeal *should* include "internal deliberative process materials" prepared exclusively to assist the Commission or the Claims Review Staff (CRS) for the purpose of evaluating a case.

If for some reason the Commission or the CRS makes an error in its evaluation of a case, that error may be contained in "deliberative materials" that are currently excluded from the full record, making such an error nearly impossible for a whistleblower to find. Note that this is not inconsistent with Federal Rule of Appellate Procedure (FRAP) 16, which the Commission seeks to accord with. FRAP 16(a)(2) references as part of the record the "report on which [the order involved] is based," which in this context could mean SEC internal deliberative process materials. FRAP 16(a)(3) further references, "the pleadings, evidence, and other parts of the proceedings before the agency." SEC internal deliberative process materials could also squarely fit into "other parts of the proceedings before the agency," and could further be construed as "evidence" of the Commission's thought process. The Commission has no stated basis for excluding these materials from the record, and the justification of avoiding potential future embarrassment is insufficient as a legal rationale.

XI. Proposed Rule 21F-18 establishing a summary disposition process

The SEC should not implement a summary disposition process. Such a process reeks of the unconstitutional procedures already implemented by many federal appellate courts for *pro se* litigants, in which “Staff Attorneys” review and summarize cases before they ever make it to a judge’s desk; the role of the judicial panel thereafter is effectively to act as a rubber stamp. These types of procedures—also implemented in the name of efficiency, cost savings, etc.—have recently been the subject of justifiably harsh criticism by now-retired Judge Posner of the United States Court of Appeals for the Seventh Circuit.² (Judge Posner retired to assist *pro se* litigants who are so often affected by these unfair procedures.) Should the SEC decide to implement a summary disposition process, there is a high likelihood that it would be challenged in federal court (possibly on due process grounds, among others), and it would do damage to the whistleblower program by decreasing potential whistleblowers’ certainty that their information would ever be taken seriously—a certainty that is already murky at best.

Generally, whenever the Commission considers making a new process, it should first ask itself whether better and more transparent communication with whistleblowers (or other types of stakeholders) might achieve its objectives faster and at lower expense.

XII. Proposed interpretive guidance regarding the meaning and application of “independent analysis” as defined in Exchange Act Rule 21F-4(b)(3)

The SEC’s proposed verbiage for this significant proposed change is insufficiently clear to provide whistleblowers with useful guidance as to what is required of them in order to qualify for an award. The terms “significant independent information” and “bridge the gap” immediately raise the question of what it means to build a “significant” “bridge”—a question that the SEC itself does not sound like it is prepared to answer. This is unacceptable.

Furthermore, use of the False Claims Act (FCA) as a basis for the SEC whistleblower program is problematic insofar as the Commission is already effectively in the business of facilitating the publication of open information about publicly traded companies (e.g. SEC Forms 10-K, 10-Q, 8-K, etc.) which, unlike many *qui tam* scenarios (where a company need not even be publicly traded to defraud the United States), will inevitably factor into the analysis of virtually every company about which the SEC will receive whistleblower information. Therefore, the Commission should proceed under the assumption that there will *almost always* be publicly available information involved in whistleblower submissions, leaving the quality of the whistleblower’s analysis as the key variable in most cases except perhaps the most brazen frauds.

The proposed changes also imply that for analysis to be “significant,” there must be a large quantity of analysis. For example, if merely pointing out “observations” based on a filed Form 10-K is not enough to meet the “significant” threshold according to the SEC’s guidance, is pointing out the material result of a mathematical calculation based on *two* data points from a Form 10-K enough to constitute a “significant” tip that “bridges the gap?” The Commission’s present guidance suggests not, but is unclear.

² See [Reforming the Federal Judiciary: My Former Court Needs to Overhaul Its Staff Attorney Program and Begin Televising Its Oral Arguments](https://www.amazon.com/Reforming-Federal-Judiciary-Televising-Arguments/dp/1976014794/ref=as_li_ss_tl) by Richard A. Posner (2017). Available from Amazon.com via the CreateSpace Independent Publishing Platform at https://www.amazon.com/Reforming-Federal-Judiciary-Televising-Arguments/dp/1976014794/ref=as_li_ss_tl.

The SEC further states, “If the violations can be inferred by the Commission from the available and/or assembled publicly available information, without more, then the whistleblower has not contributed significant independent information that reveals the violations.” This sets the bar unreasonably high. There are countless examples of cases where the Commission could and should have made inferences of myriad violations based on publicly available information *in its possession*, yet it did not, possibly due to resource availability or staffing issues, or possibly due to sheer incompetence. If the SEC means to suggest—in a document opaquely referencing its infamous complete and total failure to heed the wisdom of Harry Markopolos regarding the unprecedented Madoff fraud—that it is always supremely competent and willing and able to detect fraud in any filing, while in reality it leaves countless cases of fraud unaddressed for years, there will always be an unresolvable tension between the Commission’s expectations of whistleblowers and its performance in reality that will jeopardize the entire program.

In other words, if the SEC tells whistleblowers, “We could have figured that out on our own for years—we just didn’t,” whistleblowers will reasonably ask, “Why not?” Therefore, the Commission may want to consider a situation where a whistleblower points to public information indicating a securities violation *that has an urgent temporal nature* (e.g. impending bankruptcy, loss of funds, etc.) that SEC staff has missed to be one where the whistleblower has provided additional insight above and beyond the information on the page.

Before implementing any changes to the “independent analysis” standard, the SEC needs to provide many, many more examples of what it believes should and should not count as “independent analysis” so that the public can assess where and how the Commission draws the line. The Commission should also address whether “independent analysis” must be kept confidential for the entire duration of an SEC investigation, which could drag on for years or take years post-tip to even commence.

Most importantly, the Commission needs to use clearer language that avoids vague metaphors. Whistleblowers do not build bridges. They provide information. The SEC needs to be explicit as to the kind of information that it does and does not want.

XIII. Request for comment regarding a potential discretionary award mechanism for Commission actions that do not qualify as covered actions, involve only a de minimis collection of monetary sanctions, or are based on publicly available information

We believe this to be a particularly odd request for comment. If Congress has not provided a mechanism for the Commission to make an award outside of a monetary collection scenario—and the SEC has not identified any such statutory authority—then it is unclear how the public can help by commenting other than to lobby Congress to grant that authority. While there must be some flexibility, we do not believe that executive branch agencies can simply invent their own authority if and when they choose to do so.

Given the success of the existing whistleblower program, another parallel program for unusual circumstances seems unnecessary and ripe for abuse. The Commission should focus its efforts on its existing program and on holding Wall Street accountable, where its record is dismal and likely to suffer further.

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XIV. General Request for Public Comment

We incorporate by reference into our comments the entirety of the July 9, 2018 *Naked Capitalism* post “SEC Knives Its Whistleblower Program” by Yves Smith, attached hereto.

The SEC could do a far better job in the domain of reporting and transparency. The Commission should provide in real-time to the public the number of whistleblower cases pending, and should even consider providing a real-time breakdown of pending, completed, and disregarded cases by CUSIP or stock ticker. Record high stock market indices indicate that we have long since entered the third equity bubble period in less than 30 years, and in such times, accountability is sorely needed. Generally speaking, the SEC staff has been missing in action, busying itself with minor violations and Initial Coin Offerings (ICOs) that affect a tiny percentage of the population while the American public suffers at the hands of a Wall Street that is greedier and more destructive than ever.

Please feel free to contact me at [REDACTED] or [REDACTED] with any questions regarding this letter.

Sincerely,



Aaron Greenspan
President
Think Computer Foundation

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SEC Knives Its Whistleblower Program

Posted on [July 9, 2018](#) by [Yves Smith](#)

The SEC always hated the whistleblower program that Congress imposed on it as part of Dodd Frank reforms. Congress was responding to the SEC's grotesque institutional failure in ignoring Harry Markopolos' repeated, detailed warnings about the Bernie Madoff fraud, a Ponzi scheme that reached \$65 billion due to SEC inaction.

But as we'll describe, the SEC issued new guidance – on a Saturday night in the summer – that guts

the whistleblower program by imposing new standards that look to be contrary to the intent of Congress by making it difficult to win awards for large-scale frauds, and then reducing the payouts on them. It looks like career-minded SEC officials who resented that whistleblower filings could force them to probe wrong-doings of prospective employers are making sure the agency will only hand out parking tickets.

Admittedly, Congress had set out to enfeeble the SEC, by keeping it budget-starved and having Congressmen like Joe Lieberman threaten to cut its funding even further if it went too aggressively after big financiers. The agency had retreated to focusing enforcement almost entirely on insider trading, to the degree that became almost incapable of seeing the world any other way. For instance, it botched its first major crisis case involving the collapse of two Bear Stearns hedge funds, by bizarrely pursuing the execs managing the funds as insider traders, rather than understanding that they were victims of other Wall Street firms (and perhaps even Bear's own trading desks) that were selling toxic subprime mortgage securities and CDOs. '

Nevertheless, the new whistleblower program established an awards fund entirely outside the SEC's budget, and also tasked the SEC to set up a "Whistleblower Office." The agency was obligated to pay sources compensation set as a portion of the SEC's recovery if they contributed information that was valuable to an enforcement action.

The program went live in 2012, and under Chairman Mary Jo White, the SEC feigned enthusiasm for the new initiative, dutifully reporting how many tips it had received and asking for more funding to do a better job, even as high level SEC insiders grumbled about how the whistleblower program trampled on the agency's discretion.

Last Saturday, in the dead of night, the SEC moved to make explicit, with the release of draft rule revisions, what close observers long suspected, that despite the agency's weak support for whistleblowers, they have proven nevertheless too successful.

The proposed new rules have two main thrusts. First, they would change the formula for computing whistleblower awards so that large awards would receive fewer dollars. Second, new barriers to receiving awards would be placed in front of whistleblowers who include **any** public information in their evidence of wrong-doing. The reason that matters, as we'll explain in detail, is that whistleblowers who provide evidence of widespread or systemic frauds will almost certainly be relying significantly on public information. Perversely, that could even be deemed to include information the whistleblower got into the public domain via FOIA>

In recent years, whistleblowers have complained to us that the SEC has simply failed to respond to award applications. Mind you, we are not talking about the SEC ignoring tips about potential wrong-doing. Most of the SEC filings are along the lines of "Everything JP Morgan does is crooked," as opposed to actionable information.

Instead, what the SEC frequently doesn't respond to are the formal "award applications" that whistleblowers submitted after the SEC made an enforcement action where the whistleblower believes his filing made a contribution. The SEC requires that whistleblowers submit these requests in order to be considered for an award within 60 days of the SEC announcing a settlement.

The SEC has been remarkably and indefensibly, opaque about what is clearly a massive backlog of unresolved award claims. The agency produces a ludicrous annual report to Congress of its whistleblower program, full of useless statistics, such as the number of tips received by state, yet it

has refused to disclose the number of outstanding award applications or their average age. Only once, in 2015, has it even reported on how many award claims it received in the previous year, which was 120. Contrast this figure with the fact the agency has been resolving about 40 claims a year in recent years. That means the SEC's backlog of unresolved claims has been growing by approximately two years with each passing year. Its total backlog could realistically be more than five years at this point. That wait to receive an answer on an award is typically on top of the three to four years wait for an enforcement action to be prosecuted and resolved.

The SEC publishes heavily-redacted final orders ruling on each whistleblower award application. We found two recent ones where the agency took around five years to decide (5.25 years in one case and just under five years in the other):

<https://www.sec.gov/files/PUBLIC%20FINAL%20ORDER%20-%202012-72.pdf>

<https://www.sec.gov/files/PUBLIC%20FINAL%20ORDER%20-%202012-24.pdf>

In 2015, a Wall Street Journal article entitled [SEC Backlog Delays Whistleblower Awards](#) offered a similar snapshot of delay, as well as, the SEC resistance to disclosure:

Of the 297 whistleblowers who have applied for awards since 2011, about 247—or roughly 83%—haven't received a decision from the SEC, according to data obtained by The Wall Street Journal in response to a public-records request. Some of the award claims have been delayed more than two years.

Later in 2015, the Wall Street Journal also reported on a whistleblower who sued the SEC demanding an answer after waiting three years with no response to his award application. Almost immediately, the SEC coughed up a response, which Wikipedia, for what it's worth, says was favorable.

Even when the SEC does rouse itself to rule in favor of an award application, the agency has shown a clear bias in favor of penny-ante cases.

Since the inception of the program, more than 60 percent of the awards have been for less than \$2 million. While \$2 million can seem like a life-changing windfall, keep in mind that many whistleblowers are represented by contingency fee counsel who will take a quarter of the award, and many awards are shared among multiple whistleblowers. As a result, a \$2 million total award could ultimately amount to no more than a few hundred thousand dollars to a whistleblower after taking into account these factors, plus taxes. And bear in mind that the best positioned whistleblowers in many cases are highly-placed people in the financial industry who might be making a million or more dollars annually who risk never working again by becoming whistleblowers.

This brings us to the proposed changes to the program. **By law**, the SEC is required to pay an award to whistleblowers equal to between 10 and 30 percent of any fines, disgorgement, restitution, and interest paid by a defendant in an enforcement case, with the exact amount based on a formula keying off how helpful the whistleblowers were (for example, delay in reporting a fraud lowers the percentage). The SEC is now proposing to include a new factor in the formula, which is how large the recovery is, where larger recoveries would result in a penalty to the formula and small recoveries would receive a formula bonus.

This favoring of small-bore enforcement reflects the longstanding institutional bias of the SEC to chase petty frauds while overlooking big ones, a tendency that is more obvious during Republican administrations but operative in Democratic ones as well.

Trump's SEC chairman, Jay Clayton, has explicitly promoted an enforcement agenda of re-directing resources away from frauds impacting institutional investors toward frauds impacting retail investors. His patter is, "We're here for the little guy, and the big guys can fend for themselves," though that assertion falls apart when you recognize that the institutional frauds he is tolerating impact millions of ordinary people. For example, as we have extensively covered, private equity firms defraud their public pension fund investors. That hurts public workers and taxpayers. Similarly, banks securitize mortgages and sell designed-to-fail CDOs to institutional investors and other banks, which had the effect of severely exacerbating the foreclosure crisis.

Clayton has instead amped up the SEC's focus on penny stock fraud and very small Ponzi schemes. These frauds impact a tiny sliver of the investing public. Mary Jo White, the SEC chair under Obama, had her own version of this bias, which she articulated as a "broken windows" theory of enforcement. In practice, this meant citing big institutions for petty infractions under the supposed theory that Goldman Sachs and Bank of America would refrain from major frauds if they were fined a few hundred thousand dollars for technical infractions. This approach allowed White, as a good Democrat, to issue press releases naming powerful Wall Street enforcement targets while sparing those targets any real pain.

To their credit, when it was brought before them last week, the two Democratic commissioners on the five person board did vote against the entire proposal to change the whistleblower rules. Commissioner Kara Stein went so far as to question whether the proposed changes were even legal under the Dodd-Frank enabling statute. Their dissent makes it clear that insiders understand the genesis of the proposal, not as some re-balancing justifiable as an improvement to the whistleblower program, but as an explicit attempt to weaken it, including the incentive to report large frauds. After all, if the SEC were concerned merely that the financial incentive to report smaller frauds is too weak, it could simply change the formula to give a bonus in the smallest cases without penalizing awards in the largest cases. This is especially true because the SEC is effectively unconstrained by budget authority in this instance, since Congress appropriated \$550 million to initially prime the award pump and authorized the SEC to pay awards from the fines it receives once that initial amount runs low.

Much of the initial press focus has been on the proposal to limit large awards, given the easy-to-grasp hostility to whistleblowers evident in this scheme. However, the much more impactful part of the SEC's proposal imposes a new standard, misleadingly labeled as a "clarification" of the existing rule, which disqualifies many award claimants whose initial tips include what the SEC expansively considers "public records." The SEC's talking point here is that nobody should get paid a whistleblower award for sending the SEC New York Times articles about sketchy financial behavior.

But this extreme example, which Congress already disallowed in the enabling Dodd-Frank legislation, is a red herring.

The real issue is that massive evidence of financial and corporate fraud exists in public documents, including the SEC's own publicly-accessible databases. The SEC proposes to deny awards based on such public records if the agency determines, in its own opinion, that it could have figured out the fraud without the whistleblower's help, had it reviewed the public records presented by the whistleblower:

[A] whistleblower's submission must provide evaluation, assessment, or insight beyond what would be reasonably apparent to the Commission from publicly available information. In assessing whether this requirement is met, the Commission would determine based on its own review of the relevant facts during the award adjudication process whether the violations could have been inferred from the facts available in public sources.

Whistleblower lawyers call this as the "woulda, coulda, shoulda" standard, where the SEC would be relieved from arguing that it **did** know about a securities law violation prior to receiving a whistleblower's public records, but instead would merely have to assert that it **could have** known if it had, for whatever reason, independently reviewed the documents presented by the whistleblower.

This proposal amounts to a middle finger directed at the entire securities analysis industry, where thousands of experts toil over public records looking for, among other things, signs of fraud. Make no mistake, given the resources allocated to them, professional investors are by far the most likely source of insight about credible, large-scale corporate fraud. Those insights are derived largely from public SEC filings. It must be very uncomfortable, whenever the SEC meets with such whistleblowers and asks them to explain the source of their evidence about fraud unknown to the SEC, and the whistleblowers effectively say, "I found it in your file cabinets."

By contrast, Mary Jo White loved to sing the praises of corporate insider whistleblowers, whom she repeatedly described in public statements as giving the SEC insight into wrong-doing that would otherwise never have been visible to the agency. In other words, to some degree, the agency made its peace with the good citizen, corporate insider "see something, say something" paradigm, especially since the SEC staff was able to tell itself that these people have information advantages that no outside law enforcement person could ever hope to replicate. Stock analysts and professional fraud hunters like Ted Siedle, on the other hand, are at a clear information **disadvantage** relative to SEC staff, since they can't do things like subpoena corporate records. Yet we've seen lots of evidence that these people are running circles around the SEC staff. In other words, it looks like resentment is driving this proposed change.

It's also important to recognize that many of the most important securities law violations, in the sense of those that rise to the level of "industry practice," can really only be uncovered with public records. The obvious reason is that, other than accountants and lawyers, who are barred from receiving awards, almost nobody is an insider at more than one company at a time, so if something pervasive is to be unearthed, it will almost certainly involve information that has leaked into the public domain.

The stock option back-dating scandal from the early 2000s is a classic example of outsiders finding what the SEC missed with the SEC's own information, though it predated the whistleblower award program. A series of academic papers, leading to [a Wall Street Journal series of articles](#), demonstrated that companies were pervasively back-dating stock options. The revelation led to the resignation of more than 50 senior executives. How had the professors and the Wall Street Journal unearthed the practice? They simply compared the dates on companies' more widely viewed SEC filings, which showed earlier dates for the option issuance, with the dates on more obscure, seldom viewed SEC filings, which showed that the options had been issued later.

Had this backdating been unearthed by a whistleblower, would they meet the standard for an award? Who knows? The SEC could merely claim that, if it had bothered to compare these different filings in the relevant cases, it would have spotted the date discrepancy. Notably, the SEC would not

need to claim that there is any likelihood that it would have ever looked at this on its own, just that if it had reviewed the needles-in-a-haystack documents, once the whistleblower had done the work of pulling them out of the haystack, they would have figured it out.

Moreover, the SEC's proposal tries to give comfort by claiming that public documents are admissible if the whistleblower uses them as a basis for "independent analysis," which means revealing the pattern of fraud that otherwise would not be apparent to the SEC. The SEC contrasts this hazy standard with the non-qualifying action of a whistleblower who merely "aggregates information from multiple different sources." Again, there is a reasonable argument that, basically, the academics and Wall Street Journal did little more than "aggregate information from multiple sources" in the options backdating case, since once the work of assembling the documents had been completed, it needed effectively no analysis.

We've heard over and over that the SEC hates cases implicating a large number of firms in wrongdoing. Such cases present severe staffing challenges for the agency. But more important, they challenge a core ideological assumption of the SEC, which is that wrong-doing is a problem of "a few bad apples."

This orthodoxy is so strong within the agency that, when evidence of industry-practice lawbreaking emerges, the SEC is known to engage in "it's me, not you" self-flagellation. This means the SEC embracing a narrative that it failed in some way to properly educate the industry about its legal obligations with respect to the practice where the widespread law-breaking is occurring. You can see how this attitude leads to a hostility toward the people bringing them evidence of widespread wrong-doing and results in the current effort to choke off incentives for such individuals to come forward.

It's also worth noting that the concept of what the SEC considers a public record is extremely broad and encompasses many types of documents that the agency would effectively never have access to without whistleblowers. For example, a whistleblower might fly from the U.S. to Botswana and then travel hundreds of miles over dirt roads to access records of mine production that exist only on paper in a local government office there. These records could contradict statements that the mine owner makes in SEC filings about their mine productivity, thereby exposing a fraud. Yet the whistleblower in this case would get no credit for knowing the one location on Earth where the mine record exists or for having expended considerable effort to obtain it. Instead, the SEC would apply a test where it would look at the Botswana mine record and the mining company's SEC filings, and if the agency considered the fraud to be self-evident based on those, the whistleblower would be barred from an award.

Ultimately, the SEC whistleblower program closely parallels many financial reform initiatives we have chronicled on the blog. They are announced with great fanfare and hailed as showing real promise of implementing lasting reform. But success proves fragile and hostile forces look for every opportunity to weaken the initiative through inaction and bureaucratic strangulation. In moments when they are powerful, as the whistleblower program foes are now, they seek structural changes, often dressed up as mere administrative accommodations, that would permanently kill the program in all but name.

This entry was posted in [Legal](#), [Politics](#), [Regulations and regulators](#), [Ridiculously obvious scams](#) on [July 9, 2018](#) by [Yves Smith](#).



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10 COMMENTS

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AbateMagicThinking but Not Money

July 9, 2018 at 6:03 am

So SEC means Scrutiny Entirely Comical?

Pip Pip!

Reply ↓

Jim Young

July 9, 2018 at 9:54 am

SEC – Secretly Enabling Criminals?

Reply ↓

AbateMagicThinking but Not Money

July 9, 2018 at 7:01 pm

When it comes to farce following tragedy, the poacher does not turn gamekeeper, they just hire public-relations (in all its forms).

Pip-Pip! (are we no allowed to laugh at farce?)

Reply ↓

allan

July 9, 2018 at 10:47 am

“They are announced with great fanfare and hailed as showing real promise of implementing lasting reform. But success proves fragile and hostile forces look for every opportunity to weaken the initiative through inaction and bureaucratic strangulation ...”

... and **judicial activism**. Which is about to get a whole lot worse.

Reply ↓

John Wright

July 9, 2018 at 11:13 am

The STOCK act history may give some evidence that Congress is not interested, as a matter of self interest, in disclosure, enforcement or whistle-blowing in financial matters.

The original STOCK act (Stop Trading on Congressional Knowledge) was passed on April 4, 2012.

From https://en.wikipedia.org/wiki/STOCK_Act

“The bill was introduced by Joe Lieberman, independent United States Senator for Connecticut, on January 26, 2012, and passed in the Senate by a 96–3 vote. Later the House of Representatives passed it by a 417–2 vote. The bill was supported heavily by vulnerable incumbents and signed into law by President Obama”

But then at tax filing time a year later:

“The STOCK Act was modified on April 15, 2013, by S.716. This amendment modifies the online disclosure portion of the STOCK Act, so that some officials, but not the President, Vice President, Congress, or anyone running for Congress, can no longer file online and their records are no longer easily accessible to the public. In Section (a)2, the amendment specifically does not alter the online access for trades by the President, the Vice President, Congress, or those running for Congress. The reasoning for this change was to prevent criminals from gaining access to the financial data and using it against affected persons. This bill was introduced by Senator Harry Reid on April 11, 2013. It was considered by the Senate and passed by unanimous consent. In the house, S.716 received only 14 seconds before being passed by unanimous consent.”

If I’m reading this correctly, Congress allowed its staffers (and maybe their own relatives?) to avoid disclosing trades in an easily accessible manner. Notice the “can not file online or have easily accessible records”, even if the filing individual was willing to ignore this option.

Here’s more information: <https://www.opensecrets.org/news/2013/04/action-alert-stock-act-reversal-signed/>

“The elements of the STOCK Act that were removed include:”

“Creation of searchable, sortable disclosure of the information contained in reports even for Congress, the president, vice president, the president’s cabinet and congressional candidates.”

“Required electronic filing for Congress, the president, vice president, the president’s cabinet and congressional candidates, as well as high-level executive and congressional branch employees. Even images of the staffers’ filings will not be available for viewing on the web.”

This modification occurred under Obama.

Note: the information might be very valuable to investors, as some previous studies showed that US senators did very well, even better than corporate insiders investing in their own companies.

From: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633123

“The common stock investment portfolios of United States Senators beat the market by 12% a year, on average, between 1993 and 1998, according to a study by economist Alan J. Ziobrowski and his collaborators. In sharp contrast, the common stock investment portfolios of U.S. households as a whole underperformed the market on average by 1.4% a year during the relevant period.”

“Even more striking, corporate insiders investing in their own company’s stock only beat the market by about 6% a year on average during that period.”

The STOCK act’s history may indicate the the possibility of reform of the SEC via the Congress is very low.

Reply ↓

Chauncey Gardiner

July 9, 2018 at 11:44 am

... *All done on a “Saturday night in the summer.”* In their efforts to neuter whistleblowers, it has become crystal clear who a majority of commissioners at the SEC really work for.

Corrective measures to deter this type of behavior by senior government officials, and the indirect granting of free passes to those who violate the law, calls for a very public investigation and action to address this issue by legislators. Review and approval of whistleblower awards needs to be taken away from and made independent of senior agency officials of the agency involved, perhaps being transferred to an adequately funded Consumer Financial Protection Bureau.

This little slice of life in the swamp, and the concluding paragraph of Yves’ excellent post, also reflect the need for a Litmus Test for the next Supreme Court justice of a willingness to reverse the *Citizens United* decision which essentially legalized the corruption of our public officials and indirectly fosters an environment that enables this type of behavior. (See John Wright’s related comment at 11:13 am mark, above.)

Reply ↓

Arizona Slim

July 9, 2018 at 1:57 pm

All done on a Saturday night in the summer? Like this notable event from history?

https://en.wikipedia.org/wiki/Watergate_scandal

BTW, one of my friends was driving across Kansas with one of her daughters. On the morning of Sunday, June 18, 1972, they were reading the paper together. ISTR my friend saying that they were in a restaurant near the Kansas Turnpike.

Well, they came across the story of the Watergate break-in and they began howling with laughter. Their fellow restaurant patrons started looking their way, but that sure didn’t stop my friend and her daughter.

Even then, these two newspaper readers knew that the Nixon White House had **something** to do with this break-in.

Reply ↓
