

# Corporate Governance

## After Slow Start, Whistleblower Program Shows Gains Fighting Fraud

**Topic(s): SEC, Ethics, Risk, Disclosure, Financial Reporting, Specialized Industries, Corporate Governance**

by Rob Lenihan

**Summary:** *The SEC set up its Office of the Whistleblower to carry out a mandate from the Dodd-Frank Act. After three years, the office has had some success bringing fraud to light. At the same time, critics warn that the office could turn executives into bounty hunters and undermine companies' internal efforts to stamp out misconduct.*

In 1777, Samuel Shaw, a midshipman in the Continental Navy, and Lt. Richard Marven were jailed after accusing a commander of abusing British prisoners. The men declared they had been “arrested for doing what they then believed and still believe was nothing but their duty.” In July of that year, Congress enacted America’s first whistleblower protection law and authorized payment of the legal fees for Marven and Shaw.

Nearly 240 years later, the SEC’s Office of the Whistleblower is rewarding and defending people who come forward with what the SEC calls “high-quality original information” on corporate misconduct that leads to an enforcement action in which over \$1 million in sanctions is ordered.

“I’m very proud of the work we’ve done so far, and I think the program is off to a very strong start,” said Sean McKessy, the chief of the Office of the Whistleblower in a phone interview, which was established in August 2011 to carry out a Dodd-Frank Act mandate. “There are real benefits for people who bring us good information that can be turned into good cases.” [Sec. 922 of PL111-203](#)

The awards range from 10 to 30 percent of the money collected, with the highest award to date totaling more than \$14 million for an unidentified individual last year. In June 2014, the SEC filed its first whistleblower retaliation case against an Albany, New York, hedge fund for punishing their head trader after he filed a

whistleblower complaint with the SEC. Paradigm Capital Management and owner Candace King Weir agreed to pay \$2.2 million to settle the charges without admitting or denying guilt.

"I think that sends a strong message in addition to the underlying conduct we will be looking carefully at what employers do when employees come forward," McKessy said.

"This is a big deal," said Stephen Kohn, executive director of the nonprofit organization, the National Whistleblower Center. "The regulatory pressure is more effective than an employee discrimination lawsuit, and now the commission has agreed with our position on this."

A spokesperson for Paradigm said the firm was "pleased to resolve this matter and have it behind us."

Jenice Malecki, founder of Malecki Law in New York, represents whistleblowers, and she said she is seeing an uptick in the number of people looking to come forward.

"I can tell you that whistleblowers as potential clients have increased over the last year — substantially," Malecki said. "There's definitely an increase, and everybody who is somehow involved in the securities industry either as a customer or otherwise feels like they have some information they could tip on." Malecki said that while the statute hasn't yet changed corporate culture, it does have "great potential for great change."

"It's still pretty early in the game," she said. "It takes time for people to understand what their rights are and what they can do and what the benefits of the statute are."

Whistleblowers provide an important backup to regulators who oversee the securities industry, Malecki said.

"There's a limited budget in the SEC and all the other agencies," she said. "When you have someone on the inside who can provide a depth of information, these cases can go really fast and be less costly to the SEC because you know where the bodies are already buried."

The whistleblower's motivation for tipping off the SEC is irrelevant, she adds, as long as the information is legitimate.

"Companies should keep their nose clean," Malecki said. "They should supervise their employees, and they should know what's going on among the ranks." Kohn said the whistleblower statute is making a difference.

"I've been in contact with numerous compliance officials since this law was passed, and there's a premium now on companies self-identifying violations," he said. "So if they aren't, they should be, and many are investing more in their own compliance programs and trying to make their compliance programs more effective and efficient."

Kohn believes the jury is still out on the whistleblower statute's effectiveness.

"Overall, I've had a very favorable experience working with the SEC investigators," he said. "But the problem is the awards have been few and far between. Many of the cases are still ongoing. But until they start awarding whistleblowers on a regular basis with significant awards, the jury is out."

McKessy says the program has seen steady growth, adding that "you're going to see more payouts as the future unfolds."

The U.S. Chamber of Commerce made its feelings clear about the whistleblower provision in a 2011 comment letter in response to [Release No. 34-63237](#), *Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*. The Chamber said it was concerned that a lack of clarity in the rule "could create a perverse financial incentive for those with the job of identifying and investigating wrongful conduct."

"By making such individuals eligible to serve as whistleblowers and receive a substantial bounty, the proposed rules would put these professionals in the

position of potentially deciding between self-interest and the interest of their employer," the letter said.

The Chamber warned that the powerful financial incentives could encourage attorneys to ignore their essential duties and instead report information of any misconduct directly to the SEC.

"Probably no aspect of the program was more scrutinized and more publicly commented on than the potential impact on internal compliance that the program would have," McKessy said. "I would say in the early days that the concerns about the demise of the internal compliance programs were greatly overstated." McKessy said that most employees report problems internally before they contact the SEC.

"Only the employee is in a position to know whether reporting internally is a credible thing to do," he said. "Some companies have extraordinarily credible internal compliance functions, some companies don't. To mandate that an employee without knowing the context have to report internally before they can come to us I think is inappropriate."

Lisa Belot, a spokeswoman for the Chamber, said it's still too soon to tell if the rule is having a positive impact.

"Judging by the sheer volume of tips the SEC has received, and subsequently the number they've been able to address, they are clearly having an issue separating the legitimate complaints from the overwhelming number that are possibly illegitimate," Belot wrote in an email response to a question.

McKessy said the SEC is pleased with the steady volume of tips it receives.

"We were basically told we didn't know what we were asking for, and we were going to be inundated with an avalanche of nonsense," he said. "We have more than adequate resources to review the tips that come in. We have the office of market intelligence which is set up to do just that."

Kohn said the whistleblower statute puts a premium on high quality information.

“Unless the information you turn over is good enough to trigger an investigation, you have nothing,” he said. “There’s no reason whatsoever anyone should be against having people report violations of federal law, white-collar crime, and fraud.”