Proposed "Whistleblower" Legislation Threatens Firms Subject to Securities Laws

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October 9, 2009 - Last week, Congressman Paul Kanjorski made public draft legislation containing "whistleblower" proposals that should be of considerable concern to Jorden Burt's core client groups that are subject to the federal securities laws, including: investment companies, investment advisers, broker-dealers, and many insurance companies. The proposals were part of Kanjorski's draft "Investor Protection Act of 2009," which can be found here.

These proposals appear to have considerable momentum. Kanjorski is Chairman of the Capital Markets Subcommittee of the House Financial Services Committee, and the full Committee held a hearing on this legislation on October 6. To date, the whistleblower proposals seem to have have drawn little opposition. Moreover, the whistleblower provisions contained in Kanjorski's draft are substantially the same as provisions contained in draft Obama administration legislation that was released by the Treasury Department this summer, which can be found here.

Under the proposals, if original information voluntarily provided to the SEC by a whistleblower leads the SEC to bring an administrative or judicial action that results in monetary sanctions exceeding $1 million, the SEC could reward the whistleblower with up to 30% of the monetary sanctions resulting from the action (and any related actions).

Although this could have some salutary effects, it also could have numerous unintended negative consequences, including:

- Individuals who could prevent, remedy, or promptly report improper conduct might instead delay, in hopes that the matter would ultimately ripen into a much more serious problem about which they could profitably inform the SEC.
- Where a whistleblower's testimony is relied on to establish the substance of any violation, the potential reward would incentivize false testimony. And multiple whistleblowers could conspire to corroborate each others' false testimony and be rewarded for doing so.
- Because the proposal would give the SEC broad discretion whether to make awards and in what amounts, the SEC would face the conflict of controlling the compensation of whistleblower-witnesses in proceedings to which the SEC is a party.

- Although the proposals would prohibit any award to a whistleblower who was criminally convicted in the matter, criminal securities law convictions are rare. It would appear possible that awards could be made to "whistleblowers" who themselves were culpable in the matter, though not criminally convicted.
- Whistleblowers under these proposals may be represented by counsel and need not be officers or employees of the firm against which they give information. This increases the risk that unscrupulous persons unaffiliated with a firm may make a cottage industry of using these rewards (or the prospect thereof) to help orchestrate attacks that are unfair and in some cases dishonest.
- Adoption of these proposals would probably lead many wholly innocent firms to modify their information flow and control procedures in ways that may not be desirable from a business (or, indeed, from a legal compliance) standpoint. This could affect the firms' relationships even with outside counsel, auditors, consultants, suppliers, *etc.*, all of whom (or their employees) might be potential recipients of rewards under the proposals. Such modifications would reflect the reality that all of such persons would be more incentivized to act in ways adverse to the firm, including in circumstances where the firm had not merited such action.
- The proposals would provide extensive protection to whistleblowers against recriminations as a result of providing information to the SEC about securities law violations. Under the proposals, therefore, if a firm's officer, employee, service provider, or similar person felt in danger of being terminated, such person could gain material advantage from alleging a securities law violation against the firm, whether fairly or not.

The SEC currently has the authority to reward whistleblowers who give information that leads the SEC to impose a civil penalty for insider trading. The maximum reward in such cases is 10% of the penalty. Historically, such rewards have been made only rarely, and any problems listed above do not seem to have been common. Nevertheless, the whistleblower proposals now making their way through Congress would potentially be available in a much broader range of circumstances and in higher amounts. Enactment of these proposals, therefore, may well result in more widespread unintended negative consequences.

For additional information:

Jorden Burt has formed a special Task Force to monitor these proposals and other proposals relating to reform of financial services regulation. To obtain additional information about particular proposals that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular proposals that might have an impact on the investment adviser and fund industries you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.

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