

# Virus, Regs Highlight Need For Model State Whistleblower Law

By Patrick McCloskey (June 26, 2020)

On May 26 the North American Securities Administrators Association announced its proposal of a model state act to reward and protect whistleblowers who report wrongful securities practices to the applicable state securities regulator.[1]

NASAA's notice to its members included the text of the proposed model act, seeking public comment by June 30.[2]

The proposed model legislation resembles the federal program established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[3] the related regulations promulgated by the U.S. Securities and Exchange Commission,[4] as well as existing state laws in Indiana, enacted in 2012,[5] and Utah, enacted in 2011.[6]



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If adopted in one or more states, the proposed model act would give whistleblowers a financial incentive to report securities misconduct at the applicable state level(s), which could help state securities enforcement agencies detect fraud at earlier stages, thereby reducing harm to investors.

The proposal is one of numerous steps recently taken by NASAA to assist state securities regulators in fighting fraud at a time when (1) the COVID-19 outbreak has presented unique opportunities for scammers,[7] and (2) the SEC has proposed easing certain federal registration exemptions to facilitate capital raising.[8]

NASAA formed a COVID-19 Enforcement Task Force in late April[9] and, on June 1 it submitted a comment letter opposing most of the SEC's proposed rule changes.[10]

## General Overview

Among other things, NASAA's proposed Model Whistleblower Award and Protection Act, or MWAPA, would:

- Authorize the applicable state securities regulator to pay whistleblower awards based on monetary sanctions[11] recovered in the related administrative or judicial proceeding;
- Set the range of monetary awards between a minimum of 10% and a maximum of 30% of the monetary sanctions for the underlying violation(s);
- Set forth a nonexclusive list of factors to be considered in determining the amount of a monetary award;
- Identify disqualifications from whistleblower eligibility; and
- Provide whistleblower protections, such as confidentiality, anti-retaliation and invalidation of waivers.

## **Comparison With Existing Programs**

The 10% minimum and 30% maximum whistleblower award range in NASAA's proposed MWAPA is identical to the existing range contained in the federal program administered by the SEC's Office of the Whistleblower. However, unlike the federal whistleblower program, which requires that monetary sanctions exceed \$1 million, the proposed MWAPA does not contain a minimum amount for the model statute to apply.

In Indiana, the securities whistleblower statute has no qualifying threshold, but awards are capped at 10% of the monetary sanctions.[12] Utah has a monetary sanction threshold of \$50,000 and awards are generally limited to 30% of such monetary sanctions.[13]

As proposed, the MWAPA definition of whistleblower includes information related to a violation of state or federal securities laws or regulations.[14]

Under the federal regulations promulgated by the SEC, the whistleblower definition does not include information related to state violations,[15] and the analogous definitions in Indiana and Utah — informant and reporter, respectively — do not include information-related federal violations.[16]

The proposed MWAPA would leave it to the adopting state(s) to determine the source of funds to pay whistleblowers. In Indiana, awards are to be paid from a Securities Restitution Fund,[17] and in Utah payments are to be sourced from a Securities Investor Education, Training and Enforcement Fund.[18]

Under the federal program, the Dodd-Frank Act mandated the creation of a federal investor protection fund to source whistleblower payments.[19]

The federal securities whistleblower program has led to some significant payouts. On June 4 the SEC announced an award of almost \$50 million, its largest ever to a single whistleblower.[20]

Since the federal program was implemented in response to the Dodd-Frank Act, the SEC has awarded approximately \$501 million to 85 whistleblowers.[21] Indiana and Utah have made one whistleblower payout each to date, with Indiana awarding \$95,000 in 2016[22] and Utah awarding \$15,000 in 2014.[23]

## **NASAA's Broader Fraud Concerns**

The proposed MWAPA appears to be a measure intended to address NASAA's broader concerns about securities fraud.

On June 16 NASAA announced that there were more than 100 investigators from 44 state and provincial jurisdictions participating in its COVID-19 Enforcement Task Force and that 91 potentially fraudulent matters had been identified with 54 active investigations.[24]

In the announcement, NASAA's President Christopher Gerold stated:

The task force was established to protect investors by proactively disrupting, discouraging and deterring fraudulent or illegal activities of those seeking to exploit the coronavirus pandemic.

On June 1, the last day of the comment period for the SEC's proposal to ease and harmonize certain private offering exemptions, NASAA submitted a letter opposing most of the proposed changes, stressing fraud concerns in opposition of proposed Rule 152, on safe harbor from integration, and proposed Rule 241, testing the waters communications.

Both proposed rules represent a diminution of the types of prophylactic measures built into the securities laws for investor protection. The anti-fraud provisions of the federal securities laws are not sufficient in and of themselves to protect investors. Congress included prophylactic measures, such as Section 5 of the Securities Act, to prevent fraud and forestall abusive practices.[25]

The need to deter fraud was also identified in the comment letter of the Consumer Federation of America regarding the SEC's proposed amendments, concluding "[w]ithout the realistic threat of enforcement, many private companies are unlikely to be deterred from engaging in fraud and other unlawful activity, and investors, particularly vulnerable retail investors, will suffer." [26]

Gerold, also chief of the New Jersey Bureau of Securities, alluded to the prophylactic nature of the proposed MWAPA in NASAA's announcement, stating it could "lead to the earlier detection of securities law violations, which, in turn, provides regulators with a greater opportunity to stop the conduct alleged sooner, and prevent additional investors from being harmed."

Although federal preemption imposed by the National Securities Markets Improvements Act of 1996 prevents states from requiring registration of certain offerings, such as those exempt under Rule 506 of Regulation D and Regulation Crowdfunding, states can still commence an enforcement action with respect to fraud in such offerings.[27]

That preservation of authority could prove to be meaningful in the MWAPA context, especially in situations where the monetary sanctions are less than \$1 million and the federal whistleblower program would not apply.

### **Whistleblowing in New York**

While legislation rewarding whistleblowers who report financial and securities misconduct has been introduced in New York the past, such a statute has yet to be enacted.[28]

The New York False Claims Act does, however, provide for monetary awards to tax whistleblowers who commence a successful qui tam action for violations by certain defendants.[29] Plaintiffs can receive between 15% and 30% of the proceeds recovered in such cases.[30]

New York's securities statute, the Martin Act,[31] is both unique and onerous, compared to other states. As an example, subject to limited exceptions, private placement issuers are generally required to register as dealers of their own securities with the New York Attorney General's Office's Department of Law.[32]

In addition, the New York Attorney General's Office is not required to prove scienter in a Martin Act enforcement proceeding.[33] In a recent development, the New York Attorney General's Office has proposed a new regulation that, if adopted, would require so-called finders to register as brokers in New York state.[34]

In October 2019, New York Attorney General Letitia James simplified the process for whistleblowers generally by creating an online portal where complaints of unlawful or fraudulent conduct can be submitted on a confidential and anonymous basis.[35]

If the MWAPA or a similar statute were to be adopted in New York, whistleblowers would not only have an online portal to report securities misconduct confidentially and anonymously, but they would have a financial incentive to do so. This combination could substantially increase securities enforcement activity by the New York Attorney General's Office.

### **Potential Impact**

Since the MWAPA is a proposed model act, it is unknown at this stage which states, if any, will adopt it, as proposed or modified.

Given the active participation in NASAA's COVID-19 Enforcement Task Force, one would expect state securities administrators to encourage their respective state legislatures to introduce the MWAPA or a similar state securities whistleblower statute for enactment.

Adoption of the MWAPA in one or more states would bolster the applicable securities regulator's ability to stamp out fraud and violations of local securities laws and regulations at an early stage. As the expression goes: Money talks.

Giving whistleblowers a financial incentive to provide tips could prove to be extremely helpful, especially in sophisticated schemes to defraud investors or circumvent state securities laws or regulations.

Considering that (1) the COVID-19 pandemic has provided a new and unique opportunity for fraudsters, and (2) certain federal registration exemptions may soon be relaxed, the MWAPA could be a timely weapon against securities misconduct.

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[1] NASAA Board Approves the Release for Public Comment of a Proposed Model Act to Award and Protect Whistleblowers (May 26, 2020). <https://www.nasaa.org/54995/nasaa-board-approves-the-release-for-public-comment-of-a-proposed-model-act-to-award-and-protect-whistleblowers/?qoid=current-headlines>.

[2] See Notice of Request for Public Comments on Proposed Model Whistleblower Award and Protection Act. <https://www.nasaa.org/wp-content/uploads/2020/05/Model-Whistleblower-Award-and-Protection-Act-Request-for-Public-Comment-052620.pdf>.

[3] See Section 922 of the Dodd-Frank Act. <https://www.sec.gov/about/offices/owb/dodd-frank-sec-922.pdf>.

[4] See 17 CFR § 240.21F. <https://www.sec.gov/about/offices/owb/reg-21f.pdf>.

[5] See Title 23 Article 19 Chapter 7 of the Indiana Code (Awards for Reporting Securities Violations). <http://iga.in.gov/legislative/laws/2019/ic/titles/023#23-19-7>.

[6] See Title 61 Chapter 1 Part 1 of the Utah Code (Securities Fraud Reporting Program Act). [https://le.utah.gov/xcode/Title61/Chapter1/61-1-P1.html?v=C61-1-P1\\_1800010118000101](https://le.utah.gov/xcode/Title61/Chapter1/61-1-P1.html?v=C61-1-P1_1800010118000101).

[7] See James Langton, Private markets a breeding ground for Covid-19 scams: NASAA, InvestmentExecutive.com (April 3, 2020). <https://www.investmentexecutive.com/news/from-the-regulators/private-markets-a-breeding-ground-for-covid-19-scams-nasaa/>.

[8] SEC Proposes Rule Changes to Harmonize, Simplify and Improve the Exempt Offering Framework (March 4, 2020).

[9] NASAA Forms COVID-19 Enforcement Task Force (April 28, 2020). <https://www.nasaa.org/54844/nasaa-forms-covid-19-enforcement-task-force/?qoid=current-headlines>.

[10] See letter of NASAA to the SEC dated June 1, 2020 (File No. S7-05-20) ("NASAA June 1, 2020 Letter"). <https://www.sec.gov/comments/s7-05-20/s70520-7258827-217615.pdf>.

[11] Like the federal securities whistleblower program, "monetary sanctions" under the MWAPA would exclude restitution.

[12] See Indiana Code § 23-19-7-7(b).

[13] See Utah Code § 61-1-106(3)(b). If applicable, an award is capped at the balance of Utah's Securities Investor Education, Training, and Enforcement Fund as of the date awards are determined. Id.

[14] See MWAPA Section 2, Subparagraph (3) ("Whistleblower" means an individual who, alone or jointly with others, provides the [Securities Division] with information pursuant to the procedures set forth in this act, and the information relates to a possible violation of state or federal securities laws, including any rules or regulations thereunder, that has occurred, is ongoing, or is about to occur.").

[15] See 17 CFR § 240.21F-2(a) (qualifying information provided by whistleblowers limited to violations of the federal securities laws and any rules or regulations thereunder).

[16] See Indiana Code § 23-19-7-7(a)(1)(B) (qualifying information provided by informants limited to violations of the Indiana Uniform Securities Act); Utah Code § 61-1-103 (qualifying information provided by reporters limited to violations of the Utah Uniform Securities Act).

[17] See Indiana Code §§ 23-19-7-3 and 23-20-1-26.

[18] See Utah Code §§ 61-1-102(4) and 61-1-18.7.

[19] See Section 21F(g) of the 1934 Act.

[20] SEC Awards Record Payout of Nearly \$50 million to Whistleblower (June 4, 2020). <https://www.sec.gov/news/press-release/2020-126>.

[21] SEC Awards \$125,000 to Whistleblower (June 23, 2020). <https://www.sec.gov/news/press-release/2020-141>.

[22] JP Morgan Whistleblower Awarded \$95,000—First whistleblower award in state (August 19, 2016). <https://calendar.in.gov/site/sos/event/sos-jp-morgan-whistleblower-awarded-95000-first-whistleblower-award-in-the-state/>.

[23] Securities Commission approves first whistleblower award for 15K (May 22, 2014). [https://commerce.utah.gov/releases/14-05-22\\_sec-whistleblower-award.pdf](https://commerce.utah.gov/releases/14-05-22_sec-whistleblower-award.pdf).

[24] NASAA Updates COVID-19 Enforcement Task Force Actions (June 16, 2020). <https://www.nasaa.org/55141/nasaa-updates-covid-19-enforcement-task-force-actions/?qoid=current-headlines>.

[25] See NASAA June 1, 2020 Letter, at 6 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) ("A fundamental purpose [of the federal securities laws] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.")).

[26] See letter of the Consumer Federation of America to the SEC, dated June 4, 2020 (File No. S7-05-20), p. 55. <https://www.sec.gov/comments/s7-05-20/s70520-7283360-217896.pdf>.

[27] See Section 18(c)(1) of the Securities Act of 1933, as amended.

[28] See New York Senate Bill S4362 (2013-2014 Legislative Session) (Relates to protecting and compensating whistleblowers who provide original information to the department of financial services as to violations of certain laws) <https://www.nysenate.gov/legislation/bills/2013/S4362>; See also A.G. Schneiderman Proposes Bill To Reward And Protect Whistleblowers Who Report Financial Crimes (February 26, 2015). <https://ag.ny.gov/press-release/2015/ag-schneiderman-proposes-bill-reward-and-protect-whistleblowers-who-report>.

[29] See New York State Finance Law §§ 189[4](a).

[30] If the NYAG intervenes, the whistleblower is entitled to between 15% and 25% of the proceeds recovered. If the NYAG declines, the whistleblower is entitled to between 25% and 30%. In either case the precise amount to be awarded to the whistleblower is determined by the court. See New York State Finance Law §§ 190[6](a) & (b).

[31] Article 23-A of the New York General Business Law (the "GBL").

[32] See GBL § 359-e. An Issuer is not required to so register if such issuer is excepted from the definition of "dealer" under GBL § 359-e[1](a) or the securities or transaction is exempt under GBL § 359-f[2].

[33] See, e.g., *People v. Credit Suisse Securities (USA) LLC*, 31 NY3d 622, 632 (2018) (citing *State of New York v. Rachmani Corp.*, 71 NY2d 718, 725 (1988)).

[34] See New York State Register, April 15, 2020/Volume XLII, Issue 15; Department of Law: Brokers, Dealers and Salespersons Defined Under General Business Law, section 359-e, p. 11 ("[t]he proposed revisions to 13 NYCRR 10 and 13 NYCRR 11, seek to clarify the

registration and exam requirements for certain currently undefined subclassifications of broker-dealers and investment advisers that are paid to match up investors with securities industry participants. The proposals define and classify "Finders" and "Solicitors" for such purposes.").

[35] Whistleblowers Welcome: Attorney General James Announces New Whistleblower Submission System (October 2, 2019). <https://ag.ny.gov/press-release/2019/whistleblowers-welcome-attorney-general-james-announces-new-whistleblower>.