

The U.S. financial industry is too large and complex a beast to be effectively regulated by bureaucrats alone, and outsourcing a check on financial misdeeds to those in the best position to see what happens on a transactional level was probably a wise decision in the Dodd-Frank Act.

By R. SCOTT OSWALD



Down to the Crossroads

Where Securities Fraud and Fraud Against the Government Meet

It stretches the stylistic canon against overly broad or trite openings to begin with the observation that the 2008 financial crisis and resulting recession have changed the financial industry and its relationship with the U.S. government. The crisis happened faster and the recession was deeper than most observers predicted. The executive response was unprecedented. After the fall of Bear-Stearns and the shockwave it sent through the industry, banks were loaned unfathomable sums of money to prevent the collapse of the entire system, and the nation's largest loan securitizers were placed under federal conservatorship.

Unsurprisingly, the legislative response to these events came almost as swiftly as the Dodd-Frank Wall Street Reform and Consumer Protection Act passed in 2010, bringing with it—via the Section 922 whistleblower rewards program—a

new mode of empowerment for those committed to the integrity of the U.S. financial system. While the details of Dodd-Frank's changes to the regulatory scheme governing the financial industry were hotly debated, the whistleblower program garnered relatively little attention in the legislative process.

The upshot of this series of actions and reactions is that a mere six years after the biggest financial crisis since Black Tuesday, we are now living in something of an experimental era of Dodd-Frank whistleblower claims. Dodd-Frank is not the only effort of the U.S. Congress to use the good conscience of employees as a regulatory relief valve. The Lincoln Administration saw the value in outsourcing regulatory oversight to whistleblowers as far back as the Civil War with the passage of the False Claims Act (FCA). The FCA allowed individuals to bring an action on behalf of the United States against those who commit fraud against the government. This article seeks to examine the center of the Venn diagram, where the old (FCA) and the new (Dodd-Frank) overlap.

Government Securities: Fannie, Freddie, and the SEC

The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation—each more commonly known by its respective nickname Fannie Mae and Freddie Mac—have always resided in the murky water between the public and private sectors. They are called government-sponsored enterprises because, though they are

privately run for profit, they were created by Congress and operate under a Congressional mandate. Despite the lack of explicit government financial backing, Fannie and Freddie have generally benefited from favorable lending rates at least in part because of an *implicit* guarantee from the federal government.

In September 2008, when the proverbial bottom dropped out of the U.S. financial system, Fannie and Freddie were the securitizers of virtually all mortgage-backed securities in the United States, holding \$5.2 trillion in debt.¹ That same month, the *implicit* guarantee became *explicit* when the U.S. government placed the two entities in conservatorship, where they remain today. The result is that the U.S. government is now directly responsible for the nation's largest mortgage securitizers.

Mortgage originators often—indeed usually—originate loans and then shortly thereafter sell them to Fannie or Freddie. To the extent an originator has, for instance, significantly misrepresented the credit risk of the loans it sells to Fannie or Freddie for securitization or failed to make its loans conform to the various standards laid out by the Federal Housing Finance Agency (FHFA), it may be subject to Dodd-Frank liability. These types of material omissions and fraudulent courses of action would give rise to a Securities and Exchange Commission (SEC) action. Under Section 922 of the Dodd-Frank Act, the SEC will pay a reward to a whistleblower who voluntarily provides original information to the SEC about the fraud if it results in monetary sanctions exceeding \$1 million or in civil or criminal proceedings.²

But the whistleblower who discovers this type of fraud has a choice. In *United States v. Countrywide Fin. Corp.*,³ the court established the possibility that fraud against Fannie Mae and Freddie Mac may be fraud on government funds subject to the False Claims Act's rewards provision if committed after the May 20, 2009, amendments to the law.⁴

Prior to May 20, 2009, the False Claims Act did not encompass such claims when made to entities like Fannie Mae and Freddie Mac. However, the Fraud Enforcement and Recovery Act of 2009 ("FERA") ... amended the FCA to, among other things, define the term "claim" to include "any request or demand ... for money ... that is made to a contractor, grantee, or other recipient, if the money ... is to be spent or used on the Government's behalf or to advance a Government program or interest, and if the United States Government provides or has provided any portion of the money ... requested or demanded, or will reimburse ... any portion of the money." The amendment, which arguably extends the FCA to false claims made to Fannie Mae and Freddie Mac, took effect on May 20, 2009, but it did not have retroactive effect.⁵

The Southern District of New York also found a plausible theory of liability under the False Claims Act where a bank's failure to comply with underwriting standards induced the Department of Housing and Urban Development (HUD) to insure loans through the Federal Housing Administration (FHA) that should not have been insured.⁶ Applying this same logic to failure to meet Federal Housing Finance Agency regulatory standards when securitizing loans through Fannie Mae or Freddie Mac provides further sup-

port for the *Countrywide* approach.

So the same fraud may theoretically give rise to a whistleblower claim under the Dodd-Frank Act in the securities context, while also creating a viable action under the False Claims Act. The whistleblower in this context, therefore, has a choice whether to use the Dodd-Frank Act or the False Claims Act's rewards provisions, and he must understand the unique trade-offs that such an election presents.

Practical Considerations

The first question the whistleblower and his counsel should consider is one of practicality. The Dodd-Frank and FCA reward regimes operate differently. The FCA contains *qui tam* provisions that allow the whistleblower (referred to in the FCA context as a relator) to file the litigation in court himself under seal.⁷ It also requires that the complaint be provided to the necessary parties at the Department of Justice, along with other materials and disclosure statements.⁸ To the extent the Department of Justice, after considering the action, fails to intervene and litigate the action directly, the whistleblower may still prosecute the claim on his own.

Dodd-Frank does not contain a similar *qui tam* provision, and operates more as a pure tip/reward system. The whistleblower completes a Tip, Complaint, or Referral (Form TCR) and provides the same to the SEC, putting the matter almost entirely in the hands of the SEC to investigate and prosecute. Should the SEC decide not to pursue the action, the whistleblower must engage in an administrative process with the SEC to contest the determination or appeal the decision whether to make an award pursuant to SEC rules.⁹ Neither of these processes is appetizing to a whistleblower.

The FCA may require more of its claimants up front, but the whistleblower maintains significantly more control on the back end, making it perhaps the better avenue for the more dedicated litigant with effective counsel.

Reward Eligibility and Damages

Another issue the whistleblower might consider is the differing reward regimes. Under the False Claims Act, a relator in a successful action is entitled to a reward of "at least 15 percent but not more than 25 percent of the proceeds of the action or settlement of the claim, depending upon the extent to which the person substantially contributed to the prosecution of the action."¹⁰ This amount is between 25 and 30 percent for relators who carry the action forward without the government's support. In considering the relator's share, the Department of Justice considers several factors, including the relator's involvement in the illegal activity, the promptness and equitability of the relator's actions, and the intensity of the relator's involvement in the case. Furthermore, the 1986 amendments to the False Claims Act¹¹ mandate treble damages in successful *qui tam* actions.¹²

The Dodd-Frank claim, on the other hand, allows for between a 10 and 30 percent share for whistleblowers bringing tips that lead to successful actions.¹³ While Dodd-Frank leaves the decision of this matter to the SEC, the law also contains a statutory set of factors for consideration, including

- The significance of the information provided by the

whistleblower to the success of the covered judicial or administrative action;

- The degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;
- The programmatic interest of the commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that lead to the successful enforcement of such laws; and
- Such additional relevant factors as the commission may establish by rule or regulation.¹⁴

The range of rewards for whistleblowers reaches 5 percent higher under the Dodd-Frank action, and the Dodd-Frank action contains statutory guidelines and appeals for decisions to make an award. The False Claims Act benefits from the trebling of the losses to the government and a floor 5 percent higher than that of Dodd-Frank, but contains less statutory clarity in relator's share decisions.

Conclusion

The U.S. financial industry is too large and complex a beast to be regulated effectively by bureaucrats alone, and outsourcing a check on financial misdeeds to those in the best position to see what happens on a transactional level was probably a wise decision in the Dodd-Frank Act. In unique situations where the federal government deals directly in securities, such as that described here involving Fannie Mae and Freddie Mac, the financial regulatory check also morphs into a false claim against the United States, creating a double incentive for would-be whistleblowers to accept the invitation to be the eyes and ears of the administration.

In order to strategize effectively and form an approach to litigation in these unique circumstances, whistleblowers and their counsel must understand the differences in the two laws and make informed decisions about whether and how to proceed. ☉



R. Scott Oswald will moderate a panel on developments in federal whistleblower law with special emphasis on the False Claims Act for the Federal Bar Association's Annual Meeting and Convention. The panel will present on Thursday, September 4, at 7:30 a.m. Panelists include Zachary Cunha, affirmative civil enforcement coordinator assistant U.S. attorney for the District of Rhode

Island, and Maryann Grodin, general counsel to the inspector general, U.S. Nuclear Regulatory Commission. The panel will also likely include a member of the federal bench for the District of Rhode Island.

Endnotes

¹U.S. Considers Bringing Fannie, Freddie on to Budget (Update1), Dawn Kopecki, Sept. 11, 2008, www.bloomberg.com/apps/news?pid=newsarchive&sid=adr.czwVm3ws&refer=home.

²15 U.S.C. §§ 78u-6(a)(1), (b); 17 C.F.R. 240.21F-3(a).

³961 F. Supp. 2d 598, 609 (S.D.N.Y. 2013).

⁴Pub.L. No. 111-21, 123 Stat. 1617 (2009).

⁵*United States v. Countrywide Fin. Corp.*, 961 F. Supp. 2d 598, 609 (S.D.N.Y. 2013) (internal citations omitted).

⁶*United States v. Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593, 623-24 (S.D.N.Y. 2013).

⁷See 31 U.S.C. § 3730(b).

⁸*Id.*

⁹17 C.F.R. 240.21F-10, 21F-12.

¹⁰31 U.S.C. § 3730(d)(1).

¹¹Pub.L. No. 99-562 (1986).

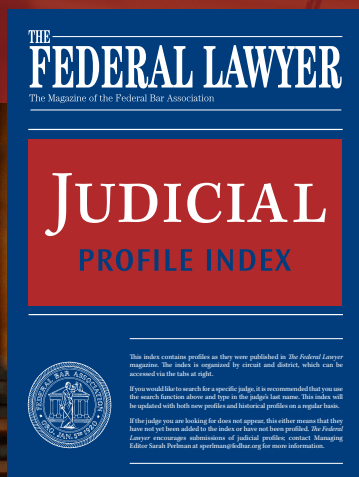
¹²31 U.S.C. § 3729(a)(1)(G).

¹³15 U.S.C. § 78u-6(b)(1).

¹⁴15 U.S.C. § 78u-6(c)(1)(B).

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