

## The SEC's Whistleblower Balancing Act

Law360, New York (November 12, 2010) -- On Monday, Nov. 3, 2010, the U.S. Securities and Exchange Commission proposed rules to implement the whistleblower bounty provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

As set forth below, in drafting the proposed rules, the SEC attempted to address a number of concerns regarding the whistleblower bounty provisions of the Dodd-Frank Act, especially with regard to the tension in the act between the goals of encouraging entities to have strong compliance systems and encouraging reporting misconduct through the use of bounty provisions.

It is not clear that the proposed rules adequately address the concerns. Accordingly, the SEC is seeking public comment regarding other potential approaches that will likely result in further refinement of the rules before their enactment.

### Overview of the Statute and the Proposed Rules

Section 922 of the Dodd-Frank Act, which amended the Securities Exchange Act of 1934 to add Section 21F, authorizes the SEC to award to whistleblowers between 10 percent and 30 percent of any monetary recovery (including penalties, disgorgement of profits, restitution and interest), for voluntarily providing to the SEC "original information" that led to the successful prosecution of any SEC enforcement action under the securities laws that results in monetary sanctions exceeding \$1 million and any related proceeding, if it is based on the information that the whistleblower provided to the SEC, and is brought by the U.S. Department of Justice, any appropriate regulatory authority, a self-regulatory organization or a state attorney general in connection with any criminal investigation.

In determining the amount of the award, the Dodd-Frank Act specifies several factors that the SEC must consider when determining the amount of the award, including the degree of assistance provided by the whistleblower, the significance of the information provided to the SEC, and the SEC's interest in deterring violations of law.

Payments only can occur based upon the provision of "original information," which the act defines as, "[I]nformation that 1) is derived from the independent knowledge or analysis of a whistleblower; 2) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and 3) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information."

Under the proposed rules, an individual is eligible for a bounty award only if the individual satisfies the following criteria:

*1) The individual does not fall within one of the categories excluded by the proposed rules.*

Only individuals are eligible for an award; the SEC is not authorized to award bounties to entities.

The proposed rules exclude the following categories of individuals from being eligible for a bounty award: a) individuals who have a pre-existing legal or contractual duty to report their information; b) attorneys who provide information obtained from client engagements (unless disclosure of the information is permitted under SEC rules or state bar rules); c)

independent public accountants who obtain information through an engagement required under the securities laws; d) foreign government officials; e) employees of certain agencies, self-regulatory organizations and the Public Company Accounting Oversight Board; and f) people who are criminally convicted in connection with the conduct.

*2) The information was provided to the SEC voluntarily.*

In general, an individual is deemed to have provided information “voluntarily” if the individual has provided information before the government, a self-regulatory organization or the Public Company Accounting Oversight Board asks for it, either formally or informally.

*3) The information constituted “original information” within the meaning of the proposed rules.*

In general, original information must be based upon the whistleblower’s independent knowledge or independent analysis, not already known to the commission and not derived exclusively from certain public sources. As discussed further below, in order to promote various public policy goals, the SEC carved a number of exclusions to this definition.

*4) The original information led to the successful enforcement by the SEC of a federal court or administrative action.*

Information provided by an individual is deemed to have led to successful enforcement in two circumstances: a) the information results in a new examination or investigation being opened and significantly contributes to the success of a resulting enforcement action, or b) the conduct was already under investigation when the information was submitted, but the information is essential to the success of the action and would not have otherwise been obtained.

*5) The SEC obtained monetary sanctions totaling more than \$1 million in the resulting enforcement action(s).*

In order to prevent wrongdoers from benefitting by, in effect, blowing the whistle on themselves, the proposed rules provide that the SEC will not pay culpable whistleblowers awards that are based upon either the monetary sanctions that such people themselves pay in the resulting SEC action, or on sanctions paid by entities whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.

If the SEC enforcement actions satisfy the \$1 million threshold, the SEC also would pay an award based on amounts collected in related actions brought by certain agencies that are based upon the same original information that led to a successful SEC action.

#### **Efforts to Address Potential Adverse Consequences of Bounty Awards**

In the proposed rules, the SEC attempted to address a number of concerns in addition to promoting Congress’s goal of encouraging individuals to provide information to the SEC regarding potential violations of the federal securities laws. These goals include:

- Encouraging individuals to report information to compliance, legal, audit and supervisory personnel who might redress the potential violation and encouraging entities to establish effective controls for the detection of potential violations.
- Encouraging individuals and entities to consult with counsel and encouraging counsel to comply with counsel’s ethical obligations to his or her clients.
- Encouraging entities to share information openly with independent accountants who are performing SEC-mandated audits.
- Discouraging individuals from engaging in unlawful conduct.

To a large extent, the SEC attempted to further these goals by carving seven exclusions to when the SEC will consider information to be “original information” derived from an individual’s independent knowledge or analysis. For example, to

address concerns regarding the adverse impact that the bounty provisions could have on an entity's compliance, legal, audit and supervisory procedures, the SEC included two exclusions:

- The individual obtained the information because the individual is a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, and the information was communicated to the individual with the reasonable expectation that the individual would take steps to cause the entity to respond appropriately to the violation, unless the entity did not disclose the information to the commission within a reasonable time or proceeded in bad faith.
- The individual otherwise obtained the information from or through an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential noncompliance with law, unless the entity did not disclose the information to the commission within a reasonable time or proceeded in bad faith.

To address the concerns regarding the attorney-client relationship, the SEC proposed exclusions for information that is subject to the attorney-client privilege or that an attorney obtained through representing a client unless the disclosure of the information is permitted by the SEC Rules of Professional Conduct for Attorneys or by state ethical rules.

To address concerns regarding the accountant-client relationship, the SEC proposed an exclusion for information obtained through performance of an engagement required under the federal securities laws. To address concerns that the bounty provisions might encourage individuals to engage in unlawful conduct, the SEC proposed an exclusion for information obtained in a manner that violated federal or state criminal law.

The SEC also attempted to encourage potential whistleblowers to proceed internally by stating that it expected "to give credit in the calculation of award amounts to whistleblowers who utilize established internal procedures for the receipt and consideration of complaints about misconduct." Proposing Release at 35 n. 40.

Presumably, the SEC expects to give this credit only to individuals who provide the information to the SEC only after giving internal procedures an opportunity to operate. By doing so, the SEC rules attempt to ease concerns that the Dodd-Frank Act creates an incentive to bypass, and therefore undermine, internal compliance initiatives.

The SEC also proposed that if a whistleblower discloses information to a person who had responsibility for an entity's compliance, audit, supervisory, or governance functions or processes, that person will be treated as having provided that information to the SEC on the date of the initial disclosure, as long as the whistleblower submits the information to the SEC within 90 days of the initial disclosure date.

This provision is intended to ease the potential concern of an internal whistleblower that someone else might preempt him by reporting directly to the SEC and that he would be penalized for utilizing internal compliance mechanisms.

While the SEC took clear steps to try to encourage employees to utilize internal complaint/compliance procedures, there is no requirement that a whistleblower first report potential violations internally.

The comments to the proposed rules state that the SEC considered such a requirement, and the SEC is seeing public comment regarding whether the rules should contain such a requirement. The SEC's comments appear to acknowledge, however, that such a requirement may undermine the Dodd-Frank whistleblower provisions' statutory mandate.

## **Conclusion**

The proposed rules represent a substantial effort by the commission and the staff to institute a bounty program in a manner that reduces the adverse impact that a bounty program otherwise might inflict on corporate compliance programs, attorney-client relationships and accountant-client relationships.

Given the complexity of the issues involved, however, there will no doubt be further development of these rules through the public comment process. Comments are due on or before Dec. 17, 2010.

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