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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Inside SEC's New Whistleblower Program

Law360, New York (June 6, 2011) -- On May 25, the U.S. Securities and Exchange Commission adopted by a 3-2 vote controversial rules implementing the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act").

These provisions are set forth in Section 922 of the Act, which amended the Securities Exchange Act of 1934 to add Section 21F to establish a whistleblower program that requires the SEC to pay an award, under regulations prescribed by the SEC and subject to certain limitations, to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action.

The rules provide a substantial incentive for employees and other individuals to alert the SEC to possible violations for the federal securities laws. The SEC has the power to impose monetary penalties and other monetary sanctions on public companies, broker-dealers, investment advisers, investment companies, other entities and individuals regulated by the SEC, and companies and individuals with which they do business. Accordingly, the rules have implications not just for public companies and regulated entities, but for a wide range of other companies and entities.

Many commenters expressed concern that the rules that the SEC proposed in November 2010 would undermine the internal compliance processes that companies have established and enhanced in recent years, particularly since the enactment of the Sarbanes-Oxley Act of 2002, and create other perverse incentives. Although the SEC took some steps to address those concerns, the final rules leave largely intact the risk that the bounty provisions will encourage company employees to circumvent the company's internal compliance processes.

Background to the 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.

Payments only can occur based upon the provision of "original information," which the Act defines as "information that (1) is derived from the independent knowledge or analysis of a whistleblower; (2) is not known to the SEC 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."

The amount of the bounty awarded should be based on the amount collected in the SEC enforcement actions and in 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.[1]

When the SEC proposed rules to implement the whistleblower bounty provisions in November 2010, the SEC attempted to address a number of concerns in the proposed rules 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
- Encouraging entities to establish and maintain effective controls for the detection of potential violations
- Creating disincentives for a potential whistleblower to allow an entity to engage in ongoing violations in order to increase the potential size of the whistleblower bounty award
- Encouraging individuals and entities to consult with counsel and counsel to comply with its ethical obligations to its clients
- Encouraging entities to share information openly with independent accountants who are performing SEC mandated audits
- Not rewarding individuals for engaging in unlawful conduct

The proposed rules generated great controversy. The SEC received more than 240 comment letters and approximately 1,300 form letters on the proposal. Commenters included individuals, whistleblower advocacy groups, public companies, corporate compliance personnel, law firms and individual lawyers, academics, professional associations, nonprofit organizations and audit firms. The comments addressed a wide range of issues.

The most controversial aspect of the proposed rules involved the interplay between the whistleblower program and companies' internal compliance processes. Many commenters urged the SEC to require whistleblowers to report through internal compliance processes as a prerequisite to being eligible for a whistleblower bounty. In adopting the rules, the SEC decided not to adopt such a requirement, but did take some steps to encourage individuals to report information to a company's internal compliance processes either before or at the same time as reporting information to the SEC.

The SEC provided that in some circumstances a whistleblower who provides original information to a company's internal compliance procedure will be treated as if the whistleblower provided the information directly to the SEC. Rule 21F-4(c)(3). The SEC also provided that in determining the size of the bounty to be awarded to a whistleblower, the SEC will favorably consider the provision of the information to a company's internal processes. Rule 21F-6(a)(4).

In our opinion, these steps are unlikely to counter the significant incentives that the whistleblower bounty provisions provide employees and other individuals to report information directly to the SEC without either a prior or simultaneous report to a company's internal compliance processes.

Overview of the Final Rules Governing Bounties

Under the rules adopted by the SEC, a person is eligible for a bounty award only if the person satisfies the following criteria:

1) The person is an individual and was not criminally convicted in connection with the conduct. A company or another entity is not eligible to be a whistleblower. Rule 21F-2

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 to the SEC before a request, inquiry or demand that relates to the subject matter is directed to the individual or the individual's representative (e.g., the individual's counsel) by the SEC, in connection with an investigation by the federal government, a state attorney general or securities regulatory authority, or in connection with an investigation, inspection or examination by a self-regulatory organization ("SRO") or the Public Company Accounting Oversight Board ("PCAOB").[2]

The rules do not treat a request to an employer as directed to all employees whose documents or information fall within the scope of the request. Thus, an SEC subpoena directed to a broker-dealer may not foreclose a whistleblower bounty award to an employee of the broker-dealer based on a subsequent submission of information by the employee to the SEC. Rule 21F-4(a)(3).

Similarly, an employee's receipt of a request for information by a company or its attorneys conducting an internal investigation may not foreclose a whistleblower bounty award to an employee based on the subsequent submission of information by the employee to the SEC.

Rule 21F-4(a)(3) provides that a whistleblower cannot "voluntarily" submit information if the whistleblower is required to report his or her original information to the SEC, as a result

- of a pre-existing legal duty, or contractual duty that is owed by the individual to the federal government, the PCAOB, an SRO, a state attorney general, or a securities regulatory authority, or
- a duty that arises out of a judicial or administrative order (e.g., independent monitors or consultants appointed as a result of a SEC or other proceedings with a requirement that they report information to the SEC).

In contrast to the proposed rules, the final rules provide that a duty to report information only to an authority other than the SEC does not result in exclusion of the whistleblower. Rule 21-4(a)(3). The requirement that the contractual duty be owed to the SEC or to one of the other authorities means that whistleblowers will not be precluded from award eligibility if they are subject to a contractual duty to report information to the SEC because of an agreement with a third party.

Accordingly, employers should not be able to preclude their employees from whistleblower eligibility by generally requiring all employees to enter into agreements that they will report evidence of securities violations directly to the SEC.

Further, Rule 21F-4(c)(3) provides that a whistleblower may be eligible for an award based upon information that the whistleblower reports through a company's internal legal and compliance procedures if the company subsequently provides the information to the commission and the individual submits the same information to the commission within 120 days of providing the information to the entity.

3) The information constituted "original information" within the meaning of the SEC's rules. In general, original information must be based upon the whistleblower's independent knowledge or independent analysis, not already known to the SEC and not derived exclusively from certain public sources. Rule 21F-4(b)(1).

The definition of "independent knowledge" is not limited to direct, first-hand knowledge. Rather, "independent knowledge" means factual information that is not derived from publicly available sources; it may be gained from the individual's experiences, communications, or observations. Rule 21F-4(b)(2). "Independent analysis" means the individual's analysis, whether done alone or in combination with others, and may involve information that is publicly available if the analysis reveals information that is not generally known or available to the public. Rule 21F-4(b)(3).

The SEC addressed a number of policy concerns relating to the whistleblower rules by carving exclusions to when the SEC will consider information to be derived from an individual's knowledge or analysis. These exclusions include information that the individual obtained in connection with an attorney-client relationship. Specifically, the SEC will not award penalties based on the submission of information that was obtained:

- through a communication that was subject to the attorney-client privilege; or
- in connection with the legal representation of a client on whose behalf the individual or the individual's employer or firm are providing services unless disclosure of that information would otherwise be permitted by an attorney pursuant to SEC Standards of Professional Conduct, applicable state attorney conduct rules, or otherwise. Rule 21F-4(b)(4)(i) and (ii).

The final rules clarify that these two exclusions apply to attorneys who work in-house for an entity and provide legal services (e.g., attorneys in an entity's general counsel's office). The two exclusions also apply to non-attorneys. Thus, if an attorney in possession of the information would be precluded from receiving an award based on his or her submission of the information to us, a non-attorney who learns this information through a confidential attorney-client communication would be similarly disqualified.

In addition, information will not be considered derived from an individual's knowledge or analysis — and therefore will not qualify an individual for a whistleblower bounty award — if the individual obtained the information because the individual was one or more of the following:

- An officer, director, trustee, or partner of an entity who learned of the information in connection with the entity's processes for identifying, reporting and addressing possible violations of law, Rule 21F-4(b)(4)(iii)(A);
- An employee whose principal duties involve compliance or internal audit responsibilities and employees of outside firms retained to perform compliance or internal audit functions for an entity, 21F-4(b)(4)(iii)(B);
- An individual employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law, Rule 21F-4(b)(4)(iii)(C); or
- An employee of, or other person associated with, a public accounting firm, if the person obtained the information through the performance of an engagement required of an independent public accountant under the federal securities laws (other than an audit subject to §240.21F-8(c)(4) of this chapter), and that information related to a violation by the engagement client or the client's directors, officers or other employees, Rule 21F-4(b)(4)(iii)(D).

The exclusions related to these particular individuals do not apply, however, if one or more of the following three conditions is satisfied:

- the whistleblower has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;
- the whistleblower has a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct; or
- at least 120 days have elapsed since the whistleblower provided the information to the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or to the whistleblower's supervisor, or since the whistleblower received the information, if the whistleblower received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's supervisor was already aware of the information. Rule 21F-4(b)(4)(v).

In the Adopting Release, the SEC suggested that the first condition will rarely be satisfied if a company has an effective internal compliance process:

"[I]n order for a whistleblower to claim a reasonable belief that disclosure of information to the Commission is necessary to prevent the relevant entity from committing substantial harm, we expect that in most cases the whistleblower will need to demonstrate that responsible management or governance personnel at the entity were aware of the imminent violation and were not taking steps to prevent it. In short, the whistleblower must have a reasonable basis for believing that the entity is about to engage in conduct that is likely to cause substantial injury to the financial interests of the entity or investors, and that notification to the Commission is necessary to prevent the entity from engaging in that conduct." Adopting Release at 74.

Nevertheless, there is a danger that many attorneys will claim to qualify for this condition. An attorney who is aware of information that the attorney reasonably believes indicates an ongoing or future violation of the federal securities laws will often be in a position to argue that he had a reasonable basis to believe that disclosure of the information to the SEC was necessary to prevent the company to cause substantial injury to the financial interest or property of the entity or investor.

4) The original information led to the successful enforcement by the SEC of a federal court or administrative action. In order to be considered eligible for an award, a whistleblower must provide information that is sufficiently specific, credible and timely that it causes the staff to open an investigation, or significantly contributes to the success of an enforcement action. Rule 21F-4(c)(1).

Information provided by an individual is deemed to have led to successful enforcement in three circumstances:

- the information results in a new examination or investigation being opened and significantly contributes to the success of a resulting enforcement action:
- the conduct was already under investigation when the information was submitted, but the information significantly contributed to the success of the action; or
- the information was reported through the entity's internal whistleblower, legal or compliance procedures for reporting possible violations of law before or at the same time that the individual reported the information to the SEC, the entity later provided the information to the SEC or provided results of an audit or investigation initiated in whole or in part in response to information that the individual reported to the entity and the information satisfies one of the two criteria set forth immediately above.

5) The SEC obtained monetary sanctions totaling more than $1 million in a resulting enforcement action(s). If the SEC enforcement actions satisfy the $1 million threshold, the SEC would pay an award based not only on the amount that the SEC collected in enforcement actions but also 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. Rule 21F-3.

For the purpose of making an award, the SEC will treat as a single action two or more administrative or judicial proceedings brought by the SEC, if these proceedings arise out of the same "nucleus of operative facts." Rule 21F-4(d).

In order to prevent wrongdoers from benefiting by, in effect, blowing the whistle on themselves, Rule 21F-16 provides that, for purposes of determining whether the required $1,000,000 threshold for an award has been satisfied, the SEC would not include any monetary sanctions that the whistleblower is ordered to pay, or that an entity is ordered to pay if the entity's liability is based substantially on conduct that the whistleblower directed, planned, or initiated.

Rule 21F-16 also provides that the SEC will not include any such amounts in the total monetary sanctions collected for purposes of calculating the amount of an award payment to a whistleblower.

Rules Governing the Whistleblower Protection Provisions

The Dodd-Frank Act substantially enhanced the protections that the Sarbanes-Oxley Act of 2002 had provided to whistleblowers against retaliation. These protections are set forth in Section 21F(h)(1) of the Exchange Act. The statutory anti-retaliation protections apply to three different categories of whistleblowers, and the third category includes individuals who report to persons or governmental authorities other than the SEC.

Specifically, Section 21F(h)(1)(A)(iii) — which incorporate the anti-retaliation protections specified in Section 806 of the Sarbanes-Oxley Act, 18 U.S.C. 1514A(a)(1)(C) — provides anti-retaliation protections for employees of public companies, subsidiaries whose financial information is included in the consolidated financial statements of public companies, and nationally recognized statistical rating organizations when these employees report to (i) a federal regulatory or law enforcement agency, (ii) any member of Congress or committee of Congress, or (iii) a person with supervisory authority over the employee or such other person working.

In the proposed rules, the SEC proposed to define a whistleblower as an individual who, alone or jointly with others, provides information to the SEC relating to a potential violation of the securities laws. Proposed Rule 21F-2(a).

In the final rules, the SEC provided that an individual is a whistleblower if (i) he possesses a reasonable belief that the information he is providing relates to a possible securities law violation (or, where applicable, to the whistleblower protection provisions in Sarbanes Oxley) that has occurred, is ongoing, or is about to occur, and (ii) the individual reports that information in a manner described in the SEC's whistleblower rules.

In adopting the final rules, the SEC agreed with those commenters who suggested that the term "potential violation" may be imprecise, and changed this to "possible violation" that "has occurred, is ongoing, or is about to occur." In the adopting release, the SEC explained that the final rules require that the information should indicate a facially plausible relationship to some securities law violation. The SEC explained that while frivolous submissions would not qualify for whistleblower status, the violation would not have to qualify as likely or probable to trigger the protections afforded to a whistleblower.

In Rule 21F-2(b)(2), the SEC stated that it may enforce the anti-retaliation provisions of Section 21F(h)(1) of the Exchange Act and any rules promulgated thereunder. Thus, the SEC takes the position that it can investigate allegations of retaliation against whistleblowers and seek remedies against anyone who violated (or negligently caused a violation) of the anti-retaliation provisions.

Conclusion

Given the size of the monetary sanctions that have been imposed in recent matters, the implementation of the whistleblower program likely will result in an increase in both the quantity and the quality of the tips submitted to the SEC. Indeed, SEC officials state that they have already witnessed such an increase.

Accordingly, companies should take steps to respond to the rules. As set forth above, the SEC adopted a number of exclusions to the definition of "original information" that preclude certain compliance and legal personnel from qualify for a whistleblower bounty unless they wait 120 days before submitting the information. While 120 days might seem like a substantial period of time, it can — depending on the circumstances and the scope of the issues involved — be difficult to complete an internal investigation in six months.

Accordingly, public companies and regulated entities should be prepared to start an internal investigation promptly upon receiving information indicating that an internal investigation is appropriate.

Similarly, companies should take steps to ensure that they have effective compliance processes. The whistleblower bounty rules are likely to increase the risk of detection if a company violates the federal securities laws. Effective compliance processes will both reduce the risk of violations and, perhaps, result in less severe sanctions in the event that a violation is detected.

In addition, although the substantial whistleblower bounties proffered by the Dodd-Frank Act might motivate some individuals to avoid a company's internal compliance processes regardless, employees are more likely to use a company's internal compliance processes if they have confidence that the processes are effective, particularly since the final rules provide an avenue for whistleblowers to receive a bounty where they have first reported internally.

In these cases, a company will be well served to have effective compliance programs that can prevent violations or at least stop such violations before a situation occurs that could result in a significant penalty to the company.

Third, companies should review their employment policies to assess whether they appropriately address the risks raised by the anti-retaliation provisions of Dodd-Frank Act. These policies should include both (1) policies requiring the maintenance of records accurately reflecting assessments of employee performance and (2) policies addressing the discipline of employees in the context of a possible violation of the federal securities laws.

--By Kenneth B. Winer and Bryan House, Foley & Lardner LLP

Kenneth Winer is a partner in the Washington, D.C., office of Foley & Lardner LLP. Bryan House is a partner in the firm's Milwaukee office.

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[1] H.R. 4173. § 922(c)(1).

[2] Rule 21F-4(a)(2) provides, in part, that the individual's "submission of information to the SEC will be considered voluntary if [the individual] voluntarily provide the same information to one of the other authorities (e.g., the PCAOB, a state securities regulator) prior to receiving a request, inquiry or demand from the Commission." Thus, a whistleblower could argue that his provision of information to the SEC should be deemed voluntary if he submits the information to, for example, a state securities regulator (in response to a request from that regulator) before receiving a request, inquiry or demand from the SEC.