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Client Alert

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SEC Adopts Whistleblower Rules Under Dodd-Frank

On May 25, 2011, the U.S. Securities and Exchange Commission (SEC) by a 3–2 vote adopted final rules implementing the whistleblower award program of Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[i] New Regulation 21F requires the SEC to pay cash awards to whistleblowers who voluntarily supply the SEC with original information leading to a judicial or administrative action in which the SEC obtains monetary sanctions over $1 million, subject to certain limitations. Whistleblowers who provide such information are eligible for a cash award of from 10 to 30 percent of the monetary sanctions. Employers are prohibited from retaliating against individuals who provide the SEC with information about possible federal securities law violations, and victims of retaliation are granted an independent cause of action.

The potential for the whistleblower rules to undercut internal corporate compliance programs remains a significant concern. The final rules do not require whistleblowers to report possible violations through internal compliance processes before contacting the SEC. However, the SEC acknowledged the concern and marginally strengthened incentives to report internally.

The new rules become effective August 12, 2011, but will apply to all whistleblower tips made since July 21, 2010, which is when Dodd-Frank was enacted. Given the significant financial incentive created by the whistleblower rules for individuals to report to the SEC possible violations of federal securities laws and the time and effort it will take issuers to resolve these matters regardless of substance, companies should take the opportunity to strengthen their internal reporting policies, processes and training.

Internal Reporting Incentivized But Not Mandated

The SEC made a few changes to the proposed rules in an attempt to provide more incentives for potential whistleblowers to report internally, although internal reporting is still not required as a condition to receiving an award. The final rules now provide that a whistleblower's use of internal reporting procedures is a factor that can increase the amount of his or her award.[ii] Also, unreasonable delay in reporting or interference with internal reporting programs is specified as a possible basis for decreasing an award. In addition, the final rules now provide that a whistleblower who reports internally will remain eligible for an award if the violating issuer then self-reports to the SEC and a sanction is ultimately imposed. Finally, a whistleblower can file a report with the SEC within 120 days (extended from the 90-day period in the proposed rules) after filing an internal report and still be treated as though he or she had filed the report with the SEC on the date the internal report was filed.[iii] The combination of these changes may marginally increase the motivation for potential whistleblowers to report a potential violation internally instead of, or before, reporting to the SEC. However, with the chance to collect a substantial portion of a potential multimillion-dollar sanction, whistleblowers will almost certainly prefer an outcome that ends in an SEC sanction over an issuer's internal resolution of the problem without such a sanction.

Whistleblower Definition Clarified

The final rules define a whistleblower as an individual who provides information to the SEC relating to a "possible" violation of federal securities laws or regulations that "has occurred, is ongoing, or is about to occur." This language is intended to clarify that information regarding future violations would qualify, while information concerning a state or foreign law violation would not qualify. The SEC decided not to raise the

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bar higher than requiring that the information concern a "possible" violation, and even immaterial potential violations qualify, as there is no materiality requirement in the final rules.

Anti-Retaliation Protection Requires Reasonable Belief
The final rules clarify that a whistleblower is protected from employment retaliation if the whistleblower possesses a "reasonable belief" that the information the whistleblower is providing to the SEC relates to a possible securities law violation that has occurred, is ongoing or is about to occur.[iv] According to the adopting release, the "reasonable belief" standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess. The retaliation protections apply to a whistleblower irrespective of whether the whistleblower is ultimately entitled to an award. Thus, there does not need to be an actual violation of law and a whistleblower's tip need not result in a successful enforcement action for the whistleblower to be protected by the anti-retaliation provisions. While not addressed directly in the final rules, the whistleblower provisions of Dodd-Frank by their terms only prohibit adverse employment actions that are taken "because of" any lawful act by the whistleblower to provide information. An adverse employment action taken for other reasons is not covered.

Submission of Information Must be Voluntary
Under the final rules, a whistleblower must provide the SEC with information voluntarily to qualify for an award. Information is deemed to be provided voluntarily if a whistleblower makes his or her submission to the SEC before a request, inquiry or demand that relates to the subject matter of the submission is directed to the whistleblower (i) by the SEC; (ii) in connection with an investigation by the Public Company Accounting Oversight Board (PCAOB) or any self-regulatory organization; or (iii) in connection with an investigation by Congress or any other authority of the federal government.[v] A request for information must be made either directly to the whistleblower or to the whistleblower's representative to render a subsequent submission by the whistleblower not voluntary.[vi] The final rules make it unlawful for anyone to interfere with a whistleblower's efforts to communicate with the SEC, including threatening to enforce a confidentiality agreement.[vii]

Original Information Required
Only "original information" provided to the SEC can qualify an individual for the whistleblower bounty. Information is original if it is: (i) derived from the whistleblower's "independent knowledge" or "independent analysis"; (ii) not already known to the SEC from any other source (unless the whistleblower is the original source of the information the SEC has); and (iii) not exclusively derived from an allegation made in a judicial or administrative hearing; in a government report, hearing, audit or investigation; or from the news media (unless the whistleblower is a source of the information). Only information provided to the SEC for the first time after July 21, 2010, (when Dodd-Frank was enacted) can qualify.[viii] "Independent knowledge" is knowledge not derived from publicly available sources.[ix] The final rules clarify that "independent analysis" can be based upon a whistleblower's evaluation of publicly available sources.[x]

Exclusions from Award Eligibility
The following categories of people are generally ineligible for awards, subject to certain limited exceptions. The information they obtain under the specified circumstances is not considered under the final rules to be derived from independent knowledge or independent analysis.

Officers and Directors. Officers, directors, trustees and partners of an entity who are informed by another person (such as an employee) of allegations of misconduct, or who learn the information in connection with the entity's internal processes for identifying, reporting or addressing possible violations of law (such as through the entity's hotline) may not use the information to make their own whistleblower claims.[xi]

Compliance and Internal Audit Personnel. Employees whose principal duties involve compliance or internal audit responsibilities, as well as employees of outside firms that are retained to perform compliance or internal audit work for an entity are not eligible for a whistleblower award.[xii] Such an

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employee is subject to the exception whether he or she learns about possible violations in the course of a compliance review or another employee reports the information to such employee.

Attorneys and Attorney-Client Privilege. Attorneys may not use information learned either through representation of a client or from privileged attorney-client communications to make their own whistleblower claims, unless in either case disclosure of the information is permitted under SEC attorney-conduct rules or state bar rules.[xiii] The final rules clarify that in-house attorneys are covered by these two exclusions and associated exceptions, and expand them to apply to non-attorneys. Thus, for instance, if an attorney would be precluded from receiving an award based on the attorney's submission of the information to the SEC, a non-attorney (such as a legal or administrative assistant) who learns this information through a confidential attorney-client communication would be similarly disqualified.

Accountants. Employees of, or other persons associated with, a public accounting firm who learn information regarding a possible violation through an audit or other engagement required under the federal securities laws are not eligible for a whistleblower award if that information relates to a violation by the client or the client's directors, officers or other employees.[xiv]

Additional Exclusions. People who obtain the information by means or in a manner that is determined by a U.S. court to violate federal or state criminal law are ineligible to receive an award.[xv] Also ineligible are foreign government officials and employees of foreign instrumentalities, including state-owned entities.[xvi] In addition, a person who acquires information from any of the persons excluded above is also excluded from award eligibility.[xvii]

Limited Exceptions to Award Ineligibility

The final rules provide limited exceptions to the exclusion for officers, directors and compliance and audit-related personnel. Under any of the following circumstances, such individuals are eligible to receive an award: (i) the whistleblower has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the issuer from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the issuer or its investors; (ii) the whistleblower has a reasonable basis to believe that the issuer is engaging in conduct that will impede an investigation of the misconduct; or (iii) at least 120 days have elapsed since the whistleblower provided the information to the issuer or since the whistleblower received the information, if the information was received under circumstances indicating that the issuer was already aware of the information.[xviii] The final rules clarified that these exclusion exceptions do not apply to attorneys.

Tip Must Lead to Successful Enforcement Action

A whistleblower's information must lead to a successful enforcement action for the whistleblower to receive an award. Under the final rules, for information reported when no SEC investigation is underway, a whistleblower now need only show that the successful enforcement action was based in whole or in part on the conduct that was the subject of the whistleblower's original information.[xix] For information reported when an SEC investigation is already underway, the information must have "significantly contributed" to successful enforcement.[xx]

Anonymous Submissions

Whistleblowers may submit information to the SEC anonymously, subject to certain conditions. The final rules require that an anonymous whistleblower be represented by counsel who must certify to the SEC that he or she has verified the whistleblower's identity. The SEC will require any anonymous whistleblower to disclose his or her identity before the SEC will pay an award.

Culpable Whistleblowers Eligible to Receive Awards

The final rules do not provide a *per se* exclusion for culpable whistleblowers from receiving an award. However, for purposes of determining whether the $1 million threshold has been satisfied or calculating the amount of an award, the SEC will not count any monetary sanctions that the whistleblower is ordered to pay or that are ordered to be paid against any entity whose liability is based substantially on conduct

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that the whistleblower directed, planned or initiated.[xxi] Also, the SEC will consider culpability in determining the amount of an award. In addition, as noted in a footnote to the final rules release, as part of a negotiated settlement agreement, deferred prosecution agreement, non-prosecution agreement, immunity agreement, cooperation agreement or other similar agreement with a highly culpable whistleblower, the SEC has the ability to obtain the whistleblower's agreement to accept less than the statutory minimum or to forgo seeking a whistleblower award.[xxii]

Calculating Sanctions and Paying Awards
The final rules clarify that, for the purpose of determining whether the $1 million threshold has been reached, the SEC must aggregate the monetary sanctions from multiple SEC proceedings arising from the "same nucleus of operative facts."[xxiii] Provided SEC sanctions are at least $1 million, the whistleblower's award will be between 10 to 30 percent of the total sanctions imposed in the SEC action and in any related judicial or administration action brought by other government agencies.[xxiv] The SEC will not grant an award for a related action if the whistleblower has already been granted an award by the Commodity Futures Trading Commission (CFTC) for that same action pursuant to the CFTC's whistleblower award program.[xxv] Where there are multiple qualifying whistleblowers, the SEC will award the whistleblowers a fraction of the 10 to 30 percent whistleblower award in accordance with, among other factors, the SEC's determination of the importance of each whistleblower's assistance.[xxvi]

Steps Companies Should Take Now
Whether the final rules will yield a sharp increase in the number of whistleblower claims and whether those claims will bypass internal reporting procedures remains to be seen. However, one effect of the final rules is already clear: attorneys are competing to represent whistleblowers in an effort to claim a share of the monetary awards. Searching for "whistleblower claims" on the Internet yields several paid advertisements by lawyers and law firms seeking to assist whistleblowers in reporting securities law violations to the SEC. Whistleblower attorneys submitted substantial commentary on the proposed rules downplaying the rules' possible harm to internal reporting procedures. However, it is unlikely these attorneys will advise clients to report a possible violation internally rather than directly to the SEC.

Issuers must address two closely related problems in response to the final rules: the new incentives that whistleblowers now have to bypass internal reporting procedures and the consequent impairment to the effectiveness of those procedures in detecting violations. Although entities cannot prevent whistleblowers from reporting directly to the SEC, they are not without methods to minimize the adverse effects of the final rules. In general, issuers should focus on maintaining the efficacy of existing reporting programs, increasing the effectiveness of existing detection and prevention measures and putting in place processes to investigate and possibly resolve potential violations within a 120-day period.

Review Policies to Incentivize Internal Reporting and Strongly Prohibit Retaliation
To counter the final rules' incentives to report directly to the SEC, issuers should evaluate and potentially revise their own incentives for employees to report internally. First, companies should review policies to ensure that whistleblowers who report internally will not be penalized by the company. The policies should be visible, readily accessible and periodically communicated internally. Although retaliation against whistleblowers is illegal, whistleblowers may still be reluctant to report internally for fear of being ostracized and demoted. Second, issuers should consider creating positive incentives for reporting possible violations internally. Such incentives could include the option to report anonymously, monetary or other awards for credible reports, or monetary or other awards for suggesting improvements to existing reporting and compliance programs. By actively encouraging and rewarding the use and improvement of internal procedures, issuers can create a culture of compliance and can mitigate the imbalance of incentives created by the final rules.

Strengthen Other Detection Efforts
With the incentives whistleblowers now have to bypass internal reporting procedures entirely, issuers should reevaluate and consider making changes to existing compliance processes and procedures. In particular, issuers should consider increasing detection efforts to supplement internal reporting programs.

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For example, issuers could increase the frequency or scope of compliance audits to increase the likelihood that a possible violation will be detected outside of the reporting program. Also, issuers could consider requiring compliance certifications from a greater number of employees and on a more frequent basis. In these certificates, employees should be asked to certify that they have no knowledge of possible securities law violations that they have not yet reported to issuer.

Conduct Internal Investigations Diligently and Expeditiously

When a possible violation is reported, the final rules effectively place a 120-day time period on an initial investigation into such possible violation. The final rules require certain personnel to wait 120 days before reporting an internally reported violation to the SEC in order to qualify for a whistleblower award.[xxvii] See "Limited Exceptions to Award Ineligibility" above. Other personnel are not subject to such limitation, and can report a violation to the SEC simultaneous with reporting to the issuer and still qualify for an award. However, it will likely take a period of time for the SEC to respond to a whistleblower report. Having policies and procedures in place to see that an initial investigation will be completed within 120 days will limit the availability of whistleblower awards to certain persons within an issuer and will place the issuer in position to respond to an inquiry from the SEC in an informed manner with regards to possible violations that are reported to the issuer and the SEC simultaneously.

Reevaluate Approach to Self-Reporting

Other than in extraordinary situations, there is likely little benefit in self-reporting a matter to the SEC that an issuer is able to conclusively determine and document constitutes no securities law violation. However, to the extent an issuer is unable to reach such a conclusion within 120 days of receiving an internal report or within such shorter time as the issuer believes it has before a whistleblower contacts the SEC, depending on circumstances, the issuer may want to accelerate a decision to self-report to the SEC to be assured of obtaining potential leniency credit for doing so.

Communicate Effectively with Individuals Reporting Internally

Individuals reporting internally should be apprised of the progress, if not the interim status, of internal investigations. In most situations, issuers should explain clearly to internal reporters the results of the internal investigation. If an issuer's internal investigation concludes no violation occurred or that the internal report is based on a misunderstanding, this conclusion should be promptly and effectively communicated to the individual reporting internally. A person reporting internally who does not understand the conclusion of the internal investigation is more likely to report directly to the SEC.

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[i] Securities and Exchange Commission, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (adopted May 25, 2011) (hereinafter "Adopting Release"). http://www.sec.gov/rules/final/2011/34-64545.pdf.
[ii] Adopting Release at 5.
[iii] *Id.* at 5–6.
[iv] Rule 21F-2(b)(1).
[v] Adopting Release at 30.
[vi] Rule 21F-4(a)(iii)(2).
[vii] Rule 21F-17(a).
[viii] Rule 21F-4(b)(1).
[ix] Rule 21F-4(b)(2).
[x] Rule 21F-4(b)(3).
[xi] Rule 21F-4(b)(4)(iii)(A).
[xii] Rule 21F-4(b)(4)(iii)(C) and (D).
[xiii] Rules 21F-4(b)(4)(i) and (ii).
[xiv] Rule 21F-8(c)(4).
[xv] Rule 21F-8(c)(3).
[xvi] Rule 21F-8(c)(2).
[xvii] Rule 21F-4(b)(4)(vi).
[xviii] Rule 21F-4(b)(4)(iv).
[xix] Adopting Release at 252.
[xx] *Id.*
[xxi] Rule 21F-16.
[xxii] Footnote 390 to the Adopting Release.
[xxiii] Rule 21F-4(d).
[xxiv] Rule 21F-3(b).
[xxv] Rule 21F-3(b)(3).
[xxvi] Rule 21F-5(c).
[xxvii] Rule 21F-4(b)(4)(iv).

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