SEC Approves Sweeping Whistleblower Bounty Regime

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On Wednesday, May 25, 2011, the Securities and Exchange Commission issued its long-awaited final rules implementing the "Securities Whistleblower Incentives and Protection" provisions of the Dodd-Frank Act.[1] New Regulation 21F defines the meaning and scope of the SEC's obligation to pay an award to one or more "whistleblowers" who "voluntarily" provide "original information" to the SEC that "leads to the successful enforcement" of an "action" or "related action" in any judicial or administrative action brought by the SEC under the federal securities laws that results in monetary sanctions of more than $1 million. The rules become effective 60 days after publication in the Federal Register.

Following the November 2010 issuance of the SEC's proposed rules,[2] the SEC received over 240 comment letters from individuals, whistleblower advocacy groups, attorneys, public companies, audit firms and other interested industry participants. According to SEC Chairman Mary Schapiro, "The final recommendation strikes the correct balance—a balance between encouraging whistleblowers to pursue the route of internal compliance when appropriate—while providing them the option of heading directly to the SEC. This makes sense as well because it is the whistleblower who is in the best position to know which route is best to pursue." Adoption of this rule is a significant development and is yet another step in a broader initiative the SEC has undertaken to encourage and reward real-time reporting of possible wrongdoing.[3]

The final rules were adopted by a narrow 3-2 vote, with Commissioners Casey and Paredes dissenting. Both dissenters echoed comments from the corporate community in objecting to the lack of an internal reporting requirement. Commissioner Casey noted that without such a requirement, the large financial awards available through the program may encourage individuals with information about potential wrongdoing to "completely bypass" company compliance procedures, thereby depriving companies of any opportunity to identify and reprimand wrongdoers swiftly and efficiently. Commissioner Paredes added that even without an internal reporting mandate, the final rules could have done more to ensure that the SEC's whistleblower program does not "unduly erode" the value of internal compliance programs.

Key Revisions to the Proposed Rules

Internal Compliance

As noted, notwithstanding strong objections by the corporate community, the final rules do not require employees to report possible violations of law through internal compliance processes as a prerequisite to eligibility for an award. Rather, the SEC made the following changes to the proposed rules in an effort to incentivize whistleblowers to utilize employer-sponsored complaint and reporting procedures:

- The SEC will consider voluntary participation in an entity's internal compliance and reporting systems as a factor that could increase the amount of an award. Conversely, a whistleblower's attempt to discourage or interfere with internal compliance and reporting may decrease the amount of an award.

- Whistleblowers who report a potential violation internally will be eligible to receive an award if the company simultaneously or later reports information to the SEC that leads to a successful enforcement action. Thus, an employee or other individual who opts to report internally is given credit not only for the original information provided to the company, but also for any additional information that the company learns in its investigation.

- The final rules extend the grace period for a whistleblower to report a potential violation to the SEC after reporting internally from 90 to 120 days. Thus, if a whistleblower offers information to a company and within 120 days provides the same information to the SEC, that whistleblower will be deemed to have reported to the SEC on the earlier date at which he reported to the company. As a result, the whistleblower's information may still be considered "original" even if, in the interim, the SEC acquired that information from another source.

The SEC noted that in "appropriate cases," it will notify a company of its receipt of a whistleblower complaint, and give the company an opportunity to investigate the matter and report back to the SEC. In determining whether to give a company such an opportunity, the SEC may consider a number of factors, including, but not limited to, the nature of the alleged conduct, the level at which the conduct allegedly occurred, and the company's existing culture related to corporate governance.

Exclusions for Certain Persons and Information

The proposed rules, with some exceptions, excluded from eligibility certain professionals such as attorneys, auditors and internal compliance personnel, whose knowledge of potential violations does not, according to the SEC, constitute "independent knowledge or analysis of a whistleblower." The final rules maintain each of the exclusions, subject to some modifications:

- Information obtained through a communication that is subject to the attorney-client privilege or in connection with legal representation remains excluded under the final rules, except

where disclosure is permitted under the rules of professional responsibility. The final rules clarify, however, that the exclusion also applies to non-attorneys who learn information through confidential attorney-client communications. The final rules also clarify that the exception applies equally to outside and in-house counsel.

- Like the proposed rules, the final rules exclude information that is learned by employees of, or other persons associated with, a public accounting firm through an audit or other engagement required under the federal securities laws. In addition, public company auditors are ineligible for awards where the information was obtained through an audit of a company's financial statements, and making a whistleblower submission would be contrary to the requirements for auditor reporting of potential illegal activity specified in Section 10A of the Exchange Act. The SEC declined to extend this exclusion to company employees involved in control or accounting functions.

- Under the final rules, compliance and internal audit personnel, outside auditors, and persons retained to investigate possible violations who are otherwise excluded from eligibility may nonetheless qualify for an award under the following three circumstances: (i) there is a reasonable basis to believe disclosure is necessary to prevent substantial injury to the financial interest or property of the company or its investors; (ii) there is a reasonable basis to believe that the company is impeding an investigation of the misconduct; or (iii) at least 120 days have elapsed since the whistleblower either reported the information internally, or learned that the information had already been reported internally.[4]

The final rules exclude officers, directors, trustees, and partners from eligibility if they are informed of allegations of misconduct, or they learned about misconduct through the company's investigative processes. They remove the language in the proposed rules that only excluded these individuals if the information was communicated to them with the reasonable expectation that they would take steps to cause the company to respond.

Eligibility of Culpable Whistleblowers

In response to the proposed rules, the SEC received comment letters advocating that the definition of "whistleblower" be limited to an individual who provides information about potential violations of the securities laws "by another person," thus excluding culpable whistleblowers from eligibility. While the SEC recognized the policy concerns associated with paying culpable whistleblowers for their own misconduct or for violations that they directly caused, the final rules contain no *per se* exclusion for culpable whistleblowers. Rather, Section 21F-6 stipulates that the SEC will consider culpability as a factor in determining the amount of an award. In addition, in determining whether the $1 million threshold has been met, the SEC will not take into account monetary sanctions ordered against any company whose liability is based substantially on conduct that the culpable whistleblower directed, planned or initiated.

Aggregation of Monetary Sanctions

For purposes of calculating whether monetary sanctions meet the $1 million threshold, the proposed rule defined an "action" as a single captioned judicial or administrative proceeding. Under the final rules, the SEC retained the original definition of an "action," but the agency now permits aggregation when multiple proceedings arise from the same nucleus of operative facts. As a result, the final rules may allow aggregation where multiple actions arise from a single investigation.

Key Provisions that Remained Unchanged from the Proposed Rules

Independent Knowledge

The proposed rules defined "independent knowledge" to include knowledge obtained from any of the whistleblower's experiences, observations, or communications, including third-party sources—subject to the exclusion of knowledge derived from publicly available sources. The final rules adopt this definition of "independent knowledge" as proposed without imposing restrictions on second-hand information. The final rules specify, however, that in order to be 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.

Scope of Anti-Retaliation Provisions

Under the proposed rules, Section 21F's anti-retaliation provisions would apply regardless of whether all of the procedural requirements to receive an award have been satisfied. Notwithstanding suggestions from commenters to limit anti-retaliation protection to those who qualify for an award, the final rules make clear that the statute's whistleblower protections apply to anyone who "possess[es] a reasonable belief that the information" provided "relates to a possible securities law violation . . . that has occurred, is ongoing, or is about to occur,"[5] irrespective of whether the whistleblower is ultimately entitled to an award.

Contingency Fees for Whistleblower Counsel

The SEC declined to adopt provisions to limit fees attorneys may collect from representing whistleblowers who receive an award under the SEC's program. Rather, the SEC opted to defer to state bar authorities and to contractual arrangements between prospective whistleblowers and their attorneys to determine appropriate fees.

Whistleblower Office

On February 18, 2011, the SEC named Sean McKessy as the Chief of the Office of the Whistleblower. The creation and staffing of the office, which is mandated by Section 924(d) of the Dodd-Frank Act, had been deferred in late 2010 due to budget uncertainty. To date, the functions of the office continue to be assigned to existing SEC staff. The SEC indicated that the office will be developing procedures in the coming months.

Conclusion

In adopting the rules, the SEC emphasized the challenge it faced of trying to modify the proposed rules in a manner that balanced the policy goals of the Dodd-Frank whistleblower provision with the goal of supporting and encouraging robust internal reporting programs. It remains to be seen whether the SEC's limited provisions to encourage internal reporting will have any meaningful impact. As highlighted by Commissioner Paredes, the corporate community will also watch closely to determine whether the exceptions to the exclusions for outside auditors and various compliance and audit personnel will effectively swallow the general rule against eligibility for these persons.

As the new Section 21F is implemented in the coming months, we recommend that companies reexamine their internal processes to ensure that they are designed to actively encourage self-reporting and to effectively investigate reports of potential violations. We further recommend that companies review their anti-retaliation policies to ensure that they are in accordance with Section 21F(h)(1) of the Exchange Act.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 922 of the Dodd-Frank Act adds new Section 21F to the Securities Exchange Act. The Final Rule, Exchange Act Release No. 34-64545 (May 25, 2011), is available at: www.sec.gov/rules/final/2011/34-64545.pdf.

[2] For a description of the proposed rules, see our November 17, 2010 Client Alert.

[3] As the SEC Director of the Division of Enforcement Robert Khuzami explained recently, "The Madoff and Stanford frauds reminded us of the importance of getting evidence early on of wrongdoing. It's important to have people come forward, and we are amenable to incentives. That means increasing corporate cooperation, encouraging self-reporting and reduced sanctions, deferred prosecution and non-prosecution agreements." Samuel Howard, "SEC Enforcement Chief Exalts Partnership Programs," Law360 (May 19, 2011), *available at*www.law360.com/articles/246227/sec-enforcement-chief-exalts-partnership-programs.

[4] Rule 21F-4(b)(4)(v)(C) stipulates that the 120-day grace period begins as of the date the whistleblower reported the information to the company's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's supervisor, or the date the whistleblower learned that any of these persons were already aware of the information.

[5] Section 240.21F-2(b)(1)(i).

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