WILMERHALE

SEC Proposes Whistleblower Protection Rules

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(U*pdated on December 7, 2010)*

The Securities and Exchange Commission has proposed regulations to implement the "Securities Whistleblower Incentives and Protection" provisions added by the Dodd-Frank Act,[1] which establish significant financial incentives for individuals to discover and report potential securities law violations to the SEC. New Section 21F of the Exchange Act requires the SEC, 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,[2] to pay an award to one or more **"whistleblowers"** who **"voluntarily"** provide **"original information"** to the SEC that **"leads to the successful enforcement"** of the **"action"** or **"related action."** The award must be between 10 and 30 percent of the collected monetary sanctions in the action or related actions. Proposed Regulation 21F would expand on the meaning of these key terms, each of which is discussed below.

Proposed Regulation 21F features a plain English, comprehensive, and self-contained roadmap for securities law whistleblowers. The SEC intends for the new rules to create strong incentives "for whistleblowers to come forward early with information about possible violations of the securities laws rather than wait until Government or other official investigators 'come knocking on the door.'" As a result of the proposed rules, whistleblower claims and awards can be expected to increase dramatically.

Perhaps the most challenging issue for the SEC, and one it expressly acknowledges, is the need to strike an appropriate balance between promoting and protecting legitimate whistleblower complaints and supporting the internal compliance and audit programs of companies. Because of the prospect of high bounties, the whistleblower provisions threaten to weaken and displace internal reporting programs and potentially represent a major shift from the Government's emphasis on the importance of internal compliance. The SEC seeks comment on all aspects of the intersection of the proposed rules and established internal reporting systems. Comments are due by December 17, 2010.

Key Terms of Proposed Regulation 21F

Whistleblower

Under the proposed rules, a whistleblower would be an individual who, alone or with others, provides the SEC with information relating to a potential violation of the securities laws.

According to the Proposing Release, the proposed rules are not intended to allow for awards to be paid to whistleblowers relating to their own misconduct. However, as currently drafted, the proposed rules do not define "whistleblower" to mean an individual who provides information about potential violations of the securities laws "by another person" and thus could be read to include information about potential violations by the whistleblower himself or herself. The SEC explicitly seeks comment on whether to include the third-person limitation in the definition of whistleblower.

Voluntarily

Under the proposed rules, a whistleblower would be deemed to be providing information "voluntarily" only if the information is given to the SEC before receipt by the whistleblower or his or her representative (or in some cases his or her employer) of any formal or informal request, inquiry, or demand from the SEC, the Congress, any other federal, state, or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, about a matter to which the information is relevant.

A submission would be considered voluntary in certain circumstances where the individual was aware of fraudulent conduct, even for an extended period of time, but chose not to come forward as a whistleblower until after he or she became aware of a governmental investigation or examination. However, the submission would only be voluntary if the individual reported before receiving an inquiry, request, or demand (assuming that he or she was not within the scope of an inquiry directed to his or her employer). The SEC asks for comment on whether this would be an appropriate result.

The SEC would generally credit a whistleblower with voluntarily submitting information to the SEC if he or she did so even after being questioned by an employer's legal counsel or compliance or audit staff about a possible violation, unless the individual's information is within the scope of a request, inquiry, or demand directed to the employer by a governmental authority. Thus, a whistleblower's information could be considered voluntary even if its submission to the SEC is triggered by a company's internal compliance processes. The Proposing Release justifies this somewhat anomalous result on the basis that it is needed so as not to undermine the purposes of Section 21F, "because there is no assurance that an employer will ultimately disclose to the Commission potential violations uncovered in the course of an internal investigation or similar process."

Recognizing that compliance with federal securities laws is enhanced by "effective programs for identifying, correcting, and self-reporting unlawful conduct by company officers or employees," and to encourage employees to report potential violations internally first, the proposed rules provide that whistleblowers would be deemed to have provided their information to the SEC on the same date

that they provide it to a company's internal compliance personnel if they provide it to the SEC within 90 days of that date. The proposed rules, however, do not require a potential whistleblower to use a company's internal compliance processes first or at all. The SEC would give credit to a whistleblower who uses a company's internal procedures when the agency determines the amount of the whistleblower award. Recognizing that these steps may not adequately promote continued effective internal compliance processes, the SEC asks for comment on whether its rules should include an internal reporting requirement.

A submission would not be considered voluntary if the person making it is under a preexisting legal or contractual obligation to make a report to a governmental authority. Thus, the proposed rules would prohibit an award to members, officers, or employees of an "appropriate regulatory agency,"[3] a law enforcement organization, or a foreign government or certain other foreign entities. Awards would also be prohibited to anyone who obtains the information as a result of an audit of financial statements and who would be subject to the requirements of Section 10A of the Exchange Act.[4] The SEC anticipates that the prohibition would also apply to other similarly situated persons who are under a pre-existing legal or contractual duty to report information about violations to the SEC or other authority listed above.

Original Information

For information to be considered "original information" under the proposed rules, it must be: (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); (iii) not exclusively derived from an allegation in the public domain (unless the whistleblower is the original source); and (iv) provided to the SEC after July 21, 2010 (the date of enactment of the Dodd-Frank Act).

The proposed rules would define "independent knowledge" to include knowledge of potential violations that is not first-hand. Knowledge obtained from any of the whistleblower's experiences, observations, or communications, including third-party sources—subject to the exclusion for knowledge obtained from public sources—could be considered "independent knowledge."[5]

"Independent analysis" would mean a person's own analysis, whether performed alone or in combination with others. "Analysis" would be defined to mean a person's "examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public."

In order to protect the critical role played by certain professionals in connection with compliance with federal securities laws, the proposed rules would, with some exceptions, exclude from the definition of original information:

- Information obtained in connection with legal representation or which is protected by the

attorney-client privilege. Notably, this exception would not apply where an attorney is permitted to disclose the information to the SEC pursuant to Section 3(d)(2) of the SEC's standards of professional conduct for attorneys,[6] or where disclosure is permitted by the applicable state bar's ethical rules.

- Information obtained through the performance of an engagement required under the securities laws by an independent public accountant, and relating to a violation by the engagement client or its directors, officers, or other employees.[7] This proposed exclusion would apply to the outside auditor's employees but would not apply to the client's employees who perform an accounting function, even if they interact with the outside auditor. The exclusion would not apply to information obtained by the auditor's employees with respect to violations by the accounting firm itself.
- Information obtained under certain circumstances from a person with legal, compliance, audit, supervisory, or governance responsibilities for a company, unless the company did not disclose the information to the SEC within a reasonable time or proceeded in bad faith. Thus, internal legal, compliance, or audit personnel (or individuals who obtain information from such persons) could become whistleblowers if the company does not self-report to the SEC within a reasonable time or acts in bad faith. The determination of reasonableness would depend on the particular facts and circumstances. Indicia of bad faith could include whether steps were taken to hinder the preservation of evidence or interfere with witnesses or whether the company engaged in a sham internal investigation.

Leads to Successful Enforcement of an Action or Related Action

Section 21F requires that the original information must lead to successful enforcement. Under the proposed rules, leading to successful enforcement would mean that the original information either (1) causes the SEC staff to commence an examination, open or reopen an investigation, or inquire into new or different conduct as part of a current examination or investigation, and "significantly contribute[s] to the success of the action"; or (2) is about conduct already under examination or investigation by an appropriate regulatory agency, would not otherwise be obtained, and is "essential to the success of the action."

An "action" under the proposed rules would be a "single captioned judicial or administrative proceeding" brought by the SEC. The action would include all defendants or respondents, and all claims, that are brought within that proceeding regardless of whether all defendants, respondents, or claims were included as a result of the information provided by the whistleblower. The SEC would not aggregate sanctions that are imposed in separate judicial or administrative actions for purposes of determining whether the $1 million threshold is satisfied, even if the actions arise out of a single investigation.

A "related action" would be a judicial or administrative action that is brought by: (1) the U.S. Attorney General; (2) an appropriate regulatory agency; (3) a self-regulatory organization; or (4) a state attorney general in a criminal case, and that is based on the same original information that the whistleblower voluntarily provided to the SEC and that led to monetary sanctions obtained by the

SEC of more than $1 million.

Other Highlights of the Proposed Rules

Proposed Regulation 21F would also:

- Make explicit that Section 21F's expansive anti-retaliation measures would not depend on an ultimate adjudication, finding, or conclusion that reported conduct constituted a violation of the securities laws. They would apply regardless of whether all of the procedural requirements to receive an award payment have been satisfied. Section 21F(h) broadly prohibits an employer from discharging, demoting, suspending, threatening, harassing (directly or indirectly), or in any manner discriminating against an individual in connection with his or her employment because of his or her lawful whistleblower-related actions. The statute also authorizes a private action in federal court by a whistleblower who alleges a violation of these provisions.
- Require that the SEC not disclose information that could reasonably be expected to reveal the identity of a whistleblower except in limited circumstances, such as in connection with a separate federal court or administrative proceeding.
- Impose procedural requirements designed to deter false submissions and encourage high-quality tips, including a requirement that the information be submitted under penalty of perjury.[8]
- Require an anonymous whistleblower to be represented by counsel who must certify that he or she has verified the whistleblower's identity. Indeed, before the SEC will pay any whistleblower award, the whistleblower's identity must be disclosed and verified.
- Clarify that the SEC staff has the authority to communicate directly (without first seeking the consent of counsel) with whistleblowers who are directors, officers, members, agents, or employees of an entity that has counsel, and who have initiated communication with the SEC related to a potential securities law violation.
- Preclude immunity for whistleblowers from SEC enforcement actions based on their own conduct in connection with violations of the federal securities laws. However, if appropriate, the SEC would take into account a whistleblower's cooperation in accordance with its Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions.

Whistleblower Office

Section 924(d) of the Dodd-Frank Act requires the SEC to establish a separate office within the SEC to administer and enforce the provisions of new section 21F. The office must report annually to the Congress on its activities, whistleblower complaints, and the response of the SEC to such complaints. The SEC announced recently that the creation and staffing of the Whistleblower Office was being deferred due to budget uncertainty. The functions of the Whistleblower Office are being temporarily assigned to existing staff within the Division of Enforcement. The SEC has indicated that additional information about the Whistleblower Office will be provided upon completion of a FY 2011

budget.

Conclusion

The new whistleblower provisions and the proposed rules create powerful incentives for whistleblowers to discover and report potential and actual violations of the federal securities laws. They raise a number of important and difficult questions with respect to which the SEC is seeking comment.

As applied to the corporate environment, depending on how the SEC's rules ultimately take shape, Section 21F portends a much broader public policy conflict between the Government's desire to encourage better corporate governance and its belief that economic incentives for reporting violations of the law will somehow improve the system. Indeed, the opposite may be inevitable. Unless the SEC's rules require otherwise, offering rewards to an employee for opting out of the corporate compliance system may run counter to what many believe are sound notions of compliance and good corporate citizenship.

In addition, the proposed rules would create a highly technical and formalistic administrative process for a whistleblower to claim a whistleblower bounty. It is foreseeable that the SEC will find itself regularly adjudicating claims for whistleblower bounties in enforcement cases. This could involve applying the many broadly defined terms in the rules in specific cases, as well as highly fact-specific determinations about the nature and significance of information provided by whistleblowers.

As the SEC proceeds with the task of refining its proposed rules, it will need to balance the policy goals of the Dodd-Frank whistleblower provision with the equally important goal of encouraging and making possible a proactive and effective compliance culture within companies. Indeed, the SEC recognizes that it will need to tread cautiously so as not to inhibit robust internal inquiry and reporting within companies.

The request for comments provides an opportunity for companies to have input into the final rules. In particular, companies may want to consider ways that the proposed rules could be improved so as not to undermine internal compliance and reporting systems and to maximize self-policing and voluntary self-reporting. As noted above, the SEC specifically requests comments, for example, on whether it should consider a rule that would require whistleblowers to use employer-sponsored complaint and reporting procedures first. Regardless of the results of the rulemaking, however, Section 21F and its implementation will have significant and potentially unanticipated effects on companies' internal reporting.

We recommend that companies review their current legal, compliance, and audit systems to ensure that they are reasonably designed, among other things, to encourage appropriate and timely inquiry into and reporting of potential and actual securities law violations. In addition, companies would be well-advised to develop or reconsider policies and procedures relating to management and board

of director responses to potential or actual violations, as well as to have anti-retaliation policies in place.

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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 Proposing Release, Exchange Act Release No. 34-63237 (Nov. 3, 2010), is available at: sec.gov/rules/proposed/2010/34-63237.pdf.

[2] Note that the federal securities laws include provisions of the Foreign Corrupt Practices Act.

[3] The proposed rules would define an "appropriate regulatory agency" as the SEC, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, "and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act." Appropriate regulatory agencies would be identical to "appropriate regulatory authorities," a term also used in Section 21F.

[4] Section 10A sets out audit requirements for registered public accounting firms auditing financial statements of issuers under the Exchange Act. In particular, Section 10A prescribes a specific reporting mechanism where an auditor becomes aware of possible illegal acts.

[5] The SEC notes that in extending the concept of independent knowledge to other than first-hand knowledge, it is following Congressional intent as evidenced by the amendment earlier this year of the "public disclosure bar" provisions of the False Claims Act, which removed the requirement that a relator (*i.e.*, the individual bringing a private action on behalf of the Government) have "direct and independent knowledge" of information, replacing that standard with a requirement that the relator have only "knowledge that is independent and materially adds to the publicly-disclosed allegations or transactions...." 31 U.S.C. 3130(e)(4), Pub. L. No. 111-148 §10104(h)(2), 124 Stat. 901 (Mar. 23, 2010). According to the SEC, "[m]any practitioners have observed that, with this amendment, the False Claims Act now permits *qui tam* actions based upon 'second-hand knowledge.'" Proposing Release Note 21. The SEC makes clear in the Proposing Release, however, that, while the False Claims Act has "played a significant role in the development of whistleblower law generally," the SEC does "not view False Claims Act precedent as necessarily controlling or authoritative in all circumstances for purposes of Section 21F." Id. at 13, n.14.

[6] Standards Of Professional Conduct For Attorneys Appearing And Practicing Before The Commission In The Representation Of An Issuer, 17 C.F.R. Part 205.

[7] The Proposing Release notes reporting requirements for outside auditors other than those of Section 10A of the Exchange Act.

[8] Indeed, in recent public remarks, the U.S. Attorney for the Southern District of New York reportedly indicated that the Department of Justice intends to prosecute whistleblowers who lie or fabricate information in order to benefit from the SEC's whistleblower program. *See* "DOJ to Prosecute Whistleblowers Who Fabricate Information, Bharara Says," BNA Daily Report for Executives (Nov. 15, 2010).

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