

SEC Adopts Rules for New Whistleblower Program

On May 25, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules that create a new whistleblower program, pursuant to which the SEC will pay significant rewards to eligible individuals who come forth with original information about a possible violation of the federal securities laws.

Under these rules, a qualified whistleblower can receive anywhere from 10 percent to 30 percent of all money recovered by the SEC through enforcement actions in which fines, penalties or other sanctions result in more than \$1 million collected. A successful SEC enforcement action can also lead to additional recoveries in related actions by other enforcement authorities as well.

"The new whistleblower program is a part of our effort to enhance the agency's capacity to detect and prevent fraud," said SEC Chairman Mary L. Schapiro. "For an agency with limited resources like the SEC, it is critical to be able to leverage the resources of people who may have first-hand information about potential violations [of the law]," she added.

The new rules were necessitated by the terms of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") which added Section 21F to the Securities Exchange Act of 1934 (the "Exchange Act") mandating the creation and funding of the whistleblower program. The Dodd-Frank Act was previously described in our July 2010 Securities Law Update entitled "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act," available on our Website at http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf.

What follows is a detailed summary of the new rules, which generally provide:

- Certain anti-retaliation measures and other protections for those who are acting in good faith while reporting possible violations of law;
 - The legal predicates for payment of awards;
 - Some guidance regarding award eligibility and disqualifications from eligibility for whistleblower status;
 - The legal criteria for determining the amount of any relevant award;
 - A set of procedures for making whistleblower submissions and claims for awards;
 - Certain confidentiality protections pertinent to whistleblower communications; and
 - Incentives for using a company's internal compliance program, when appropriate, to report violations of law in the first instance.
- The new rules are similar to those that the SEC proposed for public comment on November 3, 2010, but they bear a number of key modifications and clarifications that were made to the proposed rules pursuant to 240 public comments and more than 1,300 related letters.
- Among other things, the final rules create some narrow exceptions to the proposed rule that lawyers, auditors and internal compliance personnel cannot use information gained from their positions to claim an award. They also simplify and streamline the originally proposed process for submitting whistleblower information to the SEC.
- It is also worth noting that the SEC rejected an argument that internal compliance programs would only survive in public companies if whistleblowers were required to first report suspected misconduct through internal channels before going to the government. However, the final rules do provide incentives for internal reporting first.
- The definition for what constitutes a "whistleblower;"

For a full copy of the SEC's new whistleblower provisions, which become effective on August 12, 2011, see SEC Release No. 34-64545 (the "Release") at <http://www.sec.gov/rules/final/2011/34-64545.pdf>.

In conjunction with the Release, the SEC also announced the completion of internal staffing for the new Office of the Whistleblower, as well as the receipt of funding for the Investor Protection Fund to be used for whistleblower compensation.

DEFINITION OF A WHISTLEBLOWER

Rule 21F-2(a) defines a whistleblower as an individual who, alone or jointly with others, provides information to the SEC relating to a possible violation of the federal securities laws that has occurred, is ongoing or is about to occur.

Under this definition, a whistleblower's submission of information must relate to a possible violation of *federal* securities laws, and thus, information relating only to a state law or foreign law would not qualify.

The SEC explicitly rejected suggestions that: (i) whistleblower status should be conferred only on those who submit information about "material" violations; and (ii) whistleblowers could include entities as well as natural persons.

ANTI-RETALIATION PROVISIONS AND OTHER PROTECTIONS FOR WHISTLEBLOWERS

Section 21F of the Exchange Act makes it unlawful to interfere with a whistleblower's actions or to retaliate or threaten retaliation against a person acting as a whistleblower.

Rule 21F-17 also provides that "no person may take any action to impede a whistleblower from communicating directly with the [SEC] staff about a possible securities law violation, including enforcing or threatening to enforce a confidentiality agreement (other than agreements pertinent to legal representation)."

Rule 21F-2(b) adds that all anti-retaliation

protections set forth in Section 21F of the Exchange Act are applicable to those acting as whistleblowers, regardless of whether they satisfy all of the procedures and conditions to qualify for a whistleblower award.

Furthermore, for purposes of the anti-retaliation protections codified in the Exchange Act, an individual qualifies as a whistleblower if (i) he possesses a “reasonable belief” that the information he is providing relates to a possible securities law violation that has occurred, is ongoing or is about to occur, and (ii) he reports that information in a manner provided by Section 21F of the Exchange Act (which allows for reporting to persons or governmental authorities other than the SEC, including supervisors and certain government officials).

In the Release, the SEC clarified that 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 SEC also cautioned employers not to require employees to waive these protections because the Exchange Act explicitly provides that “any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or any rule or regulation thereunder... shall be void.”

Finally, the SEC clarified in Rule 21F-15 that the provisions of Section 21F of the Exchange Act do not confer legal amnesty or immunity upon whistleblowers in situations where the whistleblower himself or herself may be subject to liability in some way for the securities law violation being reported. However, the final rule does allow the SEC to take whistleblower cooperation into consideration in making enforcement decisions.

LEGAL PREDICATES FOR PAYMENT OF A WHISTLEBLOWER AWARD

Rule 21F-3 provides that, subject to eligibility requirements specified by regulation, the SEC will pay an award to one or more whistleblowers that “voluntarily provide the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than \$1 million.”

The amount of an award can also be based upon a “related action” if: (i) the whistleblower’s original information led the SEC to obtain monetary sanctions totaling more than \$1 million; (ii) the related action is based upon the same original information that led to the successful enforcement of the SEC action; and (iii) the related action is one brought by the Attorney General of the U.S., an appropriate regulatory agency, a self-regulatory organization, or a state attorney general in a criminal case.

However, Rule 21F-3(d) provides that the SEC will not make an award in a related action if an award has already been granted to the whistleblower by the Commodity Futures Trading Commission for recoveries related to the same reported violations.

1. What constitutes “voluntary” submission of information?

Rule 21F-4(a) provides that a submission of information is deemed to be “voluntary” if the whistleblower makes a submission prior to any request, inquiry or demand (by the SEC or various other governmental authorities that can act on securities violations) which relates to the subject matter of the submission and that is directed to the whistleblower or his/her legal representative.

This provision, among other things, prevents a person from claiming whistleblower status only after they are subpoenaed or compelled to provide information.

Rule 21F-4(a)(3) also provides that a whistleblower cannot “voluntarily” submit information if the whistleblower is required to report the information to the SEC as a result of an agency or court order, or a pre-existing legal duty or contractual duty owed to the SEC (or various government entities). Thus, SEC employees and law enforcement personnel generally cannot acquire whistleblower status to collect awards for doing their jobs. However, if a person is under a duty to report information only to an authority other than the SEC, this rule would allow for that person to qualify as a “voluntary” actor.

The SEC explicitly rejected the idea that Rule 21F-4(a)(3) should also exclude persons who have a pre-existing duty to report misconduct to a public company, although another rule does limit whistleblower eligibility, in part, based on certain professional obligations (applicable to lawyers, accountants, and

others working with privileged information).

2. What constitutes “original” information?

Rule 21F-4(b) defines “original information” as information that is:

- Derived from independent knowledge or independent analysis of the whistleblower;
- Not already known to the SEC from another source (unless the whistleblower supplied the information to the other source);
- Not exclusively derived from any allegation made in a judicial or administrative proceeding, or government report, hearing, audit or investigation, or news media report (again, unless the whistleblower was the original source of the otherwise excluded information); and
- Provided to the SEC for the first time after July 21, 2010 (the date of enactment of the Dodd-Frank Act).

Rule 21F-4(b)(2) defines “independent knowledge,” one of the elements of “original information,” as coming from factual information not derived from publicly available sources.

Thus, the new rules make clear that a person cannot profit by claiming whistleblower status for information that was publicly available to law enforcement authorities or that was originally revealed to the SEC by someone else (who did not rely upon the whistleblower as an original information source).

3. What constitutes “independent analysis”?

Rule 21F-4(b)(3) defines “independent analysis” as an analysis which results from the whistleblower’s own examination and evaluation of information. The information itself may be publicly available, but the analysis must reveal information that is not either generally known or available to the public (such as an analysis of financial statements that reveals a well-hidden fraud).

4. Individuals who are excluded from consideration as whistleblowers for lack of “independent knowledge” or “independent analysis”.

Rule 21F-4(b)(4) generally excludes three categories of individuals from consideration as whistleblowers because their knowledge

or analysis should not be considered as “independent.”

The rule excludes those individuals who acquired their information or analysis:

- Acting on behalf of a third party operating in a sensitive legal, compliance or governance role;
- During the performance of an engagement required by the federal securities laws; or
- By the use of illegal means.

4a. Legal Representatives

Rule 21F-4(b)(4) explicitly excludes the use of information that was obtained through a communication subject to attorney-client privilege, as well as information obtained as the result of the legal representation of a client unless the disclosure had been authorized.

Neither of these exclusions apply, however, where a legal representative is permitted to disclose information because of a waiver of privilege or because of a statute, a rule of the bar, or an attorney conduct rule of the SEC permitting disclosure (see, for example, 17 CFR sec. 205.3(d) and certain state bar rules allowing for disclosures that may be necessary to prevent an entity from engaging in conduct likely to cause substantial injury to the financial interest or property of the entity or its investors).

As written, the rules do prevent non-attorneys from using information that is privileged or gained in the course of a legal engagement, so that paralegals, secretaries and others in the employ of affected attorneys are also precluded from qualifying as whistleblowers.

Rule 21F-4(b)(4) also clarifies that the same exclusions are applicable to attorneys practicing in-house as well.

4b. Officers, Directors, Audit and Compliance Personnel

Rule 21F-4(b)(4)(iii) describes three more specific categories of people who will not be viewed as having “independent knowledge or analysis.”

The first category includes “officers, directors, trustees or partners of an entity if they obtained the information because another person informed them of allegations of

misconduct, or [if] they learned the information in connection with the entity’s processes for identifying, reporting and addressing potential non-compliance with law.”

This rule generally prevents people entrusted with corrective power from capitalizing on their knowledge rather than exercising their power to eliminate wrongdoing. But it does not always prevent officers from acting as whistleblowers. For example, it would not prevent, as the SEC noted, a senior officer from reporting information about other senior officers who are engaged in wrongdoing.

The second category of excluded individuals under Rule 21F-4(b)(4)(iii) are “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. Thus, a compliance officer is subject to the rule where violations are learned about in the course of compliance.

Finally, the rule also excludes information learned by employees or other persons associated with firms that are retained to conduct internal investigations or inquiries into possible violations of law generally.

4c. Public Accounting Firms

Rule 21F-4(b)(4)(iii)(D) excludes 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, if that information relates to a violation by the engagement client of the client’s directors, officers, or other employees.”

However, the rule does not prevent any individual from making a specific and credible submission alleging that the public accounting firm itself is violating or about to violate the federal securities laws or professional standards in connection with proper disclosure.

4d. Exceptions Allowing Excluded Persons to Act as Whistleblowers

Under Rule 21F-4(b)(4)(v), certain designated individuals may qualify as whistleblowers by reporting information that is otherwise excluded from use.

The first exception applies when the designated person “has a reasonable basis to

believe that disclosure of the information to the [SEC] is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors.” This is very similar to the standard set in 17 CFR sec. 205.3(d) for lawyers practicing before the SEC.

A second exception applies when the designated person who would otherwise be excluded has “a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct.”

Finally, a third exception permits an officer, director, auditor or other designated person who would otherwise be ineligible because of a position of trust, to become a whistleblower after at least 120 days have elapsed since that person provided the information in question to their supervisor or to the audit committee, chief legal officer, or chief compliance officer of the entity at which the violation occurred (if the information was received under circumstances allowed by rule).

The SEC cautioned that the 120-day provision does not imply a grace period for entities to determine the proper response to a reported violation of law. However, the promptness with which entities act upon information provided to them about wrongdoing will be taken into consideration by the SEC in decisions regarding leniency.

4e. Information Obtained in a Criminal Manner

Under Rule 21F-4(b)(iv), information provided to the SEC will not qualify as having been produced by “independent knowledge or analysis” if the provider of the information obtained it by a means or manner that is determined by a domestic court to violate applicable federal or state criminal law.

The SEC noted, however, that this rule does not cover information obtained in violation of domestic civil law or foreign law. Nor does it apply to judicial or administrative protective orders. “It would be against public policy for litigants to obtain a protective order... for the purpose of preventing the disclosure of information regarding violations of law to a law enforcement agency,” the SEC stated in the Release.

4f. Information Obtained from Excluded Persons

Rule 21F-4(b)(vi) provides that “a submission will not be deemed to be derived from ‘independent knowledge’ or ‘independent analysis’ if the whistleblower obtained the information... from a person who is subject to [exclusion under] this section, unless the information is not excluded from that person’s use, or the whistleblower is providing the [SEC] with information about possible violations involving that person.”

Thus, an employee who only learns of information through an internal investigation conducted by a lawyer or compliance professional would not be allowed to qualify as a whistleblower, and nor would an executive assistant to an excluded senior officer.

5. What constitutes an “original source”?

Under Rule 21F-4(b)(5), a whistleblower reporting information to the SEC can be considered the “original source” of information that was obtained from another source *if* the information itself was within the bounds of “original information” as defined by the rules, *and if* the other source originally obtained the information from the whistleblower or their representative.

Rule 21F-4(b)(6) also permits a whistleblower to be considered the “original source” of information derived from independent knowledge or analysis where the information or analysis “materially” adds to information already in the SEC’s possession.

Furthermore, under Rule 21F-4(b)(7), if a person reports “original information” first to personnel involved in compliance functions, and then within 120 days submits the same information to the SEC, then the date of original disclosure to compliance personnel will be considered the date of first submission for purposes of determining the “original source.”

6. What constitutes “information that leads to a successful enforcement”?

For conduct not under investigation or examination by the SEC, information will be considered to have led to successful enforcement when it is “sufficiently credible and timely to cause the staff to commence an examination, open an investigation, reopen an investigation... or to inquire concerning different conduct as part of a current

examination or investigation, and the [SEC] brings a successful judicial or administrative action based in whole or in part on the conduct identified.”

For information concerning conduct already under investigation or examination, the SEC will find that such information led to successful enforcement whenever the information “significantly contributes” to the success of an action by the SEC.

In applying this standard, the SEC stated that it will look at whether the information facilitated:

- Successful action in significantly less time or with significantly fewer resources;
- Additional successful claims; or
- Successful claims against additional entities or individuals.

ELIGIBILITY FOR AN AWARD AND DISQUALIFICATIONS

Rule 21F-8 provides that whistleblowers must provide the SEC with information in the form and manner prescribed by rule to be eligible for an award, but the rule also permits the SEC, in its sole discretion, to waive any such procedural requirements.

By rule, certain categories of individuals are also ineligible to receive whistleblower awards. These individuals include:

- People who are or were at the time they acquired pertinent information, a member, officer or employee of the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization;
- Anyone convicted of a criminal violation related to the SEC action or a related action pertinent to the potential award;
- Any person who obtained the pertinent information through an audit of a company’s financial statements;
- Any person who knowingly and willfully makes any false or fraudulent representation or uses any false document in his dealings with the SEC or any other authority in connection with an action;

- Any foreign officials; and
- Any people who acquire information from ineligible individuals, including those who acquire information from a person subject to the auditor exclusion or from any other person with intent to evade these rules.

Under Rule 21F-16, for purposes of determining whether someone is eligible because the \$1 million threshold for monetary sanctions has been achieved, the SEC will not include any monetary sanctions that the whistleblower is ordered to pay, or that an entity is ordered to pay where the entity’s liability is based “substantially” on the conduct that the whistleblower “directed, planned or initiated.”

The SEC also noted that under Section 10A of the Exchange Act an audit firm may be required to notify senior management, an audit committee or others of illegal acts (even if financially immaterial) as well as noting that some otherwise ineligible whistleblowers may be allowed to qualify for awards by reporting a violation of Section 10A.

The SEC did not codify any per se exclusion for all employees of accounting firms or for all engagements by accounting firms, as some public commenters had requested.

DETERMINING THE AMOUNT OF AN AWARD

Rule 21F-5 provides that the SEC shall pay an award of at least 10 percent and no more than 30 percent of the total monetary sanctions collected in successful actions by the SEC and in related actions.

The rule also provides that the SEC can award less than 10 percent to individual whistleblowers in the event that there are multiple whistleblowers involved in one action, but no more than 30 percent in the aggregate. Thus, one whistleblower might receive 25 percent of monetary sanctions collected and another might receive just 5 percent.

Under Rule 21F-6, the SEC can consider the following criteria to increase a whistleblower’s award percentage:

- The significance of the information provided by the whistleblower;
- The assistance provided by the

whistleblower;

- The law enforcement interest in making an award; and
- Participation by the whistleblower in internal compliance systems and reporting.

Conversely, the SEC can consider the following criteria to decrease a whistleblower's award percentage:

- The relative culpability of the whistleblower;
- Any unreasonable reporting delay by the whistleblower; and
- Any interference with internal compliance and reporting systems.

The SEC also noted that the rule clearly contemplates that in some circumstances an award may be issued to whistleblowers with some degree of culpability.

WHISTLEBLOWER SUBMISSIONS AND CLAIMS FOR AWARDS

Rule 21F-9 sets forth the process for submission of "original information" related to a whistleblower report. It requires information to be submitted on Form TCR, which requires a signer to declare under penalty of perjury that the information is "true, correct and complete to the best of the whistleblower's knowledge, information and belief." It also allows for more than one signature in the event of joint submissions by multiple whistleblowers.

In instances where information is provided by an anonymous whistleblower, Rule 21F-9 provides that the attorney for the whistleblower must sign the submission under penalty of perjury and must sign a special counsel's certification.

Because the SEC will take into account the use of internal reporting mechanisms in calculating awards, Form TCR also solicits information about whether the whistleblower(s) reported any violations to a supervisor, compliance office, hotline, ombudsman or other person or mechanism used for internal compliance and reporting.

Rule 21F-10 sets forth the procedures for whistleblowers to follow in making claims based on successful SEC actions or related actions.

CONFIDENTIALITY OF WHISTLEBLOWER COMMUNICATIONS

Rule 21F-7 fulfills the confidentiality requirements set forth in the new whistleblower provisions of the Exchange Act. This rule specifies that the SEC will not reveal the identity of a whistleblower or disclose information that could reasonably be expected to reveal a whistleblower's identity, except under circumstances provided by statute or rule.

But the rule also authorizes disclosure of information that could reveal a whistleblower's identity when disclosure is required to a defendant or respondent in a federal court or administrative action filed by the SEC or any agency to which the SEC may provide information.

Disclosure is also permitted when necessary to achieve the purposes of the Exchange Act and to protect investors, but in that circumstance, only to the Department of Justice, an appropriate regulatory authority, the Public Company Accounting Oversight Board, or to foreign securities and law enforcement authorities.

Since foreign authorities are not bound by domestic statutory or regulatory confidentiality requirements, the SEC has provided by rule that it will determine what assurances of confidentiality are appropriate to seek prior to disclosing information relative to the whistleblower's identity.

Finally, the new rules clarified the SEC's authority to communicate directly with whistleblowers who are officers, directors, agents or employees of an entity that has counsel when they have initiated communication with the SEC about a possible securities law violation.

Some commenters had argued that the SEC lacked authority to create this rule because it impinged on the authority of local bars to decide what kinds of communication with a "represented party" are allowed by law. But the SEC asserted that Congressional policy would be significantly impaired if it were required to seek permission of the entity's counsel before communicating with a whistleblower.

INCENTIVES TO ENCOURAGE INTERNAL REPORTING

As a result of public comments on the

proposed rules, the SEC promulgated a new rule that creates financial incentives for whistleblowers to report possible violations to internal compliance programs in the first instance.

Rule 21F-4(c)(3) provides that a whistleblower will receive full credit for information voluntarily provided by an employer if:

- The whistleblower reports original information through his or her employer's internal whistleblower, legal or compliance procedures before or at the same time he or she reports them to the SEC;
- The employer provides the SEC with the whistleblower's information or with the results of an investigation initiated in response to the whistleblower's information; and
- The information provided by the employer to the SEC "led to" successful enforcement as determined by rule.

A report to a supervisor will also qualify under this standard, according to the SEC, if the entity's internal compliance procedures require or permit reports of misconduct to be made in the first instance to supervisors.

Explanatory Notes:

This update is intended to call your attention to a number of rule changes of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or want to learn more about our expertise in this area.

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the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

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