

SEC Implements Dodd-Frank Whistleblower Provisions

The Securities and Exchange Commission's final rules¹ implementing Section 21F of the Securities Exchange Act of 1934 – “Securities Whistleblower Incentives and Protection” – are effective *August 12, 2011*. Section 21F was added to the Exchange Act by Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and directs the SEC to pay awards to eligible whistleblowers who voluntarily provide the SEC with original information about violations of the federal securities laws that leads to the successful enforcement of an action (or related action) by the SEC in which monetary sanctions exceeding \$1 million are collected. The amount of the award is in the discretion of the SEC, but it can be no less than 10%, and no greater than 30%, of the total monetary sanctions collected because of the eligible whistleblower's information.

The SEC has established and staffed the Office of the Whistleblower², which will work with whistleblowers, handle their tips and complaints, and help the SEC determine whistleblower awards. The Securities and Exchange Commission Investor Protection Fund, from which whistleblower awards will be paid, currently has a balance in excess of \$450 million.

As with the whistleblower, anti-retaliation protections afforded by Section 806 of the Sarbanes-Oxley Act, Dodd-Frank (and Section 21F of the Exchange Act) prohibits retaliation by an employer against an individual³ who provides information to the SEC, that he or she has a *reasonable belief*⁴ relates to a possible violation of the federal securities laws (or a rule or regulation thereunder), that has occurred, is ongoing or is about to occur, and who provides the information to the SEC in accordance with the procedures set forth in Section 21F of the Exchange Act. A whistleblower is entitled to the anti-retaliation protections even if the whistleblower ultimately does not qualify for an award and whether or not the information provided turns out to relate to an actual violation of the federal securities laws.

The prescribed manner for reporting a possible violation of the federal securities laws does not require whistleblowers to report their concerns internally to their employers before making a report to the SEC as a prerequisite to eligibility for an award. The final rules do, however, include incentives intended to encourage whistleblowers to use their companies' internal compliance and reporting systems.

For example, in determining the amount of a whistleblower award, one of the factors the SEC will consider in determining whether to *increase* the amount of the award, is whether the whistleblower participated in his or her company's internal reporting system, including (i) whether the whistleblower reported the possible securities violations through the company's internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the SEC; and (ii) whether the whistleblower assisted any internal investigation or inquiry concerning the reported securities

1 SEC Release No. 34-64545, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934.

2 http://www.sec.gov/complaint/info_whistleblowers.shtml.

3 A whistleblower cannot be a company or another entity.

4 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.

violations. Similarly, a factor in determining whether to *decrease* the amount of the whistleblower award, is whether the whistleblower undermined the integrity of the company's internal compliance and reporting system, including whether the whistleblower knowingly: (i) interfered with the company's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation; (ii) made any material false, fictitious, or fraudulent statements or representations that hindered the company's efforts to detect, investigate, or remediate the reported securities violations; and (iii) provided any false writing or document knowing the writing or document contained false, fictitious or fraudulent statements or entries that hindered the company's efforts to detect, investigate, or remediate the reported securities violations.

In addition, a whistleblower remains eligible to receive an award for his or her original information, even if he or she first reports the possible violation to the company, and the company subsequently reports the information to the SEC or provides the SEC with the results of its internal investigation, which was prompted in response to the whistleblower's information. Under this provision, so long as the whistleblower also reports the same original information to the SEC within 120 days of providing it to the company, all the information provided by the company to the SEC will be attributed to the whistleblower, which means the whistleblower will get credit -- and potentially a greater award -- for any additional information generated by the company in its investigation.

Moreover, a whistleblower who first reports the information internally will be treated as if he or she reported the information to the SEC as at the earlier internal reporting date, provided the whistleblower reports the same information to the SEC within 120 days of the internal report. This means that even if, in the interim, another whistleblower has made a submission that causes the SEC to begin an investigation into the same matter, the whistleblower who had first reported internally will be considered the first whistleblower who came to the SEC for purposes of determining priority for an award.

To qualify for a whistleblower award, a whistleblower must satisfy four requirements. The whistleblower must: (i) *voluntarily* provide the SEC; (ii) with *original information*; (iii) that *leads to the successful enforcement* by the SEC of a federal court or administrative action; (iv) in which the SEC obtains *monetary sanctions* totaling more than \$1 million.

The SEC will also pay an award based on amounts collected in certain related actions brought by the U.S. Attorney General, certain regulatory authorities (other than the SEC), self regulatory organizations (SROs), or a state attorney general in a criminal case, that are based on the same original information provided by the whistleblower to the SEC and that led to the SEC's recovery of monetary sanctions in excess of \$1 million. A whistleblower cannot recover in a related action absent a prior successful SEC action.

Information is provided "*voluntarily*", if the whistleblower submits the information to the SEC before a request, inquiry, or demand relating to the subject matter of the submission is directed to the whistleblower (i) by the SEC, (ii) in connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board ("PCAOB") or an SRO, or (iii) in connection with an investigation by Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority. Information provided after a request, inquiry or demand will not be considered voluntary even if the response is not compelled by subpoena or other applicable law. In addition, a submission will not be considered voluntary if the whistleblower is required to report the information to SEC because of a pre-existing legal duty, a contractual duty owed to the SEC or to one of the other authorities identified herein, or a duty arising out of a judicial or administrative order. For example, disclosures made by an individual who is party to a cooperation or similar agreement with another authority, such as the Department of Justice, which requires the individual to cooperate with or provide information to the SEC, would not be considered voluntary disclosure. However, a

submission of information to the SEC will be considered voluntary if the whistleblower voluntarily provided the same information to one of the other authorities identified herein prior to receiving a request, inquiry, or demand from the SEC.

“*Original information*” is information that is derived from the “independent knowledge” or “independent analysis” of the whistleblower, is not already known to the SEC, is not exclusively derived from a prior allegation, and is provided to the SEC for the first time after July 21, 2010.

“*Independent knowledge*” means factual information in the possession of the whistleblower that is not derived from publicly available sources; it may be gained from the whistleblower’s experiences, communications and observations in business or social interactions. “*Independent analysis*” means the whistleblower’s own analysis, whether done alone or in combination with others, of information that may be publicly available, but reveals information that is not generally known or available to the public.

Excluded from the definition of “original information”, is information obtained through an attorney-client privileged communication, unless disclosure of such information is otherwise permitted pursuant to the standards of professional conduct for attorneys practicing before the SEC, applicable state attorney conduct rules or otherwise. Similarly, information obtained in connection with the legal representation of a client on whose behalf the whistleblower or the whistleblower’s employer or firm provides services, and where the whistleblower seeks to use the information to make a whistleblower submission for his or her own benefit will not be considered “original information”, unless disclosure of such information is otherwise permitted pursuant to the standards of professional conduct for attorneys practicing before the SEC, applicable state attorney conduct rules or otherwise.

Further, information obtained by officers, directors, employees and certain consultants as a result of their position or role at the company, will not generally be considered information derived from “independent knowledge” or “independent analysis”; the exclusion, however, is not absolute, and under certain circumstances these designed individuals are eligible for whistleblower awards. The final rules exclude from the definition of “original information”, information obtained by a person because he or she is:

- (i) an officer, director, trustee, or partner of an entity, and another person informed him or her of allegations of misconduct, or he or she learned the information in connection with the entity’s processes for identifying, reporting, and addressing possible violations of law. Examples include learning about a violation because an employee reports misconduct to the designated person, being informed of an allegation of misconduct through the company’s hotline, or learning of a report from the company’s auditors regarding a potential illegal act. However, information about possible violations at the company independently learned or observed by the officer, director, trustee or partner would not be excluded from the definition of “original information”. For example, an officer who discovers information indicating that other members of senior management are engaged in a securities law violation can qualify as a whistleblower and be eligible for an award;
- (ii) an employee, whose principal duties involve compliance or internal audit responsibilities, or was employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for the entity. A compliance officer is subject to this exclusion whether he or she learns about a possible violation in the course of a compliance review or from another employee;
- (iii) employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or

- (iv) an employee of, or other person associated with, a public accounting firm, if the information was obtained through the performance of an engagement required of an independent public accountant under the federal securities laws, and the information relates to a violation by the engagement client or the client's directors, officers or other employees. This exclusion does not preclude accounting personnel from making specific and credible submissions alleging that their own accounting firm violated the federal securities laws or professional standards. If a whistleblower makes such an allegation, and if the submission leads to a successful SEC action against the engagement client, its officers, or employees, then the whistleblower can obtain an award based on monetary sanctions recovered against the audit client as a result of the investigation of alleged violations by the accounting firm.

The above exclusions notwithstanding, a designed person in one of the above categories may be eligible for a whistleblower award using information that is otherwise excluded to that person if: 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; or 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 supervisor, or since the whistleblower obtained the information, if the information was obtained under circumstances indicating that the entity's audit committee, chief legal officer or chief compliance officer, or the whistleblower's supervisor was already aware of the information.

A whistleblower will be considered to have provided the SEC with original information that "*leads to a successful enforcement*" of a federal court or administrative action, if:

- (i) the original information was sufficiently specific, credible and timely, to cause the SEC to commence an examination, open an investigation, reopen an investigation, or inquire concerning different conduct as part of a current examination or investigation, and the enforcement action is successful based in whole or in part on conduct that was the subject of the original information;
- (ii) the original information concerns conduct already under examination or investigation by the SEC, Congress, any other authority of the federal government, a state Attorney General or securities regulatory authority, an SRO, or the PCAOB, and the original information significantly contributed to the success of the action; or
- (iii) the original information was reported through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time it was reported to the SEC; and the entity provides the SEC with the original information or with the results of an audit or investigation initiated in whole or in part in response to the reported information; and the whistleblower independently reported the same information to the SEC within 120 days of providing it to the entity.

The requirement that the SEC collect "*monetary sanctions totaling more than \$1 million*" can be satisfied by any money, including penalties, disgorgement and interests, ordered to be paid, and any money deposited into a fund as a result of the SEC's action or a related action. For purposes of making a whistleblower award, two or more SEC proceedings arising from the same nucleus of operative facts will be treated as an SEC action. Moreover, for purposes of determining payment of an award, the SEC will deem as part of the original SEC action upon which the whistleblower award is based, any subsequent SEC proceedings that, individually, result in monetary sanctions of \$1,000,000 or less, and that arise out of the same nucleus of operative facts. For example, if a whistleblower award is paid for an action brought against an entity, and the SEC later brings a

separate proceeding against the officer of the entity that was responsible for the entity's conduct in which less than \$1 million is recovered, the SEC may treat the second proceeding as part of the previous covered action and provide a whistleblower payment based on the total of the two proceedings.

Notably, a whistleblower can submit information to the SEC anonymously through counsel; and, in any event, a whistleblower's identity is kept confidential. Moreover, a whistleblower need not have "clean hands" to receive an award. Under the final rules, while the culpability or involvement of a whistleblower is a factor in determining the amount of an award, a culpable whistleblower, in the absence of a criminal conviction, is not *per se* precluded from receiving an award. 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 that the whistleblower directed, planned, or initiated.

Certain categories of persons are not eligible to receive a whistleblower award. The final rules exclude from whistleblower award eligibility:

- (i) persons who are, or, at the time the original information was obtained were, a member, officer, or employee of the SEC, the Department of Justice, certain other regulatory agencies, an SRO, the PCAOB, or any law enforcement organization; or of a foreign government, political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority;
- (ii) anyone who is the spouse, parent, child, or sibling of an SEC member or employee, or who resides in the same household as an SEC member or employee;
- (iii) persons otherwise eligible to receive an award, but who were convicted of a criminal violation related to the SEC action or to a related action; and anyone who, in connection with his or her submission of information to the SEC or other dealings with the SEC, knowingly and willfully makes false, fictitious, or fraudulent statements or representations, or knowingly use false writings or documents with the intent to mislead or otherwise hinder the SEC; and
- (iv) persons who obtained the original information through an audit of a company's financial statements, and making the whistleblower submission would be contrary to the requirements of Section 10A of the Exchange Act, unless the information is not otherwise excluded from the person's use. Accordingly, a member of the accounting firm's audit team could not submit information to the SEC about a possible illegal act by the audit client which he or she obtained in the course of conducting an audit of the client's financial statements, because such information is required to be reported to the client under Section 10A of the Exchange Act; however, the audit team member could report allegations of potential violations by his or her own accounting firm.

In consideration of the final rules, companies need to evaluate their current internal reporting processes and policies to insure that they effectively encourage employees to report their concerns about potential violations and misconduct through internal processes. A company will want the opportunity to investigate an alleged violation internally, before being blindsided by a call from the SEC. An effective internal reporting system will be uncomplicated and non-threatening; it will include a process – which should be regularly communicated to employees - for reporting and receiving concerns about possible violations, including anonymous submissions; and it will ensure that all allegations of misconduct are taken seriously, and are addressed in a timely manner. Companies should routinely train their employees on how to report potential violations within a company's internal reporting system, and should regularly promote the use of their internal compliance programs.

The SEC stated in the final rules, that it is not seeking to undermine effective company processes for receiving reports on possible violations; and, that in appropriate cases, it expects, upon receipt of a whistleblower complaint, it will contact the company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back. Among other factors the SEC will consider in determining whether to give a company this opportunity, are the nature of the alleged conduct, the level at which the conduct allegedly occurred, and the company's existing culture related to corporate governance, and the company's internal compliance programs, including what role, if any, internal compliance had in bringing the information to management's or the SEC's attention.

This Information Memo is intended to be only a summary of the Commission's final rules. If you have any questions about the final rules or other rules and regulations of the Securities and Exchange Commission, please contact Catherine A. King, Chair, Securities Practice Group, at 315.218.8223 or caking@bsk.com.
