

To: Our Clients and Friends

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## SEC Proposed Whistleblower Rules Attempt to Balance Competing Policy Considerations

The Securities and Exchange Commission has now issued proposed rules to implement the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“[Dodd-Frank](#)”). The proposing release, Release No. 34-63237 (“Proposing Release”), can be accessed [here](#).

Dodd-Frank amended the Securities Exchange Act of 1934 by adding Section 21F. Section 21F directs the SEC to pay awards to whistleblowers who provide the SEC with information about securities laws violations that lead to successful enforcement actions. Proposed Regulation 21F defines statutory terms, establishes the standards and procedures for rewarding eligible whistleblowers and generally seeks to explain the program. In an attempt at making these rules “user-friendly”, as required by Dodd-Frank, the SEC has taken an approach similar to the one taken with Rule 14a-8. The proposed regulation is written largely in the second person, with a decidedly “how to” tone. The SEC notes that in its effort to generate user-friendly rules, it tried to construct a complete and self-contained set of rules relating to the program. As a consequence, in some places Regulation 21F restates key provisions of the statute.

The SEC acknowledged in the proposing release the “competing interests” of the potential benefits of the Dodd-Frank whistleblower incentive program on the one hand, and effective compliance programs, confidential compliance-related relationships and avoidance of a rash of untrue or insignificant whistleblower allegations on the other. The SEC stated that provisions in the proposed rules are intended “not to discourage” persons from first reporting violations to internal company personnel pursuant to robust compliance program procedures, to eliminate incentives for persons already obligated to come forward and to promote only high-quality tips.

This client alert summarizes key concepts in the proposing release and highlights the salient policy concerns shared by companies and regulators in fashioning the new whistleblower program. Comments to the proposed rules are due by December 17, 2010 and final rules implementing the Dodd-Frank whistleblower program are expected by April 2011.

## *Proposed Regulation 21F - Key Provisions*

**Who is a Whistleblower?** The term “whistleblower” is defined in the statute, and proposed Rule 21F-2(a) essentially restates the statutory definition: “You are a whistleblower if, alone or jointly with others, you provide the Commission with information relating to a potential violation of the securities laws.” The rule is explicit that a whistleblower must be an individual; an entity is not eligible.

Proposed Rule 21F-8 sets forth categories of individuals who would be ineligible for an award, including employees of the Department of Justice, regulatory or self-regulatory agencies, the PCAOB, any law enforcement organization or a company’s auditor (where contrary to Section 10A); individuals convicted of certain criminal law violations; individuals who knowingly made false statements or representations; and foreign officials.

**Payment of Awards.** Proposed Rule 21F-3 provides that awards will be paid by the SEC to eligible whistleblowers who:

- *voluntarily* provide the SEC
- with *original information*
- that leads to the *successful enforcement* by the SEC of a federal court or administrative action
- where the SEC obtains *monetary sanctions* totaling more than \$1 million.

**Voluntary Submission.** Under proposed Rule 21F-4(a), information will be considered voluntarily submitted if it is provided before the whistleblower, or any person representing the whistleblower, receives any formal or informal request from the SEC or relevant authorities about a matter related to the information. Because a request directed at an employer is deemed to be directed to all employees with information within the scope of the request, a subsequent submission by those employees will not be considered voluntary for purposes of the program unless first provided to the employer who then fails to provide the information to the SEC in a timely manner. Because SEC investigations typically involve an iterative information-gathering process, including several (usually) non-redundant requests for documents and investigative testimony, the manner in which the proposed rule would be applied in such circumstances is unclear.

The proposed rule also provides that disclosure is not voluntary if the person has a duty to report the possible violations. The proposing release makes clear this means persons working for certain authorities, including regulatory agencies and law enforcement, as well as auditors who have Section 10A duties and government contracting officers reporting on fraud on a government contract. Also excluded are persons under a preexisting agreement that requires them to assist the SEC or other investigative authorities.

In a footnote, the SEC points out that the rule’s list of disqualified authorities does not include an employer’s personnel who are conducting an internal investigation, compliance review or audit. Proposing Release, note 11. This means that under the proposed rule, a person would qualify for “voluntarily” providing information if the person went to the SEC after being questioned by his employer’s personnel about possible violations. This could potentially operate to undermine the

effectiveness of internal investigations and related compliance efforts. The SEC points to other provisions of the proposed rule - including those addressing "original information" (see below) -- as facilitating company compliance programs and internal investigations without interruption by the workings of the whistleblower program.

**Original Information.** Proposed Rule 21F-4(b) begins with the statutory definition of "original information": it must be derived from the whistleblower's "independent knowledge" or "independent analysis" and not:

- Already known to the SEC from any other source (unless it can be shown that such source obtained the information from the whistleblower);
- Derived from an allegation made in a judicial or administrative hearing, government report, hearing, audit or investigation, or from news media (unless the whistleblower is the original source); or
- Submitted on or before the July 21, 2010 effective date of Dodd-Frank.

The rule defines "independent knowledge" as factual information not derived from publicly available sources. "Independent analysis" is defined broadly in the rule as a person's analysis "done alone or in combination with others" which may be based on publicly available information. The SEC states this broad definition is a recognition that persons can, through "evaluation and analysis, provide vital assistance to the Commission staff in understanding complex schemes and identifying securities violations."

The rule then sets forth exclusions. The SEC will not consider information to be derived from independent knowledge or independent analysis if the information was obtained:

- Through a communication subject to the attorney-client privilege, subject to certain exceptions relating to attorney conduct or ethics rules
- Through legal representation of a client when the disclosure to the SEC is for the whistleblower's own benefit, subject to the same exceptions
- Through the performance of an engagement required under the federal securities laws by an independent public accountant
- By a person with legal, compliance, audit, supervisory or governance responsibilities, where the information was communicated to such person with the reasonable expectation that the person would take steps to cause the company to respond appropriately to the violation, unless the company did not disclose the information to the SEC "within a reasonable time" or proceeded in "bad faith"
- Otherwise from or through an entity's legal, compliance, audit or other similar function or processes, unless the entity did not disclose the information to the SEC "within a reasonable time" or proceeded in "bad faith"
- By a means or in a manner that violates applicable federal or state criminal law

- From any individual that would otherwise be excluded pursuant to any of the above criteria

The rule makes provision for a person who cooperates in an internal investigation or audit which does not result in an entity's disclosure to the SEC or where the entity proceeds in bad faith. In these situations, if the whistleblower provides information in the internal investigation or audit and, within 90 days, submits the same information to the SEC, the SEC will consider that the information was provided as of the date of the original disclosure and the whistleblower will be eligible for an award. The SEC states in the proposing release that these provisions are intended to "strike a balance" between two competing goals: to facilitate compliance programs by not creating an incentive for employees to benefit by "front running" internal processes and to permit awards where companies do not take appropriate steps to respond to alleged violations.

**Successful Enforcement.** Proposed Rule 21F-4(c) defines when a whistleblower's information "led to successful enforcement":

- Where the information caused the SEC to open a new investigation, reopen one that had been closed, or to inquire concerning new or different conduct as part of an existing examination or investigation and the information *significantly contributed* to the success of the action; or
- Where the information was related to conduct that was already under investigation by the SEC or another governmental authority, but was *essential* to the success of the action and would not otherwise have been obtained.

The proposing release reflects the SEC's intention to apply the latter of these in very limited circumstances. As stated by the SEC, "awards under this standard would be rare."

**Monetary Sanctions.** In order to qualify for monetary awards, an action must result in monetary sanctions received by the SEC in excess of \$1 million. Proposed Rule 21F-4(e) defines monetary sanctions to include any money, including penalties, disgorgement and interest, ordered to be paid or deposited into a disgorgement fund or other fund pursuant to the Sarbanes-Oxley Act, as a result of an SEC action or related action. The proposing release reflects the SEC's intention to interpret this broadly.

**Amount of Award.** If all of the requirements of the proposed rules are met, the SEC would be authorized to award the whistleblower an amount that is not less than 10% and not more than 30% of the monetary sanctions that the SEC collects. Proposed Rule 21F-13 indicates that awards will be paid out only to the extent that the related monetary sanctions are collected, and shall be made following the later of (i) the date on which the monetary sanction is collected, and (ii) the completion of any applicable whistleblower appeals processes related to the claim. This provision is significant because, with some frequency, the SEC either is unable to collect penalties ordered or waives all or a part of the penalty based upon the defendant's or respondent's inability to pay. It is also the case that, as contemplated by the statute, in some circumstances a payment to a whistleblower will be taken from funds otherwise dedicated to compensating aggrieved investors.

Additionally, in considering the amount of an award, the SEC would also consider (i) the significance of the information provided to the success of the SEC action or related action; (ii) the degree of

assistance provided by the whistleblower and his or her legal representatives; (iii) the SEC's "programmatic interest" in deterring violations of the securities laws through making such awards; and (iv) whether an award enhances the SEC's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information by future whistleblowers.

**Proposed Tip Form and Submission Procedures.** Proposed Rule 21F-9 sets out the procedures for submitting tips to the SEC. The rule requires a two step process. First, the whistleblower must submit the information to the SEC either online or by completing a Form TCR (*Tip, Complaint or Referral*), and mailing the form to the whistleblower office of the SEC. Second, a Form WB-DEC (*Declaration Concerning Original Information Provided Pursuant to § 21F of the Securities Exchange Act of 1934*) must be submitted at the same time as the Form TCR. If information is submitted anonymously, the tipper must provide his or her attorney with the signed Form WB-DEC. The proposed rules would require the whistleblower to provide additional information and assistance, subject to certain procedures.

Proposed Rules 21F-10 and 21F-11 provide procedures for submitting claims for awards. Under these procedures, a claim may be submitted on Form WB-APP (*Application for Award for Original Information Provided Pursuant to § 21F of the Securities Exchange Act of 1934*) to the designated whistleblower office of the SEC, subject to specified deadlines and procedures. The SEC staff will then send to the claimant a preliminary assessment as to whether the claim should be allowed or denied, and if allowed, the proposed award percentage amount. The proposed rules also provide for an appeals process for claimants that object to the denial of a claim contained in a preliminary assessment.

**Confidentiality.** Under proposed Rule 21F-7, the SEC will not disclose information that could reasonably be expected to reveal the identity of a whistleblower. The exceptions included in the rule relate to circumstances where disclosure is required to a defendant or respondent in connection with a federal court or administrative action that the SEC files, or when the SEC determines that it is necessary to disclose to the U.S. Department of Justice or other regulatory authorities in order to protect investors and accomplish the purposes of the Exchange Act.

**No Amnesty; Culpable Whistleblowers.** Proposed Rule 21F-14 makes clear that whistleblowers who assist the SEC with investigations or enforcement actions are not shielded from being the target of an SEC enforcement action by virtue of their cooperation. Under the proposed rule, the SEC will take into consideration the whistleblower's cooperation in accordance with the SEC's Policy Statement Concerning Cooperation by Individuals in Investigations and Related Enforcement Actions.

Similarly, under proposed Rule 21F-15, where a whistleblower is ordered to pay monetary sanctions in connection with an enforcement action, or where an entity whose liability is based substantially on conduct that the whistleblower directed, planned or initiated, the SEC will exclude the amounts paid by the whistleblower or the employer, as the case may be, in determining whether the \$1 million threshold has been surpassed, or in determining the amounts collected for purposes of calculating award payments.

**Staff Communications to Whistleblowers.** Proposed Rule 21F-16 provides that no one may impede a whistleblower from communicating directly with the SEC about potential violations, such as by attempting to enforce confidentiality agreements. Similarly, the rule provides that the SEC may communicate directly with whistleblowers who are directors, officers, members, agents or employees of an entity that has counsel, without first seeking the consent of the entity's counsel.

### *Policy Concerns*

In the proposing release, the SEC noted that its primary concern was crafting rules that effectuated the new Congressionally mandated whistleblower program while accommodating the important public policy considerations of:

- promoting robust compliance programs,
- preserving the principles underlying privileged and confidential client information, and
- ensuring that only credible, "high quality" information is actually reported to the SEC.

Whether the SEC succeeded in balancing these various competing interests remains to be seen. There are concerns:

- The 90-day look-back provides no assurance that employees will not bypass internal processes in order to be first in line for a financial award. After all, with a windfall payout at stake, employees will have more reason to report to the SEC first, or even simultaneously, in order to secure eligibility.
- In determining the amount of an award under the proposed rules, the SEC may, but is not required to, consider whether a whistleblower first reported the violation internally.
- Determinations of "reasonable time" and "bad faith" will be inherently subjective, giving the potential whistleblower strong incentives to report potential violations directly to the SEC and leaving companies' internal compliance processes unduly exposed.

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