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SEC Adopts Final Rules Implementing Whistleblower Provisions of Dodd-Frank

The SEC has adopted final whistleblower rules substantially as proposed, with no requirement that whistleblowers report internally, which may undermine corporate compliance processes. While there is little doubt the new rules will result in an increased number of reports of possible violations to the SEC, the quality of these additional reports remains to be seen. What is not uncertain is the time and effort it will take issuers to respond to the increased number of matters reported to the SEC.

By Scott D. McKinney, Alexander S. Holtan, and William B. Sohn

On May 25, 2011, the U.S. Securities and Exchange Commission (SEC) by a 3-2 vote adopted final rules, which are set forth in new Regulation 21F, implementing the whistleblower award program of Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] Dodd-Frank added Section 21F to the Securities Exchange Act of 1934, as amended (Exchange Act),[2] which requires the SEC pay cash awards, under regulations prescribed by the SEC (*i.e.*, new Regulation 21F), to whistleblowers who voluntarily supply the SEC with original information leading to a judicial or administrative action in which the SEC obtains monetary sanctions exceeding $1 million, subject to certain limitations.[3] Whistleblowers who provide such information are eligible for a cash award from 10 to 30 percent of the monetary sanctions. Employers are prohibited from retaliating against employees who report violations to the SEC, and victims of retaliation are granted an independent cause of action.

The most contentious aspect of the final whistleblower rules, as with the proposed rules, continues to be the interaction between the new rules and internal corporate compliance programs. While the SEC added incentives to report internally in an attempt to reduce the extent the whistleblower program may undermine corporate compliance programs, the final rules do not require whistleblowers to report internally before contacting the SEC. Under the final rules, whistleblowers who first report internally are allowed to receive an award even if the employer is then the first to report the same information to the SEC. The final rules

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also allow the SEC to consider a whistleblower's participation in, or interference with, the internal compliance process in determining the amount of the award.

The new rules become effective August 12, 2011, but will apply to all whistleblower tips made since July 21, 2010, the date Dodd-Frank was enacted. With the strong financial incentive created by the whistleblower rules for individuals to report to the SEC possible violations of federal securities laws and the cost and distraction of resolving such matters, companies should take the opportunity to strengthen their internal reporting policies, processes and training, as appropriate.

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The Final Whistleblower Rules

The SEC's rules implementing the Dodd-Frank whistleblower provisions were first proposed on November 3, 2010.[4] The SEC's proposed rules were criticized by both issuers and whistleblower advocacy groups. Issuers were concerned that the financial incentives were already too high and awards too easily earned, and could undermine internal reporting procedures and overburden the SEC with reports, ultimately delaying the detection and remedying of violations. On the other hand, whistleblower advocacy groups sought rules that would create even greater incentives for whistleblowers to report violations of securities law to the SEC. While commentators raised many substantive issues regarding the proposed rules, the SEC did not make substantial changes. The final rules represent an attempt to adjust a potential whistleblower's incentives in a way that encourages the reporting of valid concerns and encourages, but does not require, the use of existing internal corporate reporting procedures.

Internal Reporting Encouraged but Not Required

The SEC made a number of changes to the proposed rules in an attempt to provide greater incentives for potential whistleblowers to report internally, although internal reporting is still not required as a condition to receiving an award. The final rules now provide that a whistleblower's use of internal reporting procedures is a factor that can increase the amount of his or her award.[5] Also, unreasonable delay in reporting or interference with internal reporting programs is specified as a possible basis for decreasing an award. In addition, the final rules now provide that a whistleblower who reports internally will retain eligibility for an award if the issuer then self-reports to the SEC and a sanction is ultimately imposed. Finally, a whistleblower can file a report with the SEC within 120 days (extended from the 90 day period in the proposed rules) from the date of filing an internal report and still be treated as though he or she had filed on the date the internal report was filed.[6] The combination of these changes

marginally increases the motivation for potential whistleblowers to report a potential violation internally instead of, or before, reporting to the SEC.

Definition of Whistleblower Clarified

The proposed rules had defined a whistleblower as an individual who provides information concerning a potential violation of securities laws. The final rules define whistleblower as an individual who provides information to the SEC relating to a "possible" violation of federal securities laws or regulations that "has occurred, is ongoing, or is about to occur." This language is intended to clarify that information regarding future violations would qualify, while information concerning a state or foreign law violation would not qualify. The SEC decided not to raise the bar higher than requiring the information concern a "possible" violation and even immaterial potential violations qualify, as there is no materiality requirement.

Voluntary Submission of Information

Under the proposed and final rules, a whistleblower must provide the SEC with information voluntarily to qualify for an award. The final rules expand the circumstances under which the provision of information will be considered voluntary.

First, information is deemed to be provided voluntarily if a "whistleblower makes his or her submission before a request, inquiry, or demand that relates to the subject matter of the submission is directed to the whistleblower … (i) by the Commission; (ii) in connection with an investigation … by the … PCAOB or any self-regulatory organization; or (iii) in connection with an investigation by Congress [or] any other authority of the federal government."[7] The proposed rules required a potential whistleblower to make a submission prior to "information requests of any kind" from relevant regulators.[8]

Second, the SEC removed the provision of the proposed rules that would treat a request to an issuer for information as directed to all employees whose documents or information is within the scope of the request. Under the final rules, a request must be made either directly to the whistleblower or to the whistleblower's representative to render a subsequent submission by the whistleblower not voluntary.[9]

Original Information; Independent Knowledge; Independent Analysis

Only "original information" provided to the SEC can qualify for the whistleblower bounty. The definition of original information, unchanged from the proposed rules, is information that is: (i) derived from the independent knowledge or independent analysis of the whistleblower; (ii) not already known to the SEC from any other source, unless the whistleblower is the original source of the information; (iii) not exclusively derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information; and (iv) provided to the SEC for the first time after July 21, 2010 (the date of enactment of Dodd-Frank).[10] The definition of independent knowledge, also unchanged from the proposed rules, is factual information not derived from publicly available sources.[11]

The SEC has revised the definition of "analysis" in the final rules to clarify that independent analysis can be based upon a whistleblower's evaluation of publicly available sources. As revised, "analysis" is defined to mean the whistleblower's own examination and evaluation of information that may be publicly available, but which reveals information that is not generally known to the public.[12]

Exclusions from Award Eligibility

Certain categories of people are generally ineligible for awards, subject to certain exceptions.

Attorneys and Attorney-Client Privilege. Attorneys may not use information learned through representation of a client or by privileged attorney-client communications to make their own whistleblower claims (unless disclosure of the information is permitted under SEC attorney-conduct rules or state bar rules).[13] The final rules clarify that in-house attorneys are covered by these two exclusions and associated exceptions, and expand them to apply to non-attorneys. Thus, for instance, if an attorney would be precluded from receiving an award based on the attorney's submission of the information to the SEC, a non-attorney who learns this information through a confidential attorney-client communication (such as a legal or administrative assistant) would be similarly disqualified.

Officers and Directors. Officers,[14] directors, trustees, and partners of an entity who are informed by another person (such as an employee) of allegations of misconduct, or who learn the information in connection with the entity's processes for identifying, reporting, or addressing possible violations of law (such as through the entity's hotline) may not use the information to make their own whistleblower claims.[15] The final rules, unlike the proposed rules, omit from this category of award eligibility exception "non-officer supervisors."

Compliance and Internal Audit Personnel. 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 are not eligible for a whistleblower award.[16] Such an employee is subject to the exception whether he or she learns about possible violations in the course of a compliance review or another employee reports the information to such employee.

Public Accountants. Employees of, or other persons associated with, a public accounting firm who learn information regarding a possible violation through an audit or other engagement required under the federal securities laws are not eligible for a whistleblower award if that information relates to a violation by the engagement client or the client's directors, officers, or other employees.[17]

Additional Exclusions. Foreign government officials and employees of foreign instrumentalities, including state-owned entities, are ineligible to receive an award.[18] Also ineligible are people who obtain the information by means or in a manner that is determined by a U.S. court to violate federal or state criminal law.[19] In addition, a person who acquires information from any of the persons excluded above also is excluded from award eligibility.[20]

Limited Exceptions to Exclusions from Award Eligibility

The final rules provide limited exceptions to the exclusion for officers, directors, public accountants, and compliance and audit related personnel. Under any of the following circumstances, any such individual is eligible to receive an award: (i) the whistleblower has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the issuer from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the issuer or its investors; (ii) the whistleblower has a reasonable basis to believe that the issuer is engaging in conduct that will impede an investigation of the misconduct; or (iii) at least 120 days have elapsed since the whistleblower provided the information to the issuer or since the whistleblower received the information, if the information was received under circumstances indicating that the issuer was already aware of the information.[21] The final rules provide that these exclusion exceptions do not apply to attorneys.

Successful Enforcement Action

As under the proposed rules, a whistleblower's information must lead to a successful enforcement action for the whistleblower to receive an award.

The final rules make significant changes to what suffices as "information that leads to successful enforcement." Under the proposed rules, the information would have to either (1) "significantly contributed to the success of the action" if the information caused the SEC to commence an investigation, or (2) have been "essential" and "not otherwise have been obtained" if the SEC had already commenced an investigation by the time the information was reported.[22] The final rules lower the standard in both instances, making it substantially easier for a whistleblower to obtain an award.

Under the final rules, for information reported when no SEC investigation is underway, a whistleblower now need only show that the successful enforcement action was based in whole or in part on the conduct that was the subject of the whistleblower's original information.[23] For information reported when an SEC investigation is already underway, the requirements that the information be "essential" and "not otherwise have been obtained" were replaced with a requirement that the information merely have "significantly contributed" to successful enforcement.[24]

Eligibility of Culpable Whistleblowers

The final rules do not provide a *per se* exclusion for culpable whistleblowers from receiving an award. However, for purposes of determining whether the $1,000,000 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.[25] Also, the SEC will consider culpability in determining the amount of an award.

In addition, as noted in a footnote to the final rules release, as part of a negotiated settlement agreement, deferred prosecution agreement, non-prosecution agreement, immunity agreement, cooperation agreement, or other similar agreement with a highly culpable whistleblower, the SEC has the ability to obtain the whistleblower's agreement to accept less than the statutory minimum or to forgo seeking a whistleblower award.[26]

Calculating Sanctions to Determine Potential Awards; Splitting Awards

In a change from the proposed rules, the final rules clarify that, for the purpose of determining whether the $1 million threshold has been reached, the SEC must aggregate the monetary sanctions from multiple SEC proceedings arising from the "same nucleus of operative facts."[27] Provided SEC sanctions are at least $1 million, the whistleblower's award will be between 10 to 30 percent of the total sanctions imposed in the SEC action and in any related judicial or administration action brought by other government agencies.[28] The SEC will not grant an award for a related action if the whistleblower has already been granted an award by the Commodity Futures Trading Commission (CFTC) for that same action pursuant to the CFTC's whistleblower award program.[29] Where there are multiple qualifying whistleblowers, the SEC will award the whistleblowers a fraction of the 10 to 30 percent whistleblower award in accordance with, among other factors, the SEC's determination of the importance of each whistleblower's assistance.[30]

Anti-Retaliation Protection

The final rules clarify that a whistleblower is protected from employment retaliation if the whistleblower possesses a "reasonable belief" that the information the whistleblower is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur.[31] The retaliation protections apply to a whistleblower irrespective of whether the whistleblower is ultimately entitled to an award. Thus, a whistleblower's tip need not result in a successful enforcement action in order for the whistleblower to be protected by the anti-retaliation provisions. In addition, the final rules make it unlawful for

anyone to interfere with a whistleblower's efforts to communicate with the SEC, including threatening to enforce a confidentiality agreement.[32]

Implications of the Final Rules

The financial incentives provided to whistleblowers under the final rules might limit the efficacy of existing internal reporting programs, including those mandated under Section 301 of the Sarbanes-Oxley Act.[33] With the chance to collect a substantial portion of a multimillion dollar sanction, whistleblowers will naturally prefer an outcome that ends in an SEC sanction; they will not benefit nearly as much, if at all, if the violating issuer resolves the problem internally without the SEC imposing monetary penalties.

The final rules make it easier for information to qualify as voluntary.

While the final rules provide that a whistleblower's use of internal reporting procedures can increase the amount of his or her award[34] and that a whistleblower will be eligible for an award if his or her internal report results in an internal investigation that yields a monetary penalty, these changes may not provide adequate incentives for whistleblowers to report internally. To many potential whistleblowers these incentives could be outweighed by the possibility that the use of internal procedures could result in an outcome of no SEC sanction and by a perceived risk of retaliation or other consequences for reporting a matter internally.

The final rules make it easier for information to qualify as voluntary and as derived from independent knowledge or independent analysis and remove some of the limitations on information provided by key compliance and legal personnel qualifying for a whistleblower award. In addition, by allowing the aggregation of related SEC actions, the final rules make it easier for a whistleblower to qualify for an award. On the margin, these changes might make it more likely that a whistleblower will report information that is less than concrete, as the standard for qualifying for an award is lower.

Overall, it appears that the final rules leave issuers in substantially the same circumstances as the proposed rules. The SEC's new whistleblower program provides significant financial incentives for potential whistleblowers to report any possible violation directly to the SEC. The final rules do provide more encouragement for whistleblowers to report internally, but also make it easier for potential whistleblowers to qualify for an award. Even with the SEC's revisions to the final rules, the net result is that issuers face increased reputational and compliance risk as they may have a diminished ability to rely on existing internal reporting and compliance infrastructure to detect and remedy potential securities law violations.

What Companies Can Do Now

Whether the final rules will yield a sharp increase in the number of whistleblower claims and whether those claims will bypass internal reporting procedures remains to be seen. But one effect is already clear: attorneys are competing to represent whistleblowers in an effort to claim a share of the monetary awards.[35] Searching for "whistleblower claims" on the Internet yields several paid advertisements by lawyers and law firms seeking to assist whistleblowers in reporting securities law violations to the SEC. Whistleblower attorneys submitted substantial commentary on the proposed rules downplaying the rules' possible harm to internal reporting procedures.[36] However, it is unlikely these attorneys will advise clients to report a possible violation internally rather than directly to the SEC.

Issuers must address two closely related problems in response to the final rules: the new incentives whistleblowers now have to bypass internal reporting procedures and the consequent impairment to the effectiveness of those procedures in detecting

violations. Although entities cannot prevent whistleblowers from reporting directly to the SEC, they are not without methods to minimize the adverse impacts of the final rules. In general, issuers will have to focus on maintaining the efficacy of existing reporting programs, increasing the effectiveness of existing detection and prevention measures and putting in place processes to investigate and possibly resolve potential violations within a 120 day period.

Encourage the Use of Internal Reporting Procedures

To counter the final rules' incentives to report directly to the SEC, issuers should put in place their own incentives to report internally. First, issuers should put in place clear policies to see that whistleblowers who report internally will not be penalized by the entity. Although retaliation against whistleblowers is illegal,[37] whistleblowers may still be reluctant to report internally for fear of being ostracized and demoted. Issuers should make clear that this will not happen; doing so should make whistleblowers more comfortable about reporting internally. Second, issuers should create positive incentives for reporting possible violations internally. Such incentives could include monetary or other awards for credible reports or monetary or other awards for suggesting improvements to existing reporting and compliance programs. By actively encouraging and rewarding the use and improvement of internal procedures, issuers can create a culture of compliance and can mitigate the imbalance of incentives created by the final rules.

Communicate Effectively with Individuals Reporting Internally

Individuals reporting internally should be apprised of the progress, if not the interim status, of internal investigations. Companies should explain clearly to internal reporters the results of the internal investigation. If a company's internal investigation concludes no violation occurred or that the internal report is based on a misunderstanding, this conclusion must be effectively and timely communicated to the individual reporting internally. A person reporting internally who does not understand the conclusion of the internal investigation might report directly to the SEC.

Increase Other Detection Efforts

With the incentives whistleblowers now have to bypass internal reporting procedures entirely, issuer should consider making changes to existing compliance processes and procedures. Issuers should consider increasing detection efforts to supplement internal reporting programs. For example, issuers could increase the frequency or scope of compliance audits to increase the likelihood that a possible violation will be detected outside of the reporting program.

Expedite Internal Investigations

When a possible violation is reported, the final rules effectively place a 120 day time-period on an initial investigation into such possible violation. The final rules require certain personnel to wait 120 days before reporting an internally reported violation to the SEC in order to qualify for a whistleblower award.[38] Other personnel are not subject to such limitation, and can report a violation to the SEC simultaneous with reporting to the issuer and still qualify for an award. However, it will likely take a period of time for the SEC to respond to a whistleblower report. Having policies and procedures to see that an initial investigation will be completed within 120 days will limit the availability of whistleblower awards to certain persons within an issuer. It also will place the issuer in position to respond to an inquiry from the SEC in an informed manner with regards to possible violations that are reported to the issuer and the SEC simultaneously.

Conclusion

As issuers enter the uncharted waters of a legal system that now provides substantial monetary

awards to whistleblowers to report possible illegal activity to the SEC, concerns about what effects these new financial incentives will have are numerous. Although the effects remain unknown, the SEC and public companies should prepare for the possibilities of both the underutilization of existing internal reporting procedures and a sharp increase in the reports of possible securities violations to the SEC. Although issuers cannot control how the SEC will uses its whistleblower award authority, they can take action to help preserve the role of internal reporting procedures and to see they have other means of detecting and remedying violations.

NOTES

1. Securities and Exchange Commission, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (adopted May 25, 2011) (hereinafter "Final Rules"). *http://www.sec.gov/rules/final/2011/34-64545.pdf*.
2. 15 U.S.C. § 78 (2010).
3. *E.g.,* information protected by the attorney-client privilege.
4. Securities and Exchange Commission, Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 75 Fed. Reg. 70488 (proposed Nov. 3, 2010) (hereinafter "Proposed Rules").
5. Final Rules at 5.
6. *Id*. at 5–6.
7. *Id*. at 30.
8. *Id.*
9. Final SEC Rule 21F-4(a)(iii)(2).
10. Final SEC Rule 21F-4(b)(1).
11. Final SEC Rule 21F-4(b)(2).
12. Final SEC Rule 21F-4(b)(3).
13. Final SEC Rules 21F-4(b)(4)(i) and (ii).
14. The term "officer" means "a president, vice president, secretary, treasurer or principal financial officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated." Rule 3b-2.
15. Final SEC Rule 21F-4(b)(4)(iii)(A).
16. Final SEC Rules 21F-4(b)(4)(iii)(C) and (D).
17. Final SEC Rule 21F-8(c)(4).
18. Final SEC Rule 21F-8(c)(2).
19. Final SEC Rule 21F-8(c)(3).
20. Final SEC Rule 21F-4(b)(4)(vi).
21. Final SEC Rule 21F-4(b)(4)(iv).
22. Proposed Rule at 70521.
23. Final Rules at 252.
24. *Id.*
25. Final SEC Rule 21F-16.
26. Footnote 390 to the Final Rules.
27. Final SEC Rule 21F-4(d).
28. Final SEC Rule 21F-3(b).
29. Final SEC Rule 21F-3(b)(3).
30. Final SEC Rule 21F-5(c).
31. Final SEC Rule 21F-2(b)(1). 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. Final Rules at 16.
32. Final SEC Rule 21F-17(a).
33. 15 U.S.C. § 78j-1(m) (2010).
34. Final Rules at 5.
35. Brian Grow, "Spurned by Dodd-Frank, Plaintiffs' Bar Digs for Whistleblowers," Thomson Reuters Accelus (Nov. 9, 2010) (available at *http://www.complinet.com/dodd-frank/news/articles/article/spurred-by-dodd-frank-plaintiffs-bar-digs-for-whistleblowers.html)*.
36. *See, e.g.,* letter from Stuart D. Meissner, LLC (available at *http://www.sec.gov/comments/s7-33-10/s73310-223.htm)*
37. 15 U.S.C. § 78u-6(h)(1) (2011) (Dodd-Frank), 18 U.S.C. § 1514A (2010) (Sarbanes-Oxley). The first court to consider Dodd-Frank's anti-retaliation provisions gave them an expansive interpretation. *Egan v. TradingScreen, Inc.*, No. 10 Civ. 8202, 2011 WL 1672066 (S.D.N.Y. May 4, 2011).
38. Final SEC Rule 21F-4(b)(4)(iv).