

The SEC's New Whistleblower Compensation Rules

On May 25, 2011, by a vote of 3 to 2, the SEC approved its whistleblower compensation rules substantially as proposed. These rules and the SEC's new Cooperation Initiative create strong monetary incentives for employees to race to the SEC to assert misconduct, which in turn will create greater pressure for companies to investigate alleged misconduct quickly and potentially to self-report violations to the SEC.

Summary of Key Components

Although the SEC has had limited authority for decades to compensate whistleblowers, it has historically been reluctant to do so.¹ Section 922 of Dodd-Frank materially changed the SEC's whistleblower program by providing substantial incentives for whistleblowers to come forward. First, whistleblowers can now be compensated for tips that lead to any type of SEC enforcement action, where the amount of monetary sanction (penalties plus disgorgement and interest) exceeds \$1 million. Second, the maximum amount a whistleblower can receive has been raised to 30 percent of the monetary compensation from the previous cap of 10 percent and seems to contemplate a minimum award that a whistleblower would receive – 10 percent of the monetary sanction obtained in an SEC action. Third, the SEC is to provide annual reports to Congress concerning whistleblower claims, apparently in an effort to encourage the SEC to reward whistleblowers more frequently. Section 924 of Dodd-Frank also requires the SEC to create a separate office to process claims by whistleblowers and to adopt rules to implement the whistleblower compensation system. Finally, protections for whistleblowers from retaliation are strengthened. Whistleblowers now have an express private right of action against employers who retaliate against them, with remedies including reinstatement and two times back pay. Protections for whistleblowers in the Sarbanes-Oxley Act are expanded to cover employees of subsidiaries of public companies. The rules that the SEC adopted to implement the whistleblower compensation provisions of Dodd-Frank will be effective in July 2011.

Who Is Eligible for Whistleblower Compensation?

Several conditions must be met for a person to be eligible for whistleblower compensation: (i) the individual must voluntarily provide information, that is the person must provide it before requested to do so by the government or a self-regulatory organization in an inspection or investigation; (ii) the information must be provided to a governmental or self-regulatory organization. A report to a company's internal compliance or corporate governance official can count as report to the government provided either the whistleblower or his or her company reports the information to the government within 120 days of the internal report; (iii) the information must be original information, that is based upon the whistleblower's own knowledge or analysis and is not previously known to the entity to which it is reported and must "relate to a possible violation of the federal securities laws;" (iv) the information must lead to a successful enforcement action, which means the SEC brings a successful enforcement action based in whole or in part on the conduct identified in the

¹ On March 29, 2010, the SEC's Inspector General issued a report on the SEC's program to compensate whistleblowers, a twenty-year old program designed to provide financial incentives to report insider trading violations to the SEC. According to the report, although the SEC has had the authority to reward whistleblowers in insider trading cases since 1988, the SEC had only paid out \$159,537 to five whistleblowers. (This total changed radically when, on July 23, 2010, the SEC paid \$1 million to a husband and wife who provided information that led to the Pequot insider trading case. *SEC v. Pequot Capital Mgmt., Inc., et al.*, SEC Litigation Release No. 21601 (July 23, 2010), available [here](#))

whistleblower's information; (v) the successful enforcement action imposes monetary sanctions (fines, disgorgement, and interest) of more than \$1 million.

Dodd-Frank and the whistleblower compensation rules also establish who is not eligible for compensation including: (i) anyone who had a pre-existing legal or contractual duty to report the information to the governmental entity; (ii) attorneys who report privileged information, unless such reports are permitted under SEC rules or state bar rules; (iii) anyone who obtains the information through the commission of a crime; (iv) foreign government officials; (v) employees who learn the information through a firm's hotline; (vi) compliance and internal audit personnel, with some exceptions; and (vii) governmental employees and people who are criminally convicted in connection with the conduct they report.

Factors in Determining the Amount of the Whistleblower's Compensation

Several factors may increase the amount of a whistleblower's award, including the significance of the information provided by the whistleblower, the assistance provided by the whistleblower, law enforcement interest in the matter, and the whistleblower's participation in internal compliance systems. Several factors may decrease the amount of a whistleblower's award, including the whistleblower's culpability, an unreasonable reporting delay, and the whistleblower's interference with internal compliance and reporting systems.

Anti-Retaliation Protections

The Rule prohibits employment retaliation against a whistleblower. The Rule also prevents any person from interfering with a whistleblower's report, including by threatening to enforce a confidentiality agreement. These protections apply even if the whistleblower is ultimately determined not to be entitled to compensation. The SEC made clear, however, that whistleblowers may be disciplined for reasons independent of their whistleblowing activities. The SEC also commented that the anti-retaliation protection is designed to strike the "appropriate balance between encouraging individuals to provide us with high-quality tips without fear of retaliation, on the one hand, while not encouraging bad faith or frivolous reports, or permitting abuse of the anti-retaliation protections, on the other." Specifically, "[t]he '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."

Office of the Whistleblower; Form for Whistleblower Reports

As required by Dodd-Frank, the SEC has created an Office of the Whistleblower, now headed by Sean McKessy, which works with whistleblowers, handles their tips and complaints, and helps the SEC determine the awards for each whistleblower. The initial staffing of the office has been completed and the Investor Protection Fund, which will be used to pay awards to eligible whistleblowers, has been fully funded. SEC employees are authorized to communicate directly with a whistleblower even if the whistleblower is an employee of an entity that is represented by counsel.

To be eligible for compensation, whistleblowers must report information on Form TCR. This form must be signed under penalty of perjury. A whistleblower can submit information anonymously through an attorney, who prepares, signs, and files the Form TCR.

Related Change at the SEC: The Cooperation Initiative

On January 13, 2010, the SEC announced “The Cooperation Initiative,” a fundamental departure from prior SEC practice in three respects. First, individuals are now expressly offered credit for cooperation. Credit is offered to individuals based on a relatively simple list of factors, which includes “the timeliness of the individual’s cooperation, including whether the individual was first to report the misconduct to the Commission or to offer his or her cooperation in the Investigation, and whether the cooperation was provided before he or she had any knowledge of a pending investigation or related action.” Second, although the 2010 Enforcement Manual does not overrule the Seaboard Report, it offers a simplified list of factors suggesting an entity has cooperated. Removed is a long list of factors, which some practitioners read as suggesting that cooperation would never be rewarded when the underlying conduct was serious or when some procedural step was skipped. Among the factors considered in assessing an entity’s cooperation is “self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely and effectively disclosing the misconduct to the public, to regulatory agencies, and to self-regulatory organizations.” Third, the January 13, 2010 Enforcement Manual offers a clear list of rewards available for cooperation. Many of these tools have never been available before; others have been used so infrequently they were considered of limited utility.

Since the announcement of the new approach in the January 2010 Enforcement Manual, there have been only two cases where the SEC has used its new tools to reward companies for cooperation. The first case, one that Ropes & Gray handled, involved the SEC entering into a Non-Prosecution Agreement (“NPA”) with Carter’s, Inc. related to its restatement of financials in late 2009. In the fall of 2009, Carter’s discovered issues associated with its accounting for sales accommodations paid to wholesale customers. The company’s audit committee hired Ropes & Gray to conduct an internal investigation, and upon learning of issues, the company made a timely and thorough report of the matters to the SEC ahead of any public announcement and the eventual restatement of financials. The SEC rewarded the self report and follow-on extensive cooperation in the SEC’s investigation by agreeing in the NPA to refrain from bringing any enforcement action against the company, though the SEC sued a former Carter’s EVP for fraud related to the restatement. In the second case, the SEC entered a Deferred Prosecution Agreement (“DPA”) with Tenaris S.A. related to alleged FCPA violations. Tenaris conducted a worldwide internal review of FCPA matters and discovered that bribes had been paid in Uzbekistan. The company self reported the violations and cooperated with the SEC and DOJ in their investigations. Under the DPA, the SEC agreed to refrain from filing an enforcement action against the company in return for the company undertaking certain actions related to future due diligence, training and compliance activities, as well as paying almost \$10 million to the SEC and DOJ for disgorgement of profits and fines.

Implications for Clients

Together, the whistleblower compensation program and the Cooperation Initiative will encourage individuals to report violations directly to the SEC and to do so quickly, thereby becoming potentially eligible for substantial compensation and more lenient treatment in any possible enforcement action. Because of these changes, firms should expect more employee whistleblowers. This will create strong incentives for firms to promptly investigate alleged misconduct and to self-report such conduct quickly to the SEC.

A possible downside of the whistleblower compensation program could be the erosion of compliance and corporate governance efforts, which have been encouraged by the government for decades. If whistleblowers regularly race to the SEC to report possible misconduct, thereby bypassing compliance and corporate governance structures, those structures will become less useful. In essence, the SEC would replace the functions currently performed by compliance and corporate governance structures in investigating and

addressing reports of possible misconduct within a firm. As Commissioner Casey noted in dissent, “[a]n inherent risk of the approach adopted in the final rule, is that the monetary sums at stake will provide a significant enough incentive for whistleblowers to completely bypass internal reporting in favor of coming straight to the Commission. A fundamental failure of today’s release is that it underestimates this dynamic and the ensuing impact on internal compliance reporting mechanisms. Corporate compliance programs depend on a robust flow of information in order to be effective. Indeed, information is the lifeblood of such programs. Diverting a large portion of that flow of information to the government will impair companies’ ability to step in and interrupt violations at an early stage.”

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In sum, the SEC’s new whistleblower compensation program, together with the SEC’s Cooperation Initiative, may radically increase the speed and frequency with which whistleblowers report information to the SEC. In response, companies should consider the following:

1. All reports of possible misconduct should be investigated quickly and confidentially. If there are indications of serious misconduct, the company may increasingly consider a quick self-report to the SEC so that the company, rather than a whistleblower, can receive credit for the self-report.
2. Termination of a whistleblower, even if for unrelated and independent reasons, will be more risky. A company needs to compile a clear, documented record of poor performance or cause if it wishes to terminate an employee who becomes a whistleblower.
3. Although systems of compliance and corporate governance may frequently be bypassed when whistleblowers report information to the SEC, these systems will become more important. With increased risks of whistleblower reports to the SEC, it will be more important for a company to detect and correct compliance issues as quickly as possible so that an SEC investigation will be unable to detect serious misconduct that persisted for a protracted period.

For additional information about the new rules, please contact your regular Ropes & Gray advisor.