

SEC PROPOSES RULES TO IMPLEMENT DODD-FRANK WHISTLEBLOWER PROGRAM

November 22, 2010

Earlier this month, the Securities and Exchange Commission (the “SEC”) proposed rules to implement the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹ Dodd-Frank amended the Securities Exchange Act of 1934, as amended (the “Exchange Act”), to establish a program encouraging whistleblowers to report potential federal securities law violations directly to the SEC in exchange for the prospect of substantial financial rewards.² Specifically, new Section 21F under the Exchange Act (i) requires the SEC to pay whistleblowers who provide original information that leads to a successful government enforcement action rewards of between 10 and 30 percent of monetary sanctions that aggregate at least \$1,000,000 and (ii) prohibits retaliation by employers against individuals who provide the SEC with information about potential securities violations.

The proposed rules, which will be contained in a new Regulation 21F, seek to strike a balance between encouraging whistleblowers to voluntarily come forward with information related to potential federal securities law violations and addressing a number of competing concerns, in particular the risk that the whistleblower rewards will undercut the effectiveness of companies’ existing internal processes for investigating and reporting potential securities law violations. The SEC is soliciting comments on the proposed rules through December 17, 2010 and is required to adopt final rules implementing the whistleblower program no later than April 21, 2011. This client alert summarizes certain key aspects of the proposed rules.

Who is a whistleblower?

The proposed rules define a “whistleblower” as an individual who, alone or with others, provides information to the SEC relating to a potential violation of the securities laws. A whistleblower must be a natural person and not a company or other entity. The use of the term “potential violation” in the proposed rules clarifies that the anti-retaliation protections provided under Section 21F do not depend on an ultimate finding that conduct identified by the whistleblower constituted a violation of the securities laws.

What type of information must the whistleblower provide in order to be eligible for an award?

For a whistleblower to receive a monetary award under the proposed rules, the whistleblower must voluntarily provide the SEC with original information that leads to a successful SEC enforcement action resulting in monetary sanctions exceeding \$1,000,000 (or certain related regulatory or other actions). The proposed rules define certain key terms critical to eligibility to receive awards under the program:

- “Original information” is defined as information that is (i) derived from the whistleblower’s independent knowledge or analysis, (ii) not already known to the SEC from another source (unless the whistleblower is the original source of the information) and (iii) not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental

¹ Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-63237 (November 3, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-63237.pdf>.

² Our earlier client alert on the Dodd-Frank whistleblower provisions can be found at: <http://www.wcsr.com/client-alerts/dodd-frank-solicits-whistleblowers>.

report, hearing, audit or investigation or from the news media, unless the whistleblower is a source of the information. Further, to be original information, the information must be provided to the SEC for the first time after July 21, 2010 (the date of enactment of Dodd-Frank).

- “Independent knowledge” is defined as factual information in the whistleblower’s possession that is not obtained from publicly available sources, such as press releases, media reports, information on the internet or court filings. The definition of independent knowledge does not require that a whistleblower have direct, first-hand knowledge of potential violations; rather, knowledge may be obtained from any of the whistleblower’s experiences, observations or communications. “Independent analysis” includes the whistleblower’s own examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public.
- A whistleblower’s submission will be considered “voluntary” only if the whistleblower provides the SEC with information before receiving any formal or informal request, inquiry or demand from the SEC, the U.S. Congress, any other federal, state or local authority, any self-regulatory organization or the Public Company Accounting Oversight Board (the “PCAOB”) about a matter to which the information in the whistleblower’s submission is relevant.
- In considering whether the information “led to the successful enforcement” of an SEC action, the SEC will consider the significance of the whistleblower’s information to both the decision to open an investigation and the success of any resulting enforcement action. The proposed rules distinguish between situations where the whistleblower’s information causes the SEC to begin an investigation and situations where the whistleblower provides information about conduct that is already under investigation; in the latter case, awards will be limited to circumstances where the whistleblower provided essential information that the SEC would not have otherwise obtained in the normal course of the investigation.

Who is ineligible to receive a whistleblower award?

The proposed rules prohibit certain individuals from receiving whistleblower awards, including persons convicted of crimes related to the violation, persons who knowingly provide false, fictitious or fraudulent information, foreign officials and SEC employees and their relatives. The proposed rules also limit the ability of attorneys, independent auditors and compliance personnel to receive whistleblower awards under many circumstances, such as due to communications received under the attorney-client privilege or in the course of an independent audit engagement. In addition, a company’s compliance and similar personnel would generally be prohibited from receiving awards except in certain cases when the company fails to disclose the information to the SEC or acts in bad faith.

Notably, whistleblowers who themselves are complicit in the conduct they are reporting are not necessarily prohibited from receiving awards under the proposed rules. However, in determining whether to pay an award or the amount of an award, the SEC may consider the culpability of the whistleblower, including whether the whistleblower acted with scienter, both generally and in relation to others who participated in the misconduct. The proposed rules also clarify that while whistleblowers who participated in the alleged wrongful conduct are not immune from prosecution or enforcement actions, the SEC retains discretion to determine whether, by how much and in what manner to credit the whistleblower’s cooperation.

What role do internal corporate compliance programs play in the new whistleblower program?

One objective of the proposed rules is to assure potential whistleblowers that if they provide information to existing internal compliance programs, their “place in line” will be protected in the event that other whistleblowers later provide the same information directly to the SEC. Under the proposed rules, a

whistleblower who first reports a suspected violation to an internal corporate program will be deemed to have provided this information to the SEC as of the date the information is first reported to the company's internal compliance program so long as the whistleblower submits the necessary forms to the SEC within 90 days of reporting the violation internally. Additionally, in determining the amount of an award to be paid to a whistleblower under the program, the proposed rules provide that the SEC will consider higher percentage awards for whistleblowers who first report the securities law violation to an internal compliance program. However, reporting to an internal compliance program is not required in order to receive an award.

How are tips reported to the SEC?

The proposed rules establish a two-step process for submitting tips under the whistleblower awards program. The first step is the submission of information either on a Form TCR – *Tip, Complaint or Referral* or through the SEC's Electronic Data Collection System available on the SEC's website, www.sec.gov. The second step requires the whistleblower to complete a Form WB-DEC – *Declaration Concerning Original Information Provided Pursuant to §21F of the Securities Exchange Act of 1934*, signed under penalty of perjury, in which the whistleblower would be required to make certain representations about the truthfulness of the information provided and the whistleblower's eligibility for a potential award. Except under limited circumstances,³ the SEC will not reveal the identity of a whistleblower or disclose other information that could reasonably be expected to reveal the identity of a whistleblower. The proposed rules also permit anonymous submissions, so long as the anonymous whistleblower is represented by an attorney who verifies the whistleblower's identity and provides certain information regarding the whistleblower's eligibility for an award; however, anonymous whistleblowers must disclose their identities before the SEC will pay any award.

How are whistleblower awards paid?

Under the proposed rules, persons seeking a whistleblower award would be required to submit a claim for an award on Form WB-APP – *Application for Award for Original Information Provided Pursuant to §21F of the Securities Exchange Act of 1934* within 60 days after the SEC posts a "Notice of Covered Action" on its website. The SEC's Whistleblower Office would then consider whether an award is payable, subject to review by the SEC's Commissioners.

In determining the amount of the award to be paid to a whistleblower, the proposed rules require the SEC to consider the significance of the information provided by a whistleblower to the success of the SEC action or related action, the degree of assistance provided by the whistleblower, the SEC's programmatic interest in deterring violations of the securities laws by making awards to whistleblowers and whether an award otherwise enhances the SEC's ability to enforce the federal securities laws and encourages the submission of high quality information from whistleblowers. Where multiple whistleblowers are entitled to an award, the proposed rules state that the SEC will determine appropriate award percentages for each whistleblower, but total award payments, in the aggregate, will equal between 10 and 30 percent of the monetary sanctions collected in the SEC's action and related actions. Amounts would be paid from the SEC's Investor Protection Fund.

How will the SEC communicate with whistleblowers?

The proposed rules prohibit any person from taking any action to impede a whistleblower from communicating directly with SEC staff about a potential violation, including enforcing, or threatening to enforce, a confidentiality agreement with respect to such communications, unless the confidentiality agreement deals with information covered under exceptions for the attorney-client privilege or legal representation. The proposed rules also clarify the SEC staff's authority to communicate directly with whistleblowers who are directors, officers, members, agents or employees of an entity that has counsel and who have initiated communications with the SEC related to a potential securities law violation, without first seeking the consent of company counsel.

³ E.g., disclosure of information to a defendant or respondent in a federal court or administrative action.

Recommended Actions; Contact Information

The SEC's proposed rules attempt to balance the dual objectives of maximizing the incentives for whistleblowers to come forward early with high-quality information while at the same time not undercutting existing and effective company compliance and other internal processes for responding to potential violations of the federal securities laws. In light of the proposed whistleblower rules, both private and public companies should consider taking the following steps:⁴

- Review your documents – policies, handbooks, contracts and other important documents should be analyzed to see if there are problems in need of correction.
- Promote internal reporting – internal reporting should be encouraged and the procedure should protect confidentiality; a toll-free hotline or confidential reporting system can be very beneficial.
- Demonstrate commitment and prevent retaliation – the message from the top of the organization should be that there is a commitment to the spirit of the law and retaliation will not be tolerated.
- Train your personnel – those who will receive complaints and investigate them, as well as the company's management team, will need training to ensure effective internal programs.
- Take effective corrective action – nothing will impair a compliance program more than the failure to take prompt, decisive action; additionally, taking prompt corrective action can provide a “good faith” defense.
- Don't seek out the whistleblower – while it may be instinctive to try and find out who made the claim, the effort may end up tarnishing the company.
- Go beyond the basics – consider whether the company will allow third parties (independent parties, contractors, etc.) to access the complaint system and, if so, whether there should be a separate reporting channel.

If you have any questions regarding the SEC's proposed rules, please contact Elizabeth C. Southern, <http://www.wcsr.com/elizabethsouthern>, the principal drafter of this alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities> or Labor and Employment attorneys at the following link: <http://www.wcsr.com/profSearch?team=laboremployment>.

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⁴ A video summary of key steps to be taken in light of the Dodd-Frank whistleblower program can be accessed at: <http://www.youtube.com/watch?v=2mIjwKxdXNQ>.