

## SEC Proposes Whistleblower Program

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On November 3rd, the Securities and Exchange Commission (the “SEC”) published proposed Regulation 21F (the “proposed rules”), establishing a program designed to reward individuals who provide the SEC with information leading to successful enforcement actions.<sup>1</sup> The proposal was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)<sup>2</sup> and sets out procedures under which potential informants (“whistleblowers”) could qualify for significant monetary awards by providing information to the SEC regarding violations of the federal securities laws. The proposed rules are intended to encourage and reward whistleblowers who act early to expose violations and provide important evidence that helps the SEC to bring successful cases. However, they raise some significant challenges that are likely to increase the cost of doing business for many companies, including the need to consider establishing internal processes for investigating and responding to potential securities law violations (or reviewing and improving existing ones) and the risk of retaliatory claims.

### The Proposed Rules

Under the proposed rules, a whistleblower is defined as a person who provides information to the SEC relating to a potential violation of the securities laws.<sup>3</sup> A whistleblower must be a natural person, not a company or other entity. In order to earn an award, the whistleblower must voluntarily provide the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than \$1 million. The SEC will also pay awards based on amounts collected in certain “related actions.”<sup>4</sup> Whistleblowers would be considered to provide information voluntarily if they provide it before the government, a securities self-regulatory organization, or the Public Company Accounting Oversight Board requests it. The information must be based on the whistleblower’s independent knowledge or analysis, which is not already known to the SEC and is not derived exclusively from publicly available sources.

The information will be deemed to have led to successful enforcement if it results in a new examination or investigation being opened, and significantly contributes to the success of a resulting enforcement action, or, if the conduct was already under investigation when the information was submitted, the whistleblower’s information was essential to the success of the action and would not have been obtained otherwise. If all of the proposed rules’ conditions

<sup>1</sup> Securities Exchange Act Release No. 63237 (Nov. 3, 2010) (the “Proposing Release”).

<sup>2</sup> Section 922 of Dodd-Frank added Section 21F to the Securities Exchange Act of 1934, as amended (the “Exchange Act”), authorizing the SEC to pay awards to certain individuals who provide original information that leads to successful SEC enforcement actions and certain related actions.

<sup>3</sup> The definition follows the definition of “whistleblower” in Dodd-Frank, except that it uses the term “potential violation” to preserve the confidentiality of information that could reasonably be expected to reveal the whistleblower’s identity. According to the SEC, it is important to be able to determine whether a person is a “whistleblower” at the time he or she submits information, and if the term covered only those who provided information about actual, proven securities violations, then the SEC would have to determine whether the alleged conduct constitutes a securities law violation at the time the information is submitted. Otherwise, the person’s status as a “whistleblower” would remain unknown.

<sup>4</sup> A related action is a judicial or administrative action brought by the U.S. Attorney General, an appropriate regulatory agency, a self-regulatory organization, or a state attorney general, in a criminal case based on the same original information that the whistleblower voluntarily provided to the SEC, and that led the SEC to obtain monetary sanctions totaling more than \$1 million.

are met, the SEC will pay an award of between 10 percent and 30 percent of the total monetary sanctions collected in a successful action. Where multiple whistleblowers are entitled to an award, the SEC will independently determine the appropriate allocation of the award percentage for each whistleblower. The percentage awarded in connection with an SEC action may differ from the percentage awarded in related actions.

The SEC decides whether, to whom, and in what amount to make awards; however, its determination whether or to whom to make an award may be appealed to the U.S. Court of Appeals. Where the SEC follows the statutory mandate and awards between 10 and 30 percent of the monetary sanctions collected in the action, its determination regarding the amount of an award, or its allocation between multiple whistleblowers, is not appealable.

**Excluded Persons.** Certain persons would not be considered for awards under the proposed rules. These include persons with a pre-existing legal or contractual duty to report the information; attorneys who attempt to use information obtained from clients to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC or state bar rules); independent public accountants who obtain information through an engagement required under the securities laws; foreign government officials; and people who learn about violations through a company's internal compliance program, or who are in positions of responsibility for an entity, where the information is reported to them in the expectation that appropriate steps will be taken to respond to the violation. This latter exclusion is intended to prevent "front running" of internal investigations; however, it does not apply where the company does not disclose the information to the SEC in a reasonable time or otherwise acts in bad faith.

Employees of certain government agencies, exchanges, and self-regulatory organizations,<sup>5</sup> and persons who are criminally convicted in connection with the conduct giving rise to the information, likewise are excluded. If a whistleblower plays a role in causing his or her company not to disclose violations, or to delay in disclosing them, the SEC will take this into consideration in determining whether to pay an award. A whistleblower will not be permitted to claim that his or her company did not disclose information within a reasonable time if the whistleblower is partially responsible for that failure.

<sup>5</sup> Ineligible persons include members, officers, and employees of the Justice Department, the SEC, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agency that may be defined as an appropriate regulatory agency under Exchange Act Section 3(a)(34); any national securities exchange, registered securities association, registered clearing agency, the Municipal Securities Rulemaking Board, and any other organization that may be defined as a self-regulatory organization under Exchange Act Section 3(a)(26); the Public Company Accounting Oversight Board; and any law enforcement organization. Also ineligible are members, officers, or employees of a foreign government; any political subdivision, department, agency, or instrumentality of a foreign government; or any other foreign financial regulatory authority as defined in Exchange Act Section 3(a)(52).

<sup>6</sup> Section 748 of Dodd-Frank added Section 23 to the Commodity Exchange Act, authorizing the CFTC to pay awards to certain individuals who provide original information that leads to successful enforcement actions and certain related actions.

**Other Exclusions.** Under the proposed rules, the SEC will not pay awards based on monetary sanctions that whistleblowers themselves pay in resulting SEC actions, or on sanctions paid by entities, where the whistleblower directed, planned, or initiated the conduct on which the award would be based. The proposed rules also make clear that the program would not provide amnesty for those who provide information to the SEC, and that whistleblowers who assist in investigations and enforcement actions could have an action brought against them based on their own conduct. However, in such cases, the SEC would take the whistleblower's cooperation into consideration. The proposed rules also provide that the SEC will not make an award in a related action if an award already was granted to the whistleblower by the Commodity Futures Trading Commission (the "CFTC") for that same action pursuant to its whistleblower award program.<sup>6</sup> Moreover, if the CFTC previously denied an award in a related action, the whistleblower would be collaterally estopped from relitigating any issues before the SEC that were necessary to the CFTC's denial. This would ensure that a whistleblower does not obtain double recovery on the same action, and that once the CFTC decides an issue necessary to a determination to deny an award, the whistleblower will not be able to relitigate the issue before the SEC.

**Supporting Internal Compliance Procedures.** Reflecting the SEC's concern that monetary incentives to whistleblowers could cause some people to bypass a company's existing compliance, legal, audit and similar internal processes developed to respond to potential violations of the federal securities laws, the proposed rules include provisions designed to discourage bypassing internal processes in an effort to receive an award, while at the same time preserving the person's eligibility for an award. An employee would be able to qualify as a whistleblower as of the date that the employee reports the information to his or her employer (thus preserving his or her priority) provided that the employee provides the same information to the SEC within 90 days thereafter. To further encourage internal reporting, the SEC would consider paying a higher percentage award to a whistleblower who first reports the information through his or her employer's compliance program.

**Anti-Retaliation Protection.** The proposed rules make clear that the anti-retaliation protections found in Section 21F(h)(1) of the Exchange Act would apply whether or not a whistleblower satisfies all of the procedures and conditions to qualify for an award.<sup>7</sup>

**Forms.** The proposed rules include specific forms for submitting information and making claims. Form TCR (Tip, Complaint, or Referral) is to be used by anyone wishing to provide the SEC with information concerning a violation of the federal securities laws. Form WB-DEC (Declaration of Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934) is to be used by persons who provide the SEC with information concerning a federal securities law violation and wish to be considered for a whistleblower award. Form WB-APP (Application for Award for Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934) is to be used by persons making a claim for a whistleblower award in connection with information provided to the SEC or to another agency in a related action.

## Discussion

Prior to Dodd-Frank, whistleblower awards in the securities law context were rather limited. They generally were available only in insider trading cases, and awards were limited to a maximum payment of 10 percent of the penalty assessed by the SEC. With the Dodd-Frank mandate and the proposed rules, the landscape will change considerably.

No doubt the proposed rules, including the anti-retaliation provisions, will provide a strong incentive for employees and others to bring to the SEC's attention potential violations of the securities laws. In some cases this may prove to be a positive outcome, providing additional assistance to the SEC in its efforts to detect and deal with securities law violations. Nevertheless, there is a very real risk that the proposed rules will also encourage a certain amount of improper and unscrupulous activity as well.

For example, as noted above, certain provisions in the proposed rules are "intended not to discourage whistleblowers who work for companies that have robust compliance programs to first report the violation to appropriate company personnel, while at the same time preserving the whistleblower's status as an original source of the information and eligibility for an award." This should have the positive effect of encouraging companies that don't have programs that are sufficiently "robust" to review and improve

those programs.<sup>8</sup> Indeed, every company should currently be considering the need for such programs or, if they have them, how to strengthen them. But while the SEC has made an effort to protect companies that have established programs for addressing potential violations of the securities laws, the proposed rules do not *require* whistleblowers to use them. Given the size of the potential awards, there remains a strong incentive for whistleblowers to bypass internal procedures and go directly to the SEC.

Moreover, despite the considerable concern expressed in the Proposing Release and the proposed rules for protecting employees from retaliation for whistle blowing activities, there is little protection for a company that is faced with retaliatory whistle blowing, *i.e.*, a disgruntled employee who chooses to use the whistleblower process to make baseless claims as a means of settling scores. In fact, among the questions that the SEC asks is whether it should consider adopting a rule to exclude frivolous or bad faith whistleblower claims from the protections afforded by the anti-retaliation provisions, and whether it should consider rules to ensure that the anti-retaliation provisions are not used to protect employees from otherwise appropriate employment actions that are not based on whistle blowing activities.

Finally, the universe of potential whistleblowers is not limited to employees. The proposed rules define a whistleblower simply as an individual who provides information to the SEC relating to a potential violation of the securities laws. Given the considerable sums that a whistleblower may receive, it is not hard to foresee that at least some number of specious claims could arise. Angry shareholders, unethical competitors, and others could begin to use the whistleblower process to raise unfounded claims or to report perceived violations that have no basis, again in hopes of settling scores or simply realizing a financial windfall.

## Request for Comments

The Proposing Release raises more than 40 specific questions on which interested persons are asked to comment, and also seeks general comments on any other aspect of the proposed rules, including their relative costs and benefits; their effect on efficiency, competition, investment, innovation, and capital formation; and their potential effect on the economy, including costs for consumers or individual industries. Comments should be submitted by December 17, 2010.

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<sup>7</sup> Exchange Act Section 21F(h)(2), added by Dodd-Frank, forbids employers from discharging, demoting, suspending, threatening, harassing, or in any other manner discriminating against a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower in (i) providing information to the SEC in accordance with the whistleblower provisions; (ii) initiating, testifying in, or assisting in any investigation or judicial or administrative action of the SEC based on or related to such information; or (iii) making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Exchange Act, or any other law, rule, or regulation subject to the SEC's jurisdiction.

<sup>8</sup> Section 301 of the Sarbanes-Oxley Act of 2002 currently requires public company audit committees to establish whistleblower procedures relating to accounting and auditing matters, which some companies have expanded to include, among other things, securities law violations.

If you have any questions regarding any matters discussed in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact.

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