

SEC Proposes New Rule Regarding Whistleblower Program

November 10, 2010

On November 3, 2010, the Securities and Exchange Commission (the “SEC” or “Commission”) proposed a new whistleblower rule. The rule was proposed pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, which authorized the SEC to pay substantial awards to eligible whistleblowers in connection with enforcement actions. The Act specifically requires the SEC to pay an award of 10 to 30 percent of any monetary sanctions collected in connection with an SEC enforcement action, or other related action, to eligible whistleblowers who provide the Commission with original information regarding a violation of federal securities laws.

The proposed rule is intended to provide a framework for the whistleblower program contemplated by the Dodd-Frank Act and is to be codified as § 240.21F-1 through § 240.21F-16 of Title 17, Chapter II of the Code of Federal Regulations. Under the rule, a whistleblower must be a natural person, meaning that a company or other entity is not eligible to be a whistleblower. § 240.21F-2. An individual may be a whistleblower by reporting a potential violation of the securities laws and is protected against retaliation even if he or she does not qualify for an award. *Id.*

Despite SEC Chairman Mary L. Schapiro’s professed desire to avoid “unintended consequences,” there are serious questions about whether the whistleblower program will serve to undermine companies’ internal compliance programs while simultaneously subjecting market participants to a steady stream of inquiries and investigations. These potential consequences will be critical areas of focus during the comment period for the proposed rules, which runs through December 17, 2010.

Award Eligibility

To be eligible for an award, a whistleblower must voluntarily provide the Commission with original information that leads to the successful enforcement by the Commission of an action in which the Commission obtains monetary sanctions totaling more than one million dollars. § 240.21F-3(a)(1)-(4). Awards may be based on amounts collected both by the Commission and in related actions. Related actions include any actions brought by the Attorney General of the United States, a state attorney general in a criminal case, a list of government agencies, and self-regulatory organizations, provided that the SEC determines that the

same original information given to the SEC resulted in both the successful SEC action and the related actions. § 240.21F-3(b) (1)-(4). A submission will not be considered voluntary if the information provided has been requested or demanded by the Commission, another governmental authority, a self regulatory organization, or the Public Company Accounting Oversight Board (“PCAOB”). § 240.21F-4(a)(1). A submission also will not be considered voluntary if the potential whistleblower has a pre-existing legal or contractual duty to report the information. § 240.21F-4(a)(3).

The information provided to the SEC must be original information. Original information is defined as information: (1) derived from independent knowledge or analysis, (2) not already known to the Commission from another source, unless the whistleblower is the original source, and (3) not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information. § 240.21F-4(b)(1)(i)-(iii). The Commission has also carved out a number of sources which will not be considered original information, which are listed in § 240.21F-4(b)(4).

An individual who first submits information to internal compliance personnel, a self-regulatory organization, the PCAOB, or another governmental authority may be eligible for an award if they submit the same information to the SEC within 90 days. Further, the SEC will consider the information as if it had been submitted to the SEC on the date it was first submitted to one of these other authorities or individuals. § 240.21F-4(b)(7). However, the proposed rule does not require individuals to submit information through in-house complaint and reporting procedures before submitting such information to the SEC.

To qualify for an award, information provided must lead to a successful enforcement action. § 240.21F-3(a)(3). This requirement is satisfied by the provision of original information that causes the SEC to commence an examination, open or reopen an investigation, or inquire into new conduct in an existing examination or investigation, provided that the information significantly contributes to the success of the resulting action. § 240.21F-4(c)(1). This requirement will also be satisfied by the provision of original information about conduct already under investigation by the Commission, Congress, another governmental authority, a self-regulatory organization, or the PCAOB where the information would not have otherwise been obtained and is essential to the success of the action. § 240.21F-4(c)(2). The SEC has indicated that this requirement will apply in the same way to both litigated and settled actions.

The final requirement for award eligibility is that the SEC action result in monetary sanctions exceeding one million dollars. §240.21F-3(a)(4). Monetary sanctions are defined as “any money, including penalties, disgorgement and interest, ordered to be paid and any money deposited into a disgorgement fund or other fund pursuant to Section 308(b) of the Sarbanes-Oxley Act . . . as a result of a Commission action or a related action.” § 240.21F-4(e).

Awards will not be provided to anyone who fails to give the SEC information in the form and manner they require. § 240.21F-8(a). Individuals who acquire the information they provide while a member of a regulatory or government agency, a self regulatory organization, the PCAOB, or a law enforcement organization are not eligible for awards. § 240.21F-8(c)(1). Further, individuals who are convicted of a crime related to an enforcement action, or who obtain information through the performance of an audit, are also not eligible for awards. § 240.21F-8(c)(3)-(4). Individuals who are closely related to, or reside in the same household as, a member or employee of the SEC, or who acquire information from one of the individuals described above, are also ineligible. § 240.21F-8(c)(5)-(6). Finally, anyone who knowingly and willfully makes a false statement to the Commission or in a related action will not be eligible for an award. § 240.21F-8(c)(7).

Section 240.21F-9 of the proposed rule describes the procedure for submitting original information to the Commission. Original information must be accompanied by a declaration signed under penalty of perjury. § 240.21F-9(b). Information may be submitted anonymously by an individual represented by counsel. To submit information anonymously, the submitting individual must provide his or her lawyer with a completed and signed declaration. The lawyer must then provide the SEC with a declaration indicating that he or she has confirmed the identity of the submitting individual, has received from them a completed declaration, and has reviewed the declaration for completeness and accuracy. § 240.21F-9(c). The identity of a whistleblower must always be disclosed prior to the payment of an award. § 240.21F-10(c).

The Dodd-Frank Act and the proposed rule also provide confidentiality protections for whistleblowers, barring the SEC from disclosing information “that could reasonably be expected to reveal the identity of a whistleblower” except under defined circumstances. § 240.21F-7(a). Information that could reveal the identity of a whistleblower may be provided by the Commission to a list of government agencies and the PCAOB “when the Commission determines that it is necessary to accomplish the purposes of the Exchange Act and to protect investors.”

§ 240.21F-7(a)(2). Such information can also be disclosed when required to a defendant or respondent in connection with an action brought by the Commission or one of the listed agencies. § 240.21F-7(a)(1). Information may also be disclosed in accordance with the provisions of section 552a of Title 5, United States Code. § 240.21F-7(a)(3). Individual whistleblowers who are subject to harassment or discrimination arising out of their provision of information to the SEC may be eligible to assert a statutory private cause of action in response.

The Award Determination Process

The SEC has discretion to determine the percentage of monetary sanctions to award to a whistleblower within the 10 to 30 percent range established by the Dodd-Frank Act. If there are multiple eligible whistleblowers, the total award to all whistleblowers as a group will fall within the 10 to 30 percent range, and the SEC will determine an individual percentage award for each whistleblower. § 240.21F-5(a)-(b). When determining the amount of an award, the Commission will consider: the degree of assistance provided by the whistleblower and his counsel, the significance of the information to the success of the action, the programmatic interest of the SEC in deterring violations through awards, and whether an award will enhance the SEC's ability to enforce securities laws and encourage whistleblower submissions. § 240.21F-6(a)-(d).

The mechanics of the award determination process are detailed in § 240.21F-10 of the proposed rule. After the completion of a successful action, the Commission will provide notice on its website of the action. A potential claimant then has 60 days to make a claim. § 240.21F-10(a). After the period for appeal of the action has passed, or after any appeals have been resolved, the SEC will evaluate any claims it has received and will issue preliminary award determinations. § 240.21F-10(d). Preliminary determinations may be challenged and final determinations may be appealed. § 240.21F-10(e); § 240.21F-12. However, final awards within the statutory 10 to 30 percent range cannot be appealed. § 240.21F-12(a). If a claimant does not challenge a preliminary determination, it will become final and cannot be appealed. § 240.21F-10(f).

Impact of the Proposed Rules

Clearly, the Commission is aware of the potential for these proposed rules to undermine internal compliance systems created following the passage of Sarbanes-Oxley by creating an incentive for employees to bring potential violations to the SEC rather than to their employers. The program could also impact a company's ability to obtain credit for self-reporting

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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violations. In an effort to ameliorate some of these concerns, the Commission provided a 90-day “grace period” for employees who report potential violations to an internal compliance system. § 240.21F-4(b)(7). In other words, if an employee were to first report a violation internally, he or she could then report the same violation to the SEC within 90 days and still obtain credit under the whistleblower program.

Notably, the Commission considered and declined to make internal reporting mandatory, because some employers lack established procedures and protections, including assurances of confidentiality, in their compliance programs. The SEC did indicate that the absence of a requirement that employees “utilize internal compliance processes does not mean that our receipt of a whistleblower complaint will lead to internal processes being bypassed.” The SEC stated that in “appropriate cases” it would contact the company about the report and “give the company an opportunity to investigate the matter and report back.”

It is an open question – and one the SEC specifically sought comment on – whether these provisions will undermine internal compliance programs. Indeed, Commissioner Troy A. Paredes expressed concern “that the Commission’s proposal might not do enough to preserve the important role that corporate compliance programs serve.” Again, this will be a key issue to be addressed during the comment period for the proposed rules, which runs through December 17, 2010.

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