The Rules for Whistleblowers: Significant Aspects of the SEC's Whistleblower Incentives and Protection Program

Kurt E. Wolfe
202.857.2415 | kwolfe@mcguirewoods.com

McGuireWoods LLP
2001 K Street N.W.
Suite 400
Washington, D.C. 20006-1040

www.mcguirewoods.com

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The U.S. Securities and Exchange Commission (SEC) adopted a final set of rules establishing its Securities Whistleblower Incentives and Protection program on May 25, 2011. The rules, implemented under Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), reward whistleblowers for high-quality tips that lead to successful enforcement actions.

At a public meeting during which the SEC debated the efficacy of the new rules, SEC Chairman Mary Schapiro described the whistleblower program as "critical" to the SEC's ability "to leverage the resources of people who may have first-hand information about potential violations." The rules, she said, "are intended to break the silence of those who see a wrong."[*]

The proposed whistleblower program garnered extraordinary public comment. The implications of the final rules – among the most eagerly anticipated rulemaking promulgated under the Dodd-Frank Act – are significant. The following comprises the most significant aspects of the final rules for regulated entities, including but not limited to public companies, companies making non-public offerings, brokers and dealers, investment advisors, mutual funds, and securities exchanges:

1. The rules do not require a whistleblower to report potential securities laws violations internally through a regulated entity's compliance, legal, or audit procedures before submitting a tip to the SEC.

2. A whistleblower can receive a bounty based on an internal report, regardless of whether they report to the SEC, if the regulated entity later self-reports to the SEC.

3. The substantial whistleblower protections set out in the program apply regardless of whether there was an actual violation of the federal securities laws.

The following addresses these elements and other key issues related to the final whistleblower incentives and protection program.

Background

Section 922 of the Dodd-Frank Act authorizes the SEC to reward whistleblowers who provide it with original information that leads to a successful enforcement action by the SEC and/or certain state and federal regulators. On Nov. 3, 2010, the SEC unveiled its proposed whistleblower program under Section 922. To be considered for an award (or bounty) under the proposed program, a whistleblower must voluntarily submit to the SEC original information that leads to a successful judicial or administrative enforcement action by the SEC in which the SEC obtains monetary sanctions totaling more than $1 million.

On May 25, 2011, during an open meeting, SEC commissioners voted 3-2 in favor of adopting the final rules proposed by the SEC. The final whistleblower scheme, according to Chairman Schapiro, "is a result of the careful weighing of the comments which improved upon the earlier rules we proposed." The final rules so adopted will be codified in Section 21F of the Securities Exchange Act of 1934. The final rules will be effective 60 days after they are submitted to Congress or published in the Federal Register.

The Final Rules

Basic Rules Requirements

The adopted program defines a whistleblower as a natural person who submits to the SEC information related to a suspected ongoing or imminent violation of federal securities laws. To qualify as a whistleblower – and to be considered for a bounty – a whistleblower must meet the following requirements:

> (1) Voluntarily comes forward to the SEC (2) with original information about a violation of the federal securities laws (3) that leads to a successful judicial or administrative enforcement action brought by the SEC (4) in which the SEC obtains monetary sanctions totaling more than $1 million.

If a whistleblower satisfies all of these elements, he or she is *guaranteed* a bounty of 10-30% of the monetary sanctions obtained by the SEC. He or she may also be entitled to a share of any penalties recovered by certain government and regulatory agencies that bring enforcement or criminal proceedings relying on the same original information provided by the whistleblower.

Below we address the four criteria and other technical aspects of the final rules, with particular emphasis on any new elements in the adopted program from the original proposal.

Voluntarily Come Forward

The SEC made some subtle but important changes to the definition of "voluntary." Simply put, to satisfy the voluntary element under the final rules, a whistleblower must submit information to the SEC *before* it, the Public Company Accounting Oversight Board (PCAOB), a self-regulatory organization, a state attorney general, a state securities regulatory authority, or the Congress asks for the same information.

Mere awareness of an investigation or other inquiry is not sufficient to prohibit a whistleblower from making a voluntary submission. And a request to an employer will not be treated as a request of all employees who fall within the scope of the request. A

tip or complaint will be regarded as voluntary so long as the whistleblower has not himself or herself been requested or compelled by a government or regulatory agency to provide information. Importantly, a whistleblower may still voluntarily submit information to the SEC after providing information to his or her employer during the course of an internal investigation.

For the purposes of determining eligibility for an award, persons with a preexisting legal or contractual duty to report violations of the federal securities laws to the SEC generally cannot be said to voluntarily furnish information. Certain exceptions exist, which are discussed below.

Original Information

The SEC declined to revise the "original information" requirement as proposed. In sum, under the final rules, "voluntary information" comprises information that is: (1) derived from the whistleblower's independent knowledge or independent analysis; (2) not already known by the SEC; (3) not exclusively derived from publicly available information, such as news reports; and (4) provided to the SEC for the first time after the enactment of the Dodd-Frank Act.

The rules define "independent knowledge" as "factual information in the whistleblower's possession that is not derived from publicly available sources." It does not require first-hand knowledge of a possible violation. "Independent analysis," on the other hand, means "the whistleblower's own examination and evaluation of information that may be generally available, but reveals information that is not generally available." This analysis may be done in combination with others.

Independent knowledge and independent analysis do not include information subject to the attorney-client privilege; information obtained by an independent public accountant through the performance of an engagement required by the securities laws; information obtained by audit or compliance personnel; or information obtained by illegal means.

Leads to a Successful Enforcement Action

After considering public comment, the SEC significantly modified – and relaxed – the requirement that original information submitted by a whistleblower "lead to a successful enforcement action." Under the final rules, there are three categories of information that may be considered to have led to a successful enforcement action.

1. **Information concerning conduct not under investigation or examination.** Information will be deemed to have led to successful enforcement action when it is sufficiently specific, credible and timely to cause the SEC to open a new examination or investigation, reopen a closed investigation, or open a new line of inquiry in an existing examination or investigation, *and* the SEC brings a successful enforcement action based on the original information provided.

2. **Information concerning conduct already under investigation or examination.** Information will be deemed to have led to successful enforcement action when it "significantly contributed" to the success of the action.

3. **Information reported through internal compliance programs.** Information will be deemed to have led to successful enforcement action if: (1) a whistleblower reports original information through his or

her employer's internal compliance or reporting procedures before or at the same time it is passed along to the SEC; (2) the employer provides the whistleblower's information and/or any information discovered during its subsequent internal investigation to the SEC; and (3) the employer's report leads to a successful enforcement action, as described above.

Monetary Sanctions Totaling More than $1 million

The SEC also made important changes with regard to how it will calculate whether the monetary sanctions obtained in an enforcement action exceed the $1 million threshold. The original rules required that the threshold amount stem from a single captioned judicial or administrative proceeding. The final rules, however, permit the aggregation of monetary sanctions obtained in two or more SEC proceedings that arise out of a common nucleus of operative facts. These may include proceedings involving the same or similar parties, factual allegations, alleged violations of the federal securities laws, or transactions or occurrences. The "monetary sanctions" the SEC will consider comprise all amounts that are "ordered to be paid" in an SEC action, including but not limited to penalties, disgorgement, and interest.

Categories of Persons Not Eligible for Whistleblower Awards

The proposed rules carved out several classes of persons who are generally ineligible to receive a whistleblower award. According to Chairman Schapiro, in its proposed rules, the SEC "sought to exclude too many important, potential whistleblowers." Thus, the final rules alter the proposed system in two respects. First, they clarify and narrow the categories of persons excluded from consideration for an award. Second, and perhaps more significantly, the final rules add several exceptions to the general proscriptions.

As a general matter, the final rules exclude from eligibility for a whistleblower award persons with legal, compliance, supervisory, or related responsibilities. As amended in the final rules, the categories of persons who generally will not be considered for a bounty under the final rules include:

- Anyone with a preexisting legal, contractual or judicially mandated duty to report to the SEC potential violations of federal securities laws.
- External and in-house counsel who attempt to make whistleblower claims based on information obtained from attorney-client relationship. Exceptions exist where disclosure of the information is permitted under SEC or state bar rules.
- People deemed by a U.S. court to have obtained information by illegal means.
- Foreign government officials.
- Officer, directors, trustees or partners of an entity who learn of the alleged misconduct from another person, or who learn the information through the company reporting or compliance processes.
- Compliance and internal audit personnel.

- Public accountants, if the information relates to potential violations by the engagement client.

As mentioned above, the final rules create new exceptions pursuant to which compliance and internal audit personnel may be eligible for whistleblower bounties. According to Chairman Schapiro, these exceptions create avenues for "vital information" to get to the SEC. Compliance and internal audit staff otherwise proscribed from eligibility for a whistleblower award may become whistleblowers entitled to a bounty in the following circumstances:

- The compliance or internal audit staffer believes disclosure may prevent harm to the regulated entity or its investors;

- The compliance or internal audit staffer believes the entity is engaging in conduct that will interfere with an ongoing investigation; or

- 120 days or more have passed since the entity's audit committee, chief legal officer, or chief compliance officer became aware of the information. This exception merely sets out the time period after which compliance or internal audit personnel are no longer ineligible to make a whistleblower submission.

It should be noted that the new exceptions do not permit attorneys to disclose privileged information, nor do they authorize independent public accountants to disclose information obtained in the course of SEC engagements.

Also note, elsewhere in Dodd-Frank, employees of certain government and regulatory agencies are expressly excluded from consideration for a whistleblower award. Similarly, people who are criminally convicted in connection with the violation(s) of the federal securities laws may not be considered for a bounty.

The Amount of an Award

An eligible whistleblower who voluntarily submits to the SEC original information that leads to a successful judicial or administrative enforcement action by the SEC in which the SEC obtains monetary sanctions totaling more than $1 million, is guaranteed a bounty of 10-30% of the total monetary sanctions collection in SEC and related enforcement actions. In cases involving multiple whistleblowers, the total amount awarded to all informants cannot exceed 30% of the sanctions collected.

In determining the amount of any award, the SEC must consider four criteria: (1) the significance of the information submitted; (2) any further assistance provided by the whistleblower; (3) the "law enforcement interest" in making an award; and (4) the whistleblower's participation in internal compliance processes. The final rules set out a number of optional considerations the SEC will take under advisement. Chairman Schapiro has indicated that, "in deciding upon the appropriate amount of an award," the SEC will be particularly interested in "the timeliness and quality of a whistleblower's assistance."

The SEC will also consider three criteria that may *decrease* the amount of any award, including: (1) the culpability of the whistleblower for the underlying violation(s); (2) the whistleblower's unreasonable delay in reporting the violation(s); and (3) evidence that the whistleblower in any way interfered with an entity's internal compliance and reporting.

The final rules make one noteworthy change with regard to the determination of the amount of an award. They add a paragraph making clear that the determination lies solely in the SEC's discretion.

Internal Compliance Programs

The Internal Reporting Debate

During the rulemaking process, no issue was more vigorously debated than the rules' potential impact on internal compliance and reporting programs. Proponents of the rules argue that there is no value in requiring whistleblowers to report alleged violations internally before informing the SEC. Such a mandate, they insist, would have a chilling effect on would-be whistleblowers who fear retaliatory termination or work in environments where the only recourse is reporting up to the alleged wrongdoer.

Meanwhile, detractors say a set of rules without an internal reporting requirement will undermine internal audit, compliance, and reporting policies and procedures required to be implemented under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The promise of a substantial bounty only encourages whistleblowers to bypass internal compliance altogether. The rules, they say, provide no real incentive to report internally.

Much to the chagrin of corporate America, the final whistleblower rules do not require whistleblowers to report internally before submitting tips and complaints to the SEC. During his remarks on the final rules, Director of the SEC's Division of Enforcement Robert Khuzami noted four reasons the SEC declined to implement an internal reporting requirement:

1. The SEC was not presented with – and is not aware of – any empirical data demonstrating that the absence of a mandatory reporting requirement will undermine internal compliance and reporting programs.

2. The SEC believes regulated entities take seriously their obligations as corporate citizens, and those entities will continue to design and implement effective compliance programs regardless of the rule. The SEC is also of the view that effective programs will attract internal reports.

3. The SEC believes a rule that does not impose a reporting requirement is consistent with legislative intent. In Section 922 of the Dodd-Frank, Khuzami explained, Congress' aims were to encourage whistleblowers to come forward to the SEC with high-quality tips, and to protect whistleblowers who do so. Congress devised a tool designed to increase the effectiveness of enforcement by helping the Division of Enforcement identify frauds, stop them early, and thereby prevent small frauds from growing.

4. The SEC found nothing in Dodd-Frank purporting to require internal reporting as a condition of eligibility for a bounty.

The SEC believes that an internal reporting requirement would be of no use in many circumstances, and may have a detrimental effect. Khuzami argued that in "boiler rooms," "pump-and-dump," Ponzi schemes and similar frauds, there is "no point in requiring internal reporting." Entities that are engaged in such schemes typically do not

have a legitimate compliance program or internal reporting mechanism available; the whistleblower would effectively be reporting up to the alleged wrongdoer.

Requiring whistleblowers to report internally, Khuzami said, "would place an undue and additional burden on whistleblowers" and likely deter persons with knowledge of fraud from coming forward. As it stands, the final rules leave the decision to the whistleblower – the person best equipped to make a judgment as to the expediency of internal reporting.

New Internal Reporting Incentives

Although it declined to adopt an internal reporting requirement, according to Chairman Schapiro, the final rules strike a proper balance, "a balance between encouraging whistleblowers to pursue the route of internal compliance when appropriate – while providing them the option of heading directly to the SEC." It is essential, she said, to leave both avenues open to potential whistleblowers who are "in the best position to know which route is best to pursue."

Still, recognizing the "extremely valuable role" internal compliance programs play in fraud prevention, Chairman Schapiro noted that the final rules "expand upon incentives for whistleblowers to report internally" in three significant ways.

First, the rules lengthen the period of time a whistleblower can wait before submitting information to the SEC after reporting internally. The rules proposed in November 2010 provided whistleblowers a 90-day "grace period" from the date of an internal report to come forward to the SEC with the same information. The final rules grant a 120-day grace period for whistleblowers who report internally to submit the same original information to the SEC. Individuals will be regarded as a "whistleblower" from the date he or she reports internally and, thus, preserve their "place in line" for an award.

The Director of Enforcement has made it clear that the 120-day grace period should not be construed as creating any expectation or requirement for the time in which companies should self-report violations. Regulated entities should conduct a reasonable internal inquiry into the reported violation, bearing in mind that the SEC "still expects companies to report on a timely basis."

Second, the rules provide that a whistleblower's utilization of a regulated entity's internal compliance or reporting program(s) is a factor the SEC will consider in determining an award. Participation in internal reporting procedures cuts in favor of an increase in the amount of any award.

Third, and most significantly, in an effort to balance arguments regarding internal reporting, the SEC devised a system that rewards whistleblowers for internal reporting. The final rules make an internal whistleblower eligible for an award, regardless of whether the whistleblower separately submits the same original information to the SEC, if the company subsequently self-reports to the SEC information that leads to a successful enforcement action. The rules do not set out a timeframe during which the regulated entity must report. In appropriate circumstances, companies are expected, as ever, to timely report potential violations. Importantly, the whistleblower is entitled to an award based on all the information the company provides to the Division of Enforcement – not just the information or tip the whistleblower reported internally. The effect, said the SEC, is larger awards for whistleblowers.

Awarding Culpable Whistleblowers

The final rules allow persons culpable for the underlying violation(s) of securities laws to qualify for a bounty by exposing the wrongdoing. The SEC sought to balance the competing interests of incentivizing culpable whistleblowers to report violations of the federal securities laws, while prohibiting culpable whistleblowers from benefiting from their own misconduct or the misconduct of others for which they are largely responsible. To that end, the SEC will look at the culpable whistleblower's conduct and determine what role they played in the fraud.

The SEC may determine the whistleblower was so involved in the fraud that he is not deserving of an award. The SEC may, however, decide a whistleblower's bounty should simply be decreased based on the nature and scope of his or her involvement. The rule is designed to encourage "less culpable" whistleblowers to come forward, knowing they may still qualify for a reduced payout.

In addition, for the purposes of calculating whether the $1 million threshold has been met, the SEC will not include monetary sanctions paid by the culpable whistleblower or monetary sanctions paid by persons or entities whose misconduct occurred at the direction, planning or initiation of the whistleblower.

It should be noted, culpable whistleblowers are automatically – and completely – excluded from eligibility for an award if they are found criminally liable for the underlying fraud.

Anti-Retaliation Protections

The final rules make clear that its whistleblower protections apply to anyone who provides information to the SEC or internally, regardless of whether it leads to a successful enforcement action, as long as the whistleblower possesses a *reasonable belief* that the information submitted relates to a possible violation of the federal securities laws. The rules protect individuals who make disclosures of wrongdoing under the Sarbanes-Oxley, the Securities Act of 1934, federal statutes relating to investigative officers, or disclosures under any law, rule or regulation of the SEC.

The final rules impose extensive anti-retaliation protections for whistleblowers, including reinstatement for terminated whistleblowers, double back pay plus interest, and reimbursement of legal costs and fees. Whistleblowers are permitted to file complaints of retaliation directly with a federal district court, instead of initiating their complaint with OSHA, as required under the Sarbanes-Oxley regime.

Office of the Whistleblower

The Dodd-Frank Act required the SEC to establish a separate whistleblower office within the Division of Enforcement. The group's mandate is to triage whistleblower tips and complaints, work with whistleblowers to cultivate leads, and help the SEC determine the amount of an award in appropriate cases. With regard to the former, the office will employ an online system designed to harvest and analyze whistleblower tips and complaints.

The Office of the Whistleblower, formed earlier this year and headed up by Sean McKessy, is now staffed and operational. In anticipation of extensive payouts under those provisions, the SEC announced in late October that it has already established an Investor Protection Fund of more than $450 million for use in paying out whistleblower awards. The Investor Protection Fund, which will be used to pay bounties to eligible

whistleblowers, has been fully funded.

Assessing the Effectiveness of the Final Rules

The SEC insists the whistleblower program is already having a positive impact on its ability to identify and stop violations of the federal securities laws. From the day Dodd-Frank was signed into law, the SEC experienced an appreciable uptick in whistleblower tips and complaints. According to the SEC, these include numerous high-quality tips. During the SEC open meeting on May 25, 2011, Chairman Schapiro mentioned "stories from our investigators about how whistleblowers have [already] saved us weeks of investigation time because of the specific, credible and timely information they provided." Another SEC representative described a recent matter in which a whistleblower's cooperation saved the SEC six to twelve months of investigation.

While the consequences sound promising from the SEC's perspective, time will reveal the true impact of the final whistleblower rules. In declining to support the final whistleblower program as written, Commissioner Casey posed several questions that we should bear in mind in evaluating the rules:

1. Going forward, how will the SEC evaluate the effectiveness of the program? What kind of metrics will they track?

2. How will the SEC measure the rules' impact on internal compliance programs?

3. How will the SEC assess the quality of tips it actually receives, and weight that against any unintended consequences?

Commissioner Walter, for one, does not believe the SEC's work is done in this area. While she supports the final rules, she insisted "the staff must remain open to improving the whistleblower program as we implement it."

Key Takeaways

For regulated entities, the key takeaways are clear: develop, improve and promote internally your compliance and reporting policies and procedures. This might include reviewing and updating your internal whistleblower programs, putting in place a dedicated team to review internal complaints, and establishing procedures for handling tips.

In devising and advertising your legal, audit, or compliance programs, companies should stress three issues that will likely be essential to attracting internal reporting:

1. The SEC will award higher bounties for whistleblowers who report internally *before* submitting a tip to the SEC.

2. Whistleblowers who report internally are eligible for a whistleblower bounty from the SEC *whether or not* they submit a tip to the SEC, if the company self-reports. The bounty will be based not just on the whistleblower's knowledge, but on *all information* the company submits to the SEC.

3. Both the company and the whistleblower rules have strong anti-retaliation policies designed to protect whistleblowers who come forward with evidence of a violation.

Chairman Schapiro has emphasized the need for companies to "create an environment" where employees will take "seriously" compliance and reporting programs. A program that keeps these three elements in mind may be just the right incentive for employees to take your internal reporting program seriously.

For additional information and updates on the whistleblower rules, please see the McGuireWoods blog: http://www.subjecttoinquiry.com/whistleblowers

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[*] In this white paper, we rely on a number of SEC source materials, including: Press Release, SEC, SEC Adopts Rules to Establish Whistleblower Program, available at http://sec.gov/news/press/2011/2011-116.htm); SEC Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 17 CFR Parts 240 and 249 (2011), available at http://sec.gov/rules/final/2011/34-64545.pdf; Chairman Mary L. Schapiro, Speech by SEC Chairman: Opening Statement at SEC Open Meeting: Item 2 – Whistleblower Program (May 25, 2011), available at http://sec.gov/news/speech/2011/spch052511mls-item2.htm; Commissioner Luis A. Aguilar, Speech by Commissioner: Incentivizing Whistleblowers to Bring Fraud to Light (May 25, 2011), available at http://www.sec.gov/news/speech/2011/spch052511laa-item2.htm; Commissioner Elisse B. Walter, Speech by SEC Commissioner: Opening Statement – Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), available at http://www.sec.gov/news/speech/2011/spch052511ebw-item2.htm; Commissioner Troy A. Paredes, Speech by SEC Commissioner: Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), available at http://www.sec.gov/news/speech/2011/spch052511tap-item2.htm. In addition, we rely on notes taken during the SEC's May 25, 2011 Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934.