THE SEC WHISTLEBLOWER PROGRAM UNDER THE DODD-FRANK ACT

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You have undoubtedly heard in recent months that the Securities and Exchange Commission (SEC or the Commission) has proposed a new whistleblower program under the auspices of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). What you may not realize is that the *final rule* is expected to be released *in mid-April* – just a few weeks away. With that in mind, we want to take a moment to bring you up to speed on how the proposed rules work and suggest some steps you might take to meet the challenges presented by the new whistleblower program.

ANTICIPATING THE FINAL RULE

On Nov. 3, 2010, the Commission proposed a new whistleblower program, as required by Section 922 of the Dodd-Frank Act. At the Commission's request, the public was encouraged to comment on the proposed scheme through Dec. 17, 2010. Since the window for public comment closed, the Commission has been weighing up comments and revising the proposed rules in preparation for the mid-April release.

The commentary on the proposed rules is varied, with commenters vigorously disagreeing on the impact of the new rules and whether they capture legislative intent. But critics generally agree on two issues. *First,* there is a common belief the new rules will provide a windfall to whistleblowers, and the so-called "lottery" or "jackpot" awards authorized by the rule will incite a torrent of unreliable tips and complaints. *Second,* there is a genuine fear the new rules will significantly undermine corporate regulatory compliance efforts and disincentivize internal reporting.

Yet, the Commission believes it struck a careful balance in the proposed rules, and pundits expect few changes in the final version. For example, despite repeated calls for setting up some form of internal reporting requirements, the Commission has not indicated an inclination to set up a mandatory reporting regime.

THE NEW DODD-FRANK SCHEME

As currently written, the proposed whistleblower program will handsomely reward individuals who voluntarily provide original, high-quality information that leads to a successful enforcement action in which the SEC obtains sanctions in excess of $1 million. The new scheme promises would-be whistleblowers 10-30% of any monetary penalties collected in the Commission's enforcement action *and* related actions that rely upon the same information.

Under the proposed rules, a "whistleblower" is a natural person who, alone or jointly with others, provides information to the Commission relating to a potential violation of the securities laws. To qualify for an award under the new rules, a whistleblower must satisfy the following four requirements:

1. *voluntarily* provide the Commission
2. *original information* about a violation of federal securities laws
3. that leads to *a successful enforcement action*
4. resulting in *monetary sanctions totaling more than $1 million*

If all of these elements are met, a whistleblower is guaranteed an award – or "bounty" – of 10-30% of the monetary penalties the Commission recovers. The whistleblower may also be entitled to recover a portion of any sanctions recovered in related enforcement or criminal actions that rely upon the same original information, including criminal proceedings brought by the DOJ and enforcement actions undertaken by certain other regulatory agencies.

In practice, satisfying the four criteria may prove to be somewhat difficult. The 181-page whistleblower rules proposal includes many narrowly defined terms and carefully delineated conditions and procedures a would-be tipster must follow to qualify for a bounty. We address some of the more esoteric elements below.

Voluntarily Come Forward. In general, a whistleblower provides information "voluntarily" only if he or she comes forward before the government, the Commission, a self-regulatory organization, or the Public Company Accounting Oversight Board institutes a formal or informal investigation or requests or subpoenas information from the would-be whistleblower's employer. This is purely a timing issue. If an inquiry has already been undertaken, a would-be whistleblower will not qualify for an award by coming forward with information, and he or she cannot regain "voluntary" status by providing information outside the scope of a pending government request.

Original Information. "Original information" encompasses two categories of information: (1) information based on a whistleblower's "independent knowledge" or (2) information rooted in a whistleblower's "independent analysis."

"Independent knowledge" is defined in the proposed rule as factual information in the whistleblower's possession that is not obtained from publicly available sources. The whistleblower needn't have direct, first-hand knowledge of the information or of a potential violation of federal securities laws. Things observed, or information conveyed by third parties, may constitute "independent knowledge." However, information that is already known to the Commission or derived exclusively from certain public sources will not amount to "independent knowledge."

Independent analysis" must derive from a whistleblower's own (or collaborative) examination and evaluation of information. This might include the discovery of a federal securities laws violation while completing a work-related task or project. The key to independent analysis is whether the would-be whistleblower unearthed the potential violation while examining or interpreting corporate information, and voluntarily came forward with his or her conclusions.

Successful Enforcement Action by the SEC in a Federal Court or Administrative Proceeding. A whistleblower's tip might lead to a "successful enforcement action" in two circumstances: (1) if the information results in a new examination or investigation being opened and significantly contributes to the success of a resulting enforcement action or (2) if the conduct was already under investigation when the information was submitted, but the information is indispensable to the success of the action, which might not otherwise have been obtained.

Sanctions Exceeding $1 Million. The proposed rule does not make clear whether this provision requires a minimum recovery of $1,000,001. The rule repeatedly refers, however, to sanctions "*exceeding*" or "*totaling more than*" $1 million. Thus, as a practical matter, we believe $1,000,001 is the minimum recovery necessary for a whistleblower to qualify for a bounty under the new rules. For the purposes of calculating the $1,000,001 threshold, the Commission will only consider sanctions recovered in a single captioned civil or administrative proceeding. The Commission will not aggregate sanctions imposed in separate enforcement actions, even if the Commission elects to bring multiple suits arising from the same fraud. The whistleblower is only entitled to an award in any *single* action that meets the $1,000,001 minimum.

Limitations on Whistleblower Status. In addition to the four elements described above, the proposed rules outline careful limitations on who can qualify for whistleblower status.

The whistleblower must be a "natural person," meaning companies and other legal entities cannot be whistleblowers. This is marked departure from the False Claims Act, which allows corporate entities and professional whistleblower companies to be eligible for whistleblower awards.

The proposed rules also carve out certain classes of people who are not eligible for whistleblowers awards. The most noteworthy groups include the following:

1. Individuals who have a clear, pre-existing legal or contractual duty to report their potential violations of federal securities laws. This would include members of regulatory agencies or law enforcement agencies.

2. Attorneys who attempt to use information obtained from client engagements to make whistleblower claims. Exceptions exist where disclosure of the information is permitted under SEC rules or state bar rules.

3. Independent public accountants who obtain information through an engagement required under the securities laws.

4. Individuals who learn about potential violations through a company's internal compliance program and corporate executives who obtain

information with the expectation that they will take appropriate steps to respond to the violation. There may be exceptions to this proviso, however, if the compliance officer or executive comes forward because a company, in bad faith, refuses to report a known violation.

In addition, the SEC will not compensate whistleblowers where liability in a successful enforcement action is predicated substantially on conduct that the whistleblower directed, planned, or initiated. The Commission does not believe such individuals should share in the monetary sanctions imposed in an enforcement action. The purpose of this provision is to prevent wrongdoers from earning a bounty by blowing the whistle on themselves.

Preserving Whistleblower Status. As currently written, the program provides that a whistleblower must report to the SEC within 90 days after reporting the same information internally, or lose his or her whistleblower status (and access to an SEC bounty). As long as the whistleblower comes forward within this 90-day grace period, he or she will keep their "place in line" for a possible award from the Commission. The report will be deemed effective as of the date of the internal report.

The "Bounty" Provisions of the Proposed Rule. The Commission will pay an award or awards of at least 10% (and no more than 30%) to one or more whistleblowers who provide information critical to the success of an enforcement action. The proposed rule sets out a number of factors the Commission will consider in determining the amount of any award, including the significance of the information provided to the success of the enforcement action, the Commission's "programmatic interest" in deterring the particular securities violations, and whether an award "otherwise enhances its ability to enforce the federal securities laws and encourages the submission of high-quality information from whistleblowers."

The proposed rule also spells out circumstances in which the Commission will pay an award based on monetary sanctions obtained in a "related action," including criminal proceedings and enforcement matters brought by the attorney general of the United States, certain regulatory agencies, a self-regulatory organization, or a state attorney general that rely upon the same original information provided by the whistleblower.

Whistleblowers who first submit information through their internal compliance reporting programs or to other regulatory agencies have 90 days from the provision of such information to submit the necessary whistleblower forms to the Commission in order to protect their whistleblower status.

PREPARING FOR THE FINAL RULE: TAKE A PROACTIVE APPROACH

There are a number of weeks left before the final whistleblower rules are released, and companies should take this opportunity to review internal compliance and reporting programs, as well as internal investigations procedures. This is an excellent time to create or bolster internal initiatives that encourage and reward employees

who report potential securities laws violations through hotlines or other in-house reporting mechanisms. Generally speaking, proactive approaches might include the following: actively promote your company's internal reporting programs; simplify and publicize reporting procedures; or take strides to make policies more accessible and easy to understand.

As written, the program provides a 90-day window for whistleblowers to preserve their whistleblower status. Even if the period is lengthened to 180 days, as the Commission has suggested, this leaves companies with a fairly small window of opportunity to investigate, self-report, and/or take other remedial measures.

Take notice, however, that the proposed rules *do not* require a whistleblower to *wait* 90 days before going to the Commission with the same information reported internally. In fact, the proposed rules *do not* require an employee to report internally before going to the Commission. A whistleblower can report to the Commission without availing himself of internal compliance mechanisms, and at any time after he does report internally, should he choose to do so. This means a company may have little or no notice before it must launch a vigorous and efficient internal investigation. As such, we recommend companies consider the steps outlined below.

Make sure your internal compliance and reporting mechanisms are well-oiled. The SEC has reported a noticeable increase in tips and complaints from would-be whistleblowers, and internal reporting hotlines and procedures may experience a similar uptick. In order to properly sift through and analyze tips, compliance departments must be well-equipped to handle the surge.

Evaluate and consider revamping internal investigation procedures. It is essential to have a strong internal investigations group that can probe complaints quickly and efficiently. When a company receives a valid tip internally, time will be of the essence, and companies need to be prepared to expeditiously investigate complaints, devise a strong strategy to address legitimate complaints, and embark on a remedial course.

Review and consider revising your company's anti-retaliation policies. Dodd-Frank protects a significantly broader spectrum of disclosures than the anti-retaliation protections set out in Sarbanes Oxley. Make sure your policies are in sync, and advertise your policies internally. It is important for employees to know how to report. Equally, it is critical that employees know they will not face repercussions for reporting issues of concern.