

ClientAlert

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SEC Proposes New Whistleblower Program Under Dodd-Frank Act

On November 3, 2010, the US Securities and Exchange Commission (the "SEC") proposed rules to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") mandate to set up a bounty program to pay awards to eligible whistleblowers reporting federal securities law violations. The whistleblower program, and the SEC's proposed rules implementing it, have the potential to undermine corporations' efforts to monitor their own compliance with applicable laws and regulations, investigate potential instances of non-compliance, and take appropriate remedial measures, and should be carefully considered by corporate managers and legal staff.

Under the proposed rules, the SEC will pay monetary awards of between 10 and 30 percent to persons who voluntarily provide original information to the SEC that leads to successful enforcement actions by the SEC or the US Commodity Futures Trading Commission (the "CFTC") resulting in monetary sanctions totalling more than US\$1 million. The rules, which according to Commissioner Casey have "the potential to reshape the corporate compliance landscape in undesirable ways," are being closely followed by companies due to concerns that the new regime would encourage potential whistleblowers to bypass internal reporting mechanisms in hopes of collecting awards under the SEC's reporting program. This Alert summarizes some of the key aspects of the whistleblower proposal and outlines certain practical considerations for public companies in light of the new regime.

When Will the New Provisions Be Effective?

The SEC is seeking public comment on the whistleblower proposal through December 17, 2010. Final regulations must be adopted by the SEC no later than April 21, 2011 (nine months from enactment). However, because the new statutory provisions apply to any original information provided to the SEC after July 21, 2010, the SEC plans to adopt final regulations before the prescribed deadline.

Whistleblower Protections Before Dodd-Frank Act

Three statutes already on the books before the Dodd-Frank Act's enactment provide incentives or protections to whistleblowers.

The Sarbanes-Oxley Act of 2002 ("SOX") requires corporations to establish internal procedures to allow for the confidential reporting of incidents of fraud, and prohibits any retaliatory action against a whistleblower who has brought wrongdoing to the attention



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of a company supervisor or a regulatory or law enforcement official. SOX provides for civil and criminal penalties for retaliation against whistleblowers. SOX does not, however, incentivize individuals, financially or otherwise, to provide information to external authorities. Since its enactment in 2002, corporate compliance and legal advisors have extended significant efforts to implement internal compliance programs and other mandates of SOX. The Dodd-Frank Act extends the whistleblower protection provisions of SOX to cover employees of certain affiliates and subsidiaries of public companies.

The Securities Exchange Act of 1934 (the "Exchange Act") provides for financial rewards to individuals who provide information to the SEC regarding insider trading. However, the decision to provide an award is discretionary rather than mandatory, and the awards are capped at 10 percent. The provision is so underutilized that, according to a March 29, 2010 Office of Inspector General Report, since the inception of the SEC's program in 1989, only five individuals have received awards under the program, totaling US\$159,537.

The False Claims Act (the "FCA") provides a strong financial incentive to individuals who report fraud on the government. Such whistleblowers are entitled to receive between 15 and 30 percent of any award the government receives. If the government chooses not to pursue the claim, the whistleblower may pursue it independently.

Overview of the Dodd-Frank Whistleblower Program

Whistleblower Eligibility Requirements

Under the proposed rules, a whistleblower is a person who, alone or jointly with others, provides information to the SEC relating to a potential violation of the US federal securities laws, including the Foreign Corrupt Practices Act of 1977 (the "FCPA"). A whistleblower must be a natural person. A company or other entity is not eligible to receive a whistleblower award. In order to be eligible for an award a whistleblower must (i) voluntarily provide the SEC, (ii) with original information, (iii) that leads to the successful enforcement by the SEC of a federal court or administrative action, (iv) in which the SEC obtains monetary sanctions totaling more than US\$1 million. The SEC will also grant awards based upon monetary sanctions that are collected in a "related action." The related action must be based upon the same original information that led to a successful

enforcement of the SEC action and must be brought by the Attorney General of the United States, an appropriate regulatory agency, a self-regulatory agency or a state attorney general in a criminal case. In an attempt to avoid rewarding whistleblowers for blowing the whistle on themselves, the proposed rules are explicit that people who are criminally convicted in connection with the misconduct are not eligible for awards. The law is silent, however, on effect of a civil judgment, which, in the words of Commissioner Aguilar," leaves open the possibility that some wrongdoers could get awards." The proposed rules allow those who are culpable to receive awards unless they are criminally convicted. The expectation is that the SEC will receive comments saying that this is inadequate to avoid rewarding culpable behavior.

The scope of claims for which a Dodd-Frank Act whistleblower may potentially receive a financial award is broad. Any action brought by the SEC under the Securities Act of 1933, the Exchange Act, the Investment Advisers Act of 1940, the Investment Company Act of 1940 or the FCPA or brought by the CFTC under the Commodity Exchange Act will be eligible under the new provisions. This is more expansive than the reward provisions in the Exchange Act, which apply exclusively to issues of insider trading, and the FCA, which cover frauds perpetrated against the government. On the other hand, the Dodd-Frank Act is narrower than the FCA in that it requires the monetary sanctions to meet a threshold set forth by the Act (i.e., US\$1 million) as a condition to recovery, and, unlike the FCA, it does not provide for a private cause of action if the government declines to pursue litigation or enforcement.

Voluntary Submission Requirement

Under the proposed rules, whistleblowers are eligible for awards only when they provide original information to the SEC "voluntarily." Proposed Rule 21F – 4(a)(1) defines a submission as "voluntary" if the submission is made before the individual receives any request from the SEC, Congress, any government authority, any self-regulatory organization, or the Public Company Accounting Oversight Board about a matter to which the information submitted is relevant. Proposed Rule 21F – 4(a)(3) provides that submissions from certain individuals who have a pre-existing legal or contractual duty to report securities violations to the SEC will not be considered "voluntary" for purposes of Section 21F. Individuals who report internally are not barred from recovery (as discussed in greater detail below). Individuals who report directly to the SEC, bypassing any mandatory internal reporting mechanisms, remain eligible for awards under the proposed bounty program.

Original Information Requirement

In order for a submission to be considered “original information,” it must be derived from the whistleblower’s independent knowledge or analysis, not already known to the SEC from any other source, not exclusively derived from certain public sources (unless the whistleblower is the source of the information), and provided to the SEC for the first time after July 21, 2010 (i.e., the date of enactment of the Dodd-Frank Act). Significantly, the SEC’s proposed definition of “independent knowledge” does not require that a whistleblower have direct, first-hand knowledge of potential violations. Instead, knowledge may be gained from experience, communications and observations in the whistleblower’s business or social interactions.

Information will not be considered to derive from an individual’s “independent knowledge” or “independent analysis” in the following circumstances (subject to certain limitations and exceptions):

- Attorneys who obtain privileged information or attorneys who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules).
- Independent public accountants who obtain information through an engagement required under the securities laws.
- Individuals who learn information because of their compliance or similar responsibilities within a corporation, or otherwise through a company’s internal compliance program, if the information was reported to such person with an expectation that responsive steps would be taken, unless the company does not disclose the information to the authorities within a reasonable time or acts in bad faith.
- Individuals who acquire information by a means or in a manner that violates applicable federal or state criminal law. Additionally, the following individuals are also ineligible to receive an award: individuals convicted of a criminal violation that is related to the SEC’s action or to a related action for which such individual otherwise could receive an award; foreign government officials; employees of certain regulatory agencies, the Department of Justice, a self-regulatory organization, the Public Company Accounting Oversight Board or any law enforcement organization; persons who obtained the information through an audit of a company’s financial statements (where making a whistleblower submission would be contrary to the requirements of Section 10A of the Exchange Act); persons who obtained the information from any of the foregoing persons; and any spouse, parent, child or sibling of a member or employee of the SEC or person residing in the same household as a member or employee of the SEC.

Successful Enforcement by the SEC Requirement

If a whistleblower provides information about conduct that is already under investigation by the SEC, the whistleblower is eligible for an award only if he or she provides information essential to the success of the enforcement action that the staff would not have otherwise obtained in the normal course of the investigation. If a whistleblower provides information that is not related to conduct already under investigation, then such information would be deemed to have led to a successful enforcement if the information results in a new examination or the opening or reopening of an investigation and significantly contributes to the success of a resulting enforcement action.

Procedural Requirements

The proposed rules outline specific procedures for submitting “original information” to the SEC (under penalty of perjury) and making a claim for an award. The anti-retaliation protections of the Dodd-Frank Act, however, apply irrespective of whether a whistleblower satisfies all the procedures and conditions to qualify for an award under the whistleblower program.

Implications of the Proposed Dodd-Frank Whistleblower Program

Corporations are rightly concerned that the financial incentives of the Dodd-Frank Act may effectively undermine the efforts they have undertaken to establish effective internal compliance systems, motivated in large part by the policies of enforcement authorities such as the Department of Justice and the SEC itself, as well as the Federal Sentencing Guidelines. The program also raises the prospect that a company could in some circumstances lose the opportunity to avail itself of the benefits under those policies of investigating and self-reporting violations of law. Several aspects of the SEC’s proposal to implement the program are particularly problematic.

The proposed rules do not require an employee to first report allegations of wrongdoing to his or her company’s compliance department. Combined with the prospect of large cash awards, this creates an incentive to bypass internal compliance departments and report wrongdoing directly to external authorities. This incentive in turn could undermine corporate compliance programs by reducing the effectiveness of companies’ existing procedures for identifying, investigating, and responding to potential violations of federal securities laws. Another concern under the proposed rules is that whistleblowers might be encouraged not only to bypass internal compliance departments, but also to wait until a potential problem grows into a larger issue in order to increase their chance of collecting a significant financial award.

In an apparent effort to address some of these concerns, the SEC's proposal provides that an employee may submit an internal report and still be eligible for an award under the SEC's program, so long as he or she provides the information to the SEC within 90 days of submitting the internal report. Further, under the proposed rules, whistleblowers who initially go through internal reporting mechanisms could be rewarded with higher monetary awards, although the SEC's proposal does not mandate such increased awards or impose an automatic penalty for failure to use such an internal system. Also, in appropriate cases, the SEC's proposal indicates that it may contact a company that is the subject of a report, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back. While the SEC's proposal does not mandate this approach in any particular circumstances, it notes that this practice is relatively widely used and that it is expected to continue. The proposed rules also attempt to address another area of concern—a potential drastic increase in frivolous allegations—by requiring that all information be submitted under penalty of perjury and that anonymous whistleblowers be represented by counsel who will verify their identity.

What Should Public Companies Do Next?

In light of the increased protections afforded to whistleblowers under the Dodd-Frank Act whistleblower regime, companies would be well advised to reexamine their compliance programs. A whistleblower complaint to the SEC could result in significant costs to a company, both in terms of legal expenses and demands on the time of its employees. Therefore, companies should heighten the visibility of their reporting mechanisms and position themselves to be ready to effectively and efficiently respond to internal reports of potential wrongdoing. The following are a few steps for companies to consider in preparation for the new whistleblower regime:

- **Effective Internal Reporting Mechanisms.** Companies should evaluate and update their internal compliance programs to ensure they provide for effective internal reporting mechanisms. For example, a hotline program permitting employees to provide information anonymously and in real time promotes efficient, rapid reporting, and signals a company's commitment to compliance and good corporate citizenship. Companies should ensure that any reports received from employees through internal mechanisms remain confidential and, where appropriate, lead to prompt investigation and appropriate disciplinary action. Companies may also consider opening the hotlines or other reporting avenues to relevant third parties such as customers, suppliers or business partners.
- **Regular Employee Communications Regarding Compliance Policies and Existing Reporting Channels.** Companies should aim to provide ongoing company-wide outreach to educate employees regarding existing compliance policies and internal reporting channels to ensure that the programs set in place are being effectively utilized.
- **Internal Reporting Incentives.** Some companies have reportedly considered whether revising their compliance programs to provide for monetary awards or similar incentives may be appropriate to encourage employees to report potential misconduct within the company before submitting information to a government authority. Such awards are likely to be insignificant compared to the prospect of at least US\$100,000 potentially recoverable under the SEC's proposed bounty program. While companies may set up programs to incentivize internal reporting, they should be careful that these actions do not create incentives for false or overstated allegations and the basis for company-whistleblower disputes.
- **Training Programs.** Managers and human resources personnel must be trained to recognize and correctly handle reports of any improper conduct. Employees must be made aware of internal reporting mechanisms and must clearly understand the purposes for which such mechanisms are set up. Regular training of all employees, including management, regarding the scope of the federal securities laws may reduce the likelihood of employees reporting unfounded or mistaken claims to the SEC in the hopes of receiving a financial award.
- **Anti-Retaliation Policies.** The Dodd-Frank Act provides for substantial sanctions against a company that retaliates against a whistleblower. Companies should develop comprehensive anti-retaliation policies that provide strong protections for employees who use internal reporting mechanisms. This should encourage employees to come forward internally and may help identify and address potential issues prior to commencement of any costly and burdensome SEC investigation. In its investigations, the government will likely look for any evidence of retaliation, with the burden on employers to justify their actions.
- **Procedures to Address Reports to the SEC.** Companies should develop formal procedures for senior managers to rapidly respond to the SEC in the event of a whistleblower complaint. Such procedures should not only outline specific steps to be taken in the event of an SEC inquiry, but should also provide for independent internal investigations following the external disclosure by a whistleblower.
- **More Thorough Self-Reporting.** In many corporate investigations, it can be difficult to determine when actual wrongdoing has been found such that it is time to self-report. This process is now further complicated because a company will often wish to be as comprehensive as possible when self-reporting to avoid missing any issues that may have already been reported to the SEC by a whistleblower, and avoid creating an impression of inadequate or partial self-reporting.

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