SEC Approves Final Rules for Implementation of Dodd-Frank Whistleblower Program

Employers subject to the regulations of the Securities and Exchange Commission (SEC) should be aware that on May 25, 2011, the SEC, by a 3-2 party-line vote, approved final rules to implement the whistleblower program established pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). As discussed in prior advisories,[1] the Act, now codified at Section 21F of the Securities Exchange Act of 1934, created new financial incentives and protections for employees who disclose information about alleged violations of securities laws that subsequently lead to a successful SEC enforcement action.

Of particular consequence, the final rules do not require a whistleblower to make use of internal compliance reporting procedures before reporting to the SEC. The main criticism of the SEC's proposed whistleblower rules was that they actually encouraged whistleblowers to bypass internal compliance procedures and instead go straight to the SEC to collect their bounty. The SEC did very little to address this concern in finalizing the rules. Consequently, corporate compliance programs, in which companies have invested significant resources, may be undermined. In addition, companies may be incentivized to self-report minor issues which previously would have been investigated and remediated internally without government involvement.

Overview of Final Rules

Generally, the final rules authorize the SEC to pay an award to a "whistleblower" who "voluntarily" provides "original information" that "leads to [ ] successful enforcement" in which the SEC obtains monetary sanctions totaling more than $1,000,000.[2] Specifically,

1 *See* "SEC Proposes Regulations to Implement Dodd-Frank Whistleblower Program," December 2010, *available at* http://arnoldandporter.com/resources/documents/Advisory-SEC_Proposes_Regulations_to_Implement_Dodd-Frank_Whistleblower_Program_120310.pdf; "Whistleblower Incentives and Protections in the Financial Reform Act," July 2010, *available at* http://www.arnoldporter.com/public_document.cfm?id=16087&key=10H3.

2 The rules allow for aggregation of multiple SEC cases that arise out of the same nucleus of operative facts. Furthermore, the SEC will pay an award based on amounts collected in certain related actions. A related action is defined as a judicial or administrative action that is brought by the Attorney General of the United States, an appropriate regulatory authority, a self-regulatory organization or a state attorney general in a criminal case if based on the same information that the whistleblower voluntarily provided to the SEC that led the SEC to obtain sanctions totaling more than $1,000,000.

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the SEC may provide an award of between 10 to 30 percent of the total monetary sanctions collected.

Definition of Whistleblower: As set forth in the rules, a "whistleblower" is a person who provides the SEC with information relating to a possible[3] violation of the federal securities laws.[4] Generally, information is provided "voluntarily" if the information is provided before the SEC, Public Company Accounting Oversight Board or a self-regulatory organization directly requests the information from the whistleblower or his/her representative (e.g., an attorney).

Exclusion of Certain Key Types of Individuals: The provision of information will not be deemed voluntary if the individuals are required to report the information to the SEC as a result of a pre-existing legal duty, a contractual duty or a duty that arises out of a judicial or administrative order.

The Whistleblower Must Provide Original Information: Under the rules, "original information" is defined, in short, as information derived from the whistleblower's independent knowledge or independent analysis that is not already known to the SEC and that is not based on allegations made in judicial or administrative hearings or from particular public sources. These concepts are similar to those found in other whistleblower statutes, such as the False Claims Act. However, the rules also provide that the SEC will not consider information to be derived from independent knowledge or independent analysis if the information, among other things, was subject to the attorney-client privilege; if the information was learned in connection with the legal representation of a client; or generally if the potential whistleblower is an officer or director of the company, or a compliance or internal audit employee of the company.

A potential whistleblower, who is an officer, director, auditor, or compliance employee or is in a similar role identified in the rules, however, may be eligible for an award for information he or she received in one of these positions if: 1) the potential whistleblower has a reasonable belief that disclosure of the information to the SEC is necessary to prevent the relevant entity from engaging in conduct likely to cause substantial injury to the financial or property interest of the entity or investors, or that the relevant entity is engaging in conduct that will impede an investigation of such conduct; or 2) at least 120 days have elapsed since the potential whistleblower provided the information to responsible persons at the entity or to his or her supervisor, or at least 120 days have passed since the potential whistleblower learned the information if he or she received it under circumstances indicating that the responsible persons at the entity or the potential whistleblower's supervisor already knew the information. This differs from the proposed rules in that potential whistleblowers in the roles identified above only would have been award-eligible if the entity did not disclose the alleged misconduct to the SEC within a reasonable amount of time or if the entity proceeded in bad faith.

Criteria for an Award: The rules define "information that leads to successful enforcement" as: 1) information "sufficiently specific, credible and timely" to cause the SEC to open an examination or investigation, reopen an investigation, or to inquire concerning different conduct as part of an existing investigation or examination, and the SEC brings a successful action based on the information provided; 2) information about conduct already under investigation or examination that significantly contributed to the success of the action; or 3) information the whistleblower provides through an entity's whistleblower, legal or compliance procedures before or after the whistleblower provides the information to the SEC, the entity provides the information to the SEC (or information gathered in response to the whistleblower's notification), and the information provided to the SEC satisfies either (1) or (2) above.[5]

Of particular import, for award eligibility a whistleblower is not required to report through internal compliance processes before reporting to the SEC. According to the SEC, however, the final rules still seek to incentivize

3 In the adopting release, the SEC states that to constitute a possible violation, the information must have a "facially plausible relationship to some securities law violation."

4 A company or other entity is not considered a whistleblower.

5 Additional key terms are defined in the rules.

whistleblowers to utilize their internal compliance systems. For instance, a whistleblower's participation in internal compliance systems is one factor the SEC might take into account when determining the amount of a whistleblower's award. Also, as indicated above, the rules still authorize the SEC to provide an award to a whistleblower who reports internally and whose company passes the information to the SEC even if the whistleblower did not report to the SEC directly. Lastly, the rules give an employee who first reports information internally the benefit of the internal reporting date for purposes of the SEC whistleblower program, provided that the employee submits the same information to the SEC within 120 days of the initial disclosure.

Anti-Retaliation Provisions: Although the SEC has not proposed specific anti-retaliation provisions for whistleblowers specified in the Act, the Act prohibits employers from retaliating against employees who have acted lawfully in providing information to the SEC about alleged violations of securities laws. Employers are barred from firing, demoting or otherwise discriminating against an employee based on that employee's lawful disclosure of information or assistance with a SEC investigation. Under the Act, employees who have been discharged or discriminated against are given a private right of action to sue their employers for retaliation. However, according to the first federal court to interpret the anti-retaliation provisions of the Act, a valid cause of action requires that the employee either allege that the information was reported to the SEC or that the disclosure fell under the Sarbanes-Oxley Act, the Securities Exchange Act or other laws and regulations subject to the jurisdiction of the SEC that do not require reporting to the SEC.[6]

Significance

As noted above, the final rules do not require a whistleblower, in order to receive an award, to report alleged violations of securities laws through internal compliance processes before reporting to the SEC. This had been the principal criticism of the SEC's proposed rules. The only concession the SEC made to this criticism was to provide for a "relation back" period of up to 120 days. Thus, if a whistleblower goes first to his or her internal compliance group, and only later goes to the SEC, he or she can claim the date on which he or she reported to his or her compliance group as the relevant date for claiming the bounty, so long as that was within 120 days of going to the SEC. Perversely, this may strengthen the incentive to report to the SEC. If a company's internal compliance review is taking longer than 120 days, the whistleblower may feel compelled to go to the SEC for fear of losing the earlier "first-to-report" bounty measuring date. And, there is no requirement that the whistleblower report to an internal compliance group first.

These were the bases on which Commissioner Troy Paredes issued a statement dissenting from the SEC's adoption of these rules, with the support of Commissioner Kathleen Casey. As indicated by Commissioner Paredes, the SEC's refusal to require whistleblowers to report to their own internal compliance department before going to the SEC might have significant implications. For instance, following Sarbanes-Oxley, US corporations invested substantial resources in developing compliance programs to solicit and investigate employee concerns. However, individuals now have a financial incentive to report suspected impropriety to the SEC first and bypass a company's internal compliance procedures, potentially rendering internal compliance programs irrelevant.

In addition, as a consequence of the financial incentives under the rules, the number of self-reports to the SEC could increase substantially. In particular, the government previously made clear that it did not expect companies to disclose relatively minor non-systematic, one-off compliance issues. Thus, many such issues were handled through internal investigations conducted by company personnel without the need to self-report. One question raised by the new rules is whether this paradigm will continue to work in light of the new financial incentives for whistleblowers. Indeed, we are already aware of companies that have decided to self-report issues which, in years past, would have been handled internally.

6 *Egan* v. *TradingScreen Inc.*, No. 10 civ. 8202, 2011 WL 1672066 (S.D.N.Y. May 4, 2011).

While the final rules do include certain measures intended to encourage a whistleblower to report through internal compliance procedures, there might be little financial incentive to do so. For example, the final rules provide that a whistleblower's award may increase if the whistleblower reports through internal compliance before or at the same time he/she reports to the SEC. But any such increase remains within the SEC's discretion. Until it becomes evident that the SEC will increase the award if internal compliance procedures are followed, a whistleblower may have little incentive to report internally first.

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