SEC Proposes Regulations to Implement Dodd-Frank Whistleblower Program

In November 2010, the Securities and Exchange Commission (SEC) issued proposed rules to implement the whistleblower program established pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). These proposed rules follow an announcement from the SEC that it has established a $451.9 million fund to make awards to whistleblowers pursuant to the program. As discussed in a previous advisory[1], the Act, which is now codified as Section 21F of the Securities Exchange Act of 1934, created new financial incentives and protections for employees who disclose information about alleged violations of commodities and securities laws that subsequently lead to successful SEC or Commodity Futures Trading Commission (CFTC) enforcement actions. Separate and apart from the proposed rules, in early December, the SEC announced that the establishment of a standalone Whistleblower Office would be deferred due to budget uncertainty, with the functions of the whistleblower program assigned to current Enforcement Division staff. The SEC has requested comments on the proposed rules be submitted by December 17, 2010. This advisory discusses the proposed rules.

I. Overview of Proposed Rules

A. Financial "Bounties" for Certain Employees to Disclose Information

The Act authorizes the CFTC and SEC to provide monetary rewards to a "whistleblower" who "voluntarily" provides "original information" that "leads to successful enforcement" action under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 in which the SEC recovers monetary sanctions in excess of US$1 million in aggregate. The proposed rules define each of these key terms and, consequently, limit the scope of the program in several important ways.

1 *See* "Whistleblower Incentives and Protections in the Financial Reform Act," July 2010, *available at:* http://www.arnoldporter.com/public_document.cfm?id=16087&key=10H3.

Contacts

John A. Freedman
+1 202.942.5316

Richard L. Jacobson
+1 202.942.6975

Drew A. Harker
+1 202.942.5022

Matthew D. Keiser
+1 202.942.6398

For example, the proposed rules define "original information" as being derived from "independent knowledge" (meaning based on the whistleblower's experiences, communications, and observations, as opposed to public sources) or "independent analysis." While these concepts are familiar from other whistleblower statutes (such as the False Claims Act), the definition of "original information" goes on to contain an extensive carve-out that provides that information is not "original" if it is learned through (a) the attorney-client privilege; (b) in conjunction with information learned through engagement as an independent public accountant; (c) an illegal manner; or (d) a company's legal, compliance, audit, supervisory, or governance functions (so long as the corporation discloses the information to the SEC "within a reasonable time.") In its commentary describing these rules, the SEC notes that the carve out is intended to keep the new rules from providing incentives to undermine the attorney-client relationship, the traditional role of an independent accounting firm, or a company's own compliance programs.

In similar provisions, the proposed rules make clear that in order to be eligible to be a whistleblower, the individual cannot be employed by a government regulator or self-regulatory organization, nor can the individual have been convicted of a crime related to the conduct. The individual similarly cannot have obtained the information through the audit of the company's financial statements, or otherwise have a pre-existing legal duty to report the information to authorities.

The proposed rules define "voluntarily" to mean that the information is provided to the SEC before any government agency or self-regulatory organization requests it, either directly from the individual or from the individual's employer. The proposed rules do contain a carve out, however, that would allow an individual to be considered a whistleblower if their employer fails to provide documents or information from the individual to the SEC.

The proposed rules also define "leads to successful enforcement" to make clear that the information provided must be important to the resolution of the investigation. For example, with regard to conduct that previously had been unknown to the SEC staff, the information has to "significantly contribute" to the success of the action. Similarly, where the staff was already examining the conduct, the information has to be "essential to the success of the action" and could not have "otherwise been obtained."

B. Protections for Whistleblowers

The new proposed rules do not spell out the anti-retaliation provisions for whistleblowers specified in the Act—these rules will likely be issued in another release.

The proposed rules do provide, however, that a whistleblower may submit its information on an anonymous basis through counsel, and prohibit the SEC and its staff from disclosing "information that could reasonably be expected to reveal the identity of a whistleblower" unless and until such disclosure is required in conjunction with an enforcement action.

C. Procedures and Forms

The proposed rules contain extensive provisions that explain how the SEC is to establish the amount of the award and the criteria for determining the amount of the award. Consistent with the language of the Act, these rules provide that if the conditions are met, the award must be "at least 10 percent and no more than 30 percent of the monetary sanctions" that are collected. Notably, the pool of funds is not limited to the amount the SEC collects; the proposed rules specify that the pool of sanctions will include amounts "the other authorities are able to collect." The proposed rules specify that the SEC is to give notice on its website when a particular investigation has recovered in excess of $1 million. The proposed rules give the SEC considerable discretion in determining the amount of the award so long as it considers the significance of the information provided, the degree of assistance provided, the programmatic interest of the SEC to deter violations, and whether the award would otherwise enhance the Commission's ability to enforce the securities laws. The proposed rules also specify that if more than one whistleblower is eligible, the SEC determines what percentage each whistleblower receives, but that the total award will not amount to more than 30 percent of the total collections. The proposed rules also provide that the SEC's decision to make an award may be appealed. However, the amount of an award or the allocation among multiple whistleblowers is not appealable.

The proposed rules contain procedures for submitting original information, and include the following proposed forms: Form WB-DEC (Declaration Concerning Original Information Provided Pursuant to Section 21F of the Exchange Act) and Form TCR (Tip Complaint and Referral Form).

II. Significance

As noted in our prior advisory, the Act's whistleblower program provides serious financial incentives for individuals with knowledge of actual or potential securities violations to report them to the SEC. The SEC has already funded this program with over $450 million, suggesting that it believes the program has significant potential to assist in the identification, investigation, and prosecution of new matters.

In certain respects, the whistleblower program may undermine normal corporate compliance structures for addressing potential securities violations. Following Sarbanes-Oxley, US corporations invested significant resources in developing compliance programs to solicit and investigate employee concerns. The whistleblower program provides a powerful financial incentive for an individual, who might have previously alerted the company's compliance director, CEO, general counsel, or Audit Committee of suspected impropriety, to go directly to the SEC. While the proposed regulations mitigate some of this risk by making clear that professionals whose normal job functions include compliance matters (such as internal compliance personnel, legal counsel, and auditors) are ineligible for the whistleblower program (so long as the corporation discloses the information to the SEC within a "reasonable time"), there is nothing in the proposed rules that would dissuade individuals from going directly to the SEC rather than availing themselves of mechanisms their corporation makes available to address such issues. The proposed rules themselves note and solicit comments concerning the tension between the proposed whistleblower program and the operation of effective internal compliance programs; and also note that the whistleblower program can create an incentive for an individual to "front run" an internal investigation, which can undermine a company's ability to detect and deter violations. The proposed rules do not address the idea of creating some mechanism for the SEC's whistleblower program office to alert company audit committees to give the company an opportunity to take appropriate responsive and remedial actions when it receives credible reports.

The proposed rules also leave certain important logistical issues unaddressed. For example, the interplay between the whistleblower confidentiality provisions and the federal rules of procedure have yet to be tested in an enforcement action. Would the SEC be required to identify a whistleblower in response to a successful Rule 9(b) motion to dismiss the complaint for failure to plead fraud with particularity? Would the SEC be required as part of its initial disclosures to disclose the names of any whistleblowers? Would the SEC be required to disclose the whistleblower's name or Form TCRs pursuant to discovery requests? These questions are not answered by the proposed rules.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Scott B. Schreiber
Co-chair, Securities Enforcement and Litigation Practice
+1 202.942.5672
Scott.Schreiber@aporter.com

Michael D. Trager
Co-chair, Securities Enforcement and Litigation Practice
+1 202.942.6976
Michael.Trager@aporter.com

John A. Freedman
+1 202.942.5316
John.Freedman@aporter.com

Richard L. Jacobson
+1 202.942.6975
Richard.Jacobson@aporter.com

Drew A. Harker
+1 202.942.5022
Drew.Harker@aporter.com

Matthew D. Keiser
+1 202.942.6398
Matthew.Keiser@aporter.com