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SEC Adopts Final Whistleblower Rules

On May 25, 2011, by a 3-2 vote, the Securities and Exchange Commission approved new Rules 21F-1 through 21F-17 under the Securities Exchange Act of 1934 which implement the whistleblower program mandated by Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These rules provide a powerful new monetary incentive for employees and others to report misconduct with no requirement to do so internally before contacting the Commission. The whistleblower program will be administered by the Commission's Office of the Whistleblower, and the new rules become effective on August 12, 2011.

Overview

Section 21F of the Exchange Act, which was added to the Exchange Act by Section 922 of the Dodd-Frank Act, directs the Commission to pay cash awards to whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to a successful enforcement action in which the Commission obtains monetary sanctions in excess of $1 million. Despite concerns raised by a number of the persons commenting on the proposed rules, the final rules do not require whistleblowers to report violations through their companies' internal compliance and reporting systems. Instead, the Commission made certain changes from the proposed rules designed to incentivize whistleblowers to use internal reporting systems when appropriate, such as:

- clarifying that the Commission will give weight to a whistleblower's participation in (or interference with) an internal compliance process when determining the amount of an award,
- giving credit to a whistleblower who provides information to a company which then passes the information along to the Commission, and
- extending to 120 days the period of time during which a whistleblower can wait before reporting to the Commission, after reporting internally, and still receive credit back to the original date of the internal report.

Amounts awarded to one or more whistleblowers in connection with any prosecution can range from 10% to 30%, in the aggregate, of monetary sanctions collected.

The final rules also expand upon the anti-retaliation protections set forth in Section 21F(h)(1) of the Exchange Act. In particular, the protections from employment retaliation apply to a whistleblower if he or she has a reasonable belief that the information provided relates to a possible securities law violation that has occurred, is ongoing or is about to occur. The rules clarify the authority of the Commission to

enforce such protections and that the protections apply regardless of whether the whistleblower ultimately satisfies all of the requirements for payment of an award. Employers will not be allowed to require employees to waive or limit such rights.

Who is a "whistleblower?"

Rule 21F-2 defines a *"whistleblower"* as a natural person who, alone or jointly with others, provides the Commission with original information relating to a possible violation of the federal securities laws, rules or regulations that has occurred, is ongoing, or is about to occur. Reporting a *"possible violation"* means that the information submitted has a facially plausible relationship to a federal securities law violation; frivolous claims or information relating only to state or foreign law violations will not be sufficient.

The whistleblower must submit the information in accordance with the procedures set forth in the rules. The Commission has attempted to simplify the procedures through the adoption of new Form TCR (Tip, Complaint or Referral), which requires a declaration by the whistleblower under penalty of perjury that the information submitted is true and correct to the best of his or her knowledge and belief. The Commission may, in its sole discretion, waive any failure to follow these procedures upon a showing of extraordinary circumstances.

Certain categories of persons are not eligible to receive an award. For example, members, officers or employees of the Commission, the Department of Justice, the Public Company Accounting Oversight Board ("PCAOB"), certain other regulatory agencies and self-regulatory organizations ("SRO"), or any law enforcement organization are ineligible. Similarly, foreign government officials are ineligible, as are family and household members of Commission employees, and persons who receive the information with the intent to evade the eligibility rules. Anyone convicted of a criminal violation that is related to the action for which he or she otherwise could receive an award, and anyone who, in the whistleblower submission or other dealings with the Commission or another authority in a related action, knowingly and willfully makes any false, fictitious or fraudulent statement or knowingly uses any false document with intent to mislead or otherwise hinder the Commission, will lose their eligibility.

A whistleblower is also not eligible for an award if the information given to the Commission was obtained through an audit of a company's financial statements, and making the submission would be contrary to the requirements of Section 10A of the Exchange Act. Thus, members of an audit engagement team who discover or detect an illegal act during the course of their audit procedures or audit work (including quarterly reviews) would be ineligible, as the auditor is required to comply with the reporting requirements of Section 10A. A member of the audit team could, however, make a submission alleging that his or her firm violated Section 10A if, for example, the audit firm failed to assess or investigate illegal acts of an audit client or failed to report to the Commission.

Qualifying for an Award

Meeting the eligibility requirements does not automatically lead to the payment of an award. To qualify for an award, an eligible whistleblower must also satisfy four requirements. The whistleblower must:

- voluntarily provide the Commission,
- with original information,
- that leads to the successful enforcement by the Commission of an action,
- in which the Commission obtains monetary sanctions in excess of $1 million.

The Commission will also pay an award based on amounts collected in certain related actions brought by the U.S. Attorney General, certain regulatory authorities or SROs, or by a state attorney general in a criminal case based on the same original information provided to the Commission and that led the Commission to obtain monetary sanctions in excess of $1 million.

Information is *"voluntarily"* submitted if it is provided before a request, inquiry or demand relating to the information is directed to the whistleblower (a) by the Commission, (b) in connection with an investigation, inspection or examination by the PCAOB or an SRO, or (c) in connection with an investigation by Congress, any other federal authority, or a state attorney general or securities regulatory authority. Information submitted after a request, inquiry or demand will not be considered voluntary even if the response is not compelled by subpoena or other law. A submission also will not be considered voluntary if it is required to be reported because of a pre-existing legal duty, a contractual duty owed to the Commission or one of the other listed authorities, or a duty arising out of a judicial or administrative order.

"Original information" is information derived from the independent knowledge or independent analysis of the whistleblower, and not already known to the Commission from another source. *"Independent knowledge"* means factual information not derived from publicly available sources, while *"independent analysis"* includes the examination and evaluation of information that may be publicly available, but which reveals information not generally known or publicly available. In other words, some additional evaluation or insight by the whistleblower is required.

The rules also enumerate certain circumstances under which the Commission would not consider a whistleblower's submission to be derived from independent knowledge or analysis. These exclusions apply to persons whose knowledge is acquired because of their role in the compliance activities of a company, or by illegal means. These excluded persons include:

- persons who obtain information through an attorney-client privileged communication or in connection with the legal representation of a client (including by in-house counsel), unless disclosure would otherwise be permitted by applicable federal or state rules;
- officers and directors who are informed by another person of allegations or who learn the information in connection with an internal compliance process;
- an entity's compliance and internal audit personnel;
- personnel of a firm retained to conduct an inquiry or investigation; and
- employees of a public accounting firm working on an audit or other engagement required under the federal securities laws, if the information relates to violations by the client.

But exceptions to these exclusions also exist. If the potential whistleblower has a

reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent conduct likely to cause substantial injury to the entity or investors, or that the entity is engaging in conduct that will impede an investigation, or at least 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, or chief compliance officer of the company, then such person will no longer be ineligible to make a submission based on the information in his or her possession.

As noted above, the information must also lead to a *"successful enforcement"* of a judicial or administrative action, and the final rules provide for the following three circumstances under which that requirement can be met:

- by giving original information that causes the Commission to commence an examination, open or reopen an investigation, or inquire concerning different conduct as part of a current examination or investigation, and the Commission's action is successful based in whole or part on such original information;
- by giving original information about conduct already under examination or investigation, and such information significantly contributes to the success of the action; or
- by reporting original information through an entity's internal compliance procedures before or concurrently with a report to the Commission, and the entity later provides to the Commission the information or the results of an internal investigation initiated in response to the information.

With respect to the third circumstance, the whistleblower must submit the same information to the Commission in accordance with its procedures within 120 days of providing it to the entity.

The final requirement involves *"monetary sanctions in excess of $1 million,"* which can be satisfied by any money (including penalties, disgorgement and interest) ordered to be paid and any money deposited into a fund as a result of a Commission action or related action. Two or more smaller actions arising from the same operative facts may be aggregated by the Commission when calculating the threshold. In determining whether the $1 million threshold has been met, or for purposes of determining the amount collected for purposes of making payments, the Commission will not take into account any monetary sanctions that the whistleblower himself is ordered to pay or that an entity is ordered to pay because of conduct that the whistleblower directed, planned or initiated.

Calculating the Payment Amount

Assuming the eligibility and procedural requirements are met, the Commission then decides, in its discretion, the amount of the award or awards to be paid. The aggregate amount of the awards will be at least 10% and no more than 30% of the monetary sanctions collected by the Commission and the other authorities. For purposes of determining the appropriate award percentage, the Commission considers the unique facts and circumstances of each case, including the factors listed below which the rules say may influence the decision.

Factors that may increase the amount of an award include:

- the significance of the information provided,
- any assistance provided by the whistleblower,
- the law enforcement interest of the Commission in the subject matter of the particular action, and
- whether the whistleblower participated in, and the extent to which he assisted, an entity's internal compliance or reporting system or investigation.

Factors that may decrease the amount of an award include:

- the culpability or involvement of the whistleblower in the matter,
- whether the whistleblower unreasonably delayed reporting the violations, and
- whether, in cases where the whistleblower interacted with an internal compliance or reporting system, the whistleblower interfered with or undermined the integrity of the system.

If more than one whistleblower is entitled to an award in connection with the same or related action, the Commission will allocate the awards among the whistleblowers, up to the 30% maximum aggregate amount.

Next Steps for Public Companies

The Commission's whistleblower program sets in motion new and significant monetary incentives for people to report misconduct, whether to their employer or directly to the Commission. Prior to adoption of this program, there were reports that the Commission had already seen an increase in the quantity and quality of the tips it is receiving. With the adoption of these new rules, it seems certain that the level of whistleblower activity will only increase.

While certain features of the rules are intended to incentivize whistleblowers to report violations through internal channels first, employees will do so only in a work environment where they feel comfortable that their claims will be taken seriously. Companies that wish to have an effective internal compliance and reporting system, and thereby maintain some control over the investigative process and the potential benefits of self-reporting violations if an issue arises, should take a fresh look at their internal systems and procedures.

The internal reporting process should be easy to use and protect the confidentiality of those who access it. Employees should be routinely trained on how to report potential violations, whether through hotlines or other means of accessing the company's chief legal officer or audit committee. Most importantly, a company policy and culture that protects employees from retaliation should be strongly emphasized.

Companies should also review the investigative procedures they have in place to ensure swift action will be taken should an issue arise. This would include a review of who will be on the investigative team and what procedures will be followed in any particular scenario. As public awareness of the Commission's whistleblower program and its potential awards increases, companies likewise should increase their readiness to respond.