Cooley

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In July 2010, Congress passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which addressed a wide range of matters. One of the provisions of Dodd-Frank was to establish a whistleblower program that requires the SEC to pay an award, under regulations prescribed by the SEC and subject to certain limitations, to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action. Dodd-Frank also provides that the SEC shall establish a Whistleblower Office to administer the SEC's whistleblower program, and prohibits retaliation by employers against individuals that provide the SEC with information about potential securities violations.

With the creation of the ability of whistleblowers to receive a substantial award, we expect to see an increase in whistleblower activity, which has been borne out in our conversations with the SEC. Although the new whistleblower provisions are designed to help the SEC obtain high-quality tips related to fraud and other serious securities law violations, we will have to wait to find out whether the SEC is instead inundated with spurious claims based on rumors; early indications from the SEC are that the SEC is receiving high quality tips on a daily basis.

On November 3, 2010, the SEC proposed rules for implementing the whistleblower provisions of Dodd-Frank.These proposed rules include a description of the SEC's Whistleblower Office required to be established under Dodd-Frank. However, on December 2, 2010, the SEC announced that the establishment of the SEC's Whistleblower Office has been delayed due to budgetary uncertainties, and that it will rely on current staff to administer the whistleblower program.

Set forth below are highlights of the proposed rules.

Background

New Section 21F of the Securities Exchange Act of 1934, as added by Dodd-Frank, directs the SEC to pay awards, subject to certain limitations and conditions, to whistleblowers who voluntarily provide the SEC with original information about a violation of the securities laws that leads to a successful enforcement action that results in monetary sanctions exceeding $1,000,000. The awards will be between 10% and 30% of the total monetary sanctions collected, including monetary sanctions collected in related actions by other agencies, with the possibility that the awards may be shared among multiple whistleblowers. In creating these rules, the SEC struggled with a number of issues, including: what information qualifies as information entitling an award; who can be a whistleblower and who is excluded; who is entitled to the award if there are multiple reports; how to avoid spurious reports; how to determine the amount of the award; and how to protect whistleblowers from retaliation. The proposed implementing rules attempt to address these issues, and set forth procedures to be followed.

Cooley commentary and recommendations

All companies should already have a strong compliance program in place to prevent fraud and other bad acts, and the new Dodd-Frank provisions and proposed SEC rules do not change the vigor with which companies should be designing and implementing their compliance programs. However, companies should expect that there may be a "race to the SEC" to make reports, especially in the case of employees leaving the company, either in the hopes of striking it rich or to use as leverage in bringing actions for alleged wrongful termination of employment. Further, employees may be less inclined to report internally through the compliance program if their motivation is to receive an award from the SEC, for fear that either someone else will report to the SEC first, or that the matter will be resolved by the company thereby not leading to any enforcement action from which an award will be payable (despite the protections included in the rules to prevent this type of incentive). As a result, companies should be aware of these alternative motivations, and consider what programs, employee training or alterations to their compliance programs, should be made to incentivize employees to use these compliance programs rather than report to the SEC.

Detailed summary of the proposed rules

The remainder of this *Alert,* in question and answer format, is a summary of the proposed new rules, which create a new Regulation 21F that would implement the new whistleblower provisions of Dodd-Frank.

Who can be a whistleblower?
A whistleblower is an individual who, alone or jointly with others, provides information to the SEC relating to a potential violation of the securities laws. A company or other entity is not eligible to be a whistleblower. However, certain persons will not qualify to receive awards under the new rules, such as attorneys and auditors representing the company, persons who participated in the wrongdoing, persons that make false or fraudulent statements to the SEC, foreign officials, and certain relatives of SEC employees.

Will every whistleblower receive an award?
Not necessarily. The SEC will only pay an award to one or more whistleblowers who

- "voluntarily" provide the SEC
- with "original information"
- that "lead to a successful enforcement action" by the SEC in federal court or in an administrative action
- in which the SEC obtains at least $1 million in monetary sanctions.

When does a whistleblower "voluntarily" report information to the SEC?
Information is provided voluntarily if it is submitted to the SEC before the SEC, Congress or any other regulatory authority makes a formal or informal request, inquiry or demand. Requests directed to the company are also deemed to be directed to the employee if the employee possesses the documents or other information subject to the request, unless the company fails to provide the employee's documents or information to the requesting authority in a timely manner. Disclosures by persons who have a clear duty to report the type of violation at issue are not considered voluntary, such as employees of a regulatory agency.

What type of information qualifies as "original information"?
For information to be "original information," it must be:

- derived from the individual's independent knowledge or analysis
- not already known to the SEC or other regulatory entity from another source
- not exclusively derived from an allegation made in another forum unless the whistleblower was the source of the information
- provided to the SEC after July 21, 2010.

Note that independent knowledge need not be acquired first hand; it can include knowledge derived from facts or other information learned from third parties. Independent analysis can include analysis of generally known or available information if that analysis reveals information not generally known or available to the public; however, excluded from information obtained with "independent knowledge" or "independent analysis" is information obtained in the following seven circumstances:

- information obtained through a communication that is subject to the attorney-client privilege that has not been waived or otherwise may not be violated;
- information learned by a person in connection with the legal representation of a whistleblower or a whistleblower's firm or employer;
- information learned by an independent public accountant or a related person in connection with an engagement by a company required under the securities laws by the independent public accountant, relating to that company or is directors, officers or employees;
- information learned by a person with legal, compliance, audit, supervisory or governance responsibilities that is communicated with a reasonable expectation that the person would take appropriate steps to cause the company to respond to the violation (unless the company does not disclose the information to the SEC within a reasonable amount of time or proceeds in bad faith);
- information obtained from or through a company's legal, compliance, audit, or similar functions or processes for identifying, reporting and addressing potential non-compliance with applicable laws (unless the company does not disclose the information to the SEC within a reasonable amount of time or proceeds in bad faith);

- information obtained by means of, or in a manner that, violates applicable federal or state criminal law; and
- information obtained from anyone who obtained the information from persons subject to the first six exclusions.

If the SEC already knows the information disclosed by a whistleblower, then the information will not be "original information" unless the SEC learned of the information from another source, and that source learned of the information from the whistleblower. In such case, the burden of proof is on the whistleblower to prove that he/she was the original source, and the claim by the whistleblower must be made within 90 days of the conveyance of the information to the other source.

What constitutes original information that "led to the successful enforcement" of an SEC action or a related action?
To qualify for an award, the original information must lead to a successful enforcement of an SEC action or a related action. If the information led the SEC to open an investigation and the information "significantly contributed" to the success of the enforcement action, it would qualify. In addition, in the case of ongoing investigations, if the information was essential to the success (a higher standard) of an investigation already ongoing, it would qualify. However, the SEC has stated that only be in rare circumstances would the latter case be applicable.

What type of proceeding qualifies as a proceeding from which an award may be paid?
To qualify, the proceeding must be a *single* federal court or administrative action in which the SEC obtains monetary sanctions totaling more than $1 million. Consequently, information leading to multiple enforcement actions would not be aggregated (*e.g.,* information leading to two enforcement actions, each resulting in $800,000 in sanctions, would not result in a whistleblower award).

In addition, payment of an award with respect to a "related action" will be paid if the related action is an action related to a proceeding in which the SEC obtains monetary sanctions totaling more than $1 million, the related action is based upon the same original information that led to the successful SEC proceeding, and the related action is brought by the Attorney General of the United States, an appropriate regulatory agency, a self-regulatory organization (such as a stock exchange), or a state attorney general in a criminal case. However, no award will be paid with respect to a related action if an award has already been paid with respect to that action by the Commodities Futures Trading Commission (CFTC), or an award has been denied under the CFTC's whistleblower award program related to that related action.

Must a whistleblower comply with the company's internal compliance programs before reporting to the SEC?
Although the SEC considered imposing a requirement that, before making a submission, a potential whistleblower must first follow internal company complaint and reporting procedures—thus allowing companies an opportunity to address misconduct—the SEC decided against that position. However, the SEC also does not intend that internal processes will be bypassed. The SEC believes that it has appropriately structured the rules to protect the whistleblower's "place in line" so that a potential whistleblower will not be disadvantaged by following internal company complaint and reporting procedures prior to making a report to the SEC.

What will be the size of the whistleblower's award? Dodd-Frank, as well as the new rules, provide that the award will be between 10% and 30% of the monetary sanctions recovered, the exact amount to be determined by the SEC. If there are multiple whistleblowers, the total will not exceed 30%, and so one whistleblower may receive 25% and another 5%. The criteria the SEC must use to make the determination of the exact amount between these two percentages are: the significance of the information to the success of the action; the degree of assistance provided by the whistleblower and any legal representative of the whistleblower; the programmatic interest in deterring violations of the securities laws; and whether an award otherwise enhances the SEC's ability to enforce the federal securities laws, protect investors, and encourages the submission of high quality information from whistleblowers.

Will the identity of the whistleblower be disclosed by the SEC?
The SEC will not disclose the identity of the whistleblower except when the SEC is required to disclose the identity, such as in a court or administrative action. In addition, the SEC may disclose the identity to the Department of Justice or other appropriate regulatory agency when it determines that it is necessary to achieve the purposes of the Exchange Act and to protect investors.

Can a whistleblower submit information anonymously to the SEC?
Yes. However, to do so the whistleblower would need to be represented by an attorney, and that attorney would need to provide their contact information to the SEC, but the whistleblower must reveal his/her identity prior to receiving any award.

Are there specific procedures that a whistleblower must follow to submit their information to the SEC?
Yes. The whistleblower must submit the information either through the SEC's standard form or online database for receiving tips, complaints and referrals. In addition, the whistleblower must complete a form, signed under penalty of perjury, representing that the information provided is truthful and that the whistleblower is eligible to receive a potential award. When information is submitted anonymously, the whistleblower's attorney must submit the information, certify that the attorney has verified the whistleblower's identity and retain the whistleblower's signed form in the attorney's files. In addition, to receive an award, whistleblowers must make a claim for an award within 60 days of notice that monetary sanctions were levied against the company.

Will a whistleblower, by reporting information, be provided amnesty for having participated in misconduct?
No. However, the SEC may credit cooperation by whistleblowers who have participated in misconduct.

May a company prevent a potential whistleblower from reporting if the potential whistleblower has signed a confidentiality agreement?
No. The proposed rules would prohibit any person from impeding a whistleblower from communicating directly with the SEC staff about a potential securities law violation, including generally by enforcing, or threatening to enforce, a confidentiality agreement. A determination that a whistleblower is ineligible to receive an award for any reason does not deprive the individual of the anti-retaliation protections, for example, if the individual fails to satisfy all the procedures and conditions to qualify for an award under the program.

If you have any questions about this *Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

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