

## SEC ISSUES PROPOSED RULES FOR WHISTLEBLOWER CLAIMS

On November 3, 2010, the Securities and Exchange Commission proposed new rules governing whistleblower claims under Section 922 of the Dodd-Frank Act. The whistleblower proposal is only one of 78 new sets of rules that the Commission is required to promulgate under Dodd-Frank.<sup>1</sup> Public comments on the whistleblower proposal are due by December 17, 2010. Most careful observers will regard the proposal as a serious and evenhanded attempt by the agency to use the full extent of its rulemaking authority to mitigate some of the unintended consequences of the statute and provide a reasonable and fair process for resolving whistleblower claims.

In drafting the whistleblower proposal, the SEC staff has clearly been mindful of the potential pitfalls presented by Section 21F. The proposing release acknowledges the risks of 1) undermining compliance programs within organizations; 2) creating conflicts of interest for legal, compliance and finance professionals; and 3) encouraging meritless claims.<sup>2</sup> The release goes far in addressing the first risk, and perhaps as far as it can in addressing the second and third.

Some in the plaintiffs' bar have criticized the proposal as exceeding the Commission's authority by placing too many barriers in the way of whistleblower recoveries. With few exceptions, however, the most significant barriers for whistleblowers are inherent in the statute. For each step outside the clear language of the statute that appears to favor potential defendants, there is another that appears to favor potential claimants.

The Dodd-Frank whistleblower provisions are among the most potentially far-reaching changes enacted by the legislation, and among the least predictable in their effects. If, as seems likely, the SEC's final rules for whistleblower claims resemble those proposed, legal and compliance personnel within organizations will be under more pressure than ever before to quickly and accurately assess the need for self-reporting of internal complaints to the SEC.

### OVERVIEW

Section 922 of the Dodd-Frank Act, now Section 21F of the Securities Exchange Act, requires the SEC to pay between 10% and 30% of any recovery over \$1,000,000 to persons who voluntarily provide the Commission with original information regarding a violation of the securities laws that leads to a successful enforcement action by the SEC or other agencies.<sup>3</sup> In its

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<sup>1</sup> See Implementing Dodd-Frank Wall Street Reform and Protection Act - Upcoming Activity, available at <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml> (last visited Dec. 1, 2010).

<sup>2</sup> Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-63237; File No. S7-33-10, at 4-5 (proposed Nov. 3, 2010) [hereafter *Proposing Release*].

<sup>3</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, Sec. 922(a), Pub. Law 111-203, 124 Stat. 1376, to be codified as 15 U.S.C. § 78u-6(b)(1) (effective July 22, 2010).

proposed rules the SEC: 1) defines “whistleblower”; 2) sets out a number of exclusions from those otherwise eligible for an award; and 3) defines the criteria and process that will govern the payment of awards.

Proposed Rule 21F-3(a) tracks the language of the statute, providing that:

In general, the Commission will pay an award or awards to one or more whistleblowers who:

- (1) Voluntarily provide the Commission
- (2) With original information
- (3) That leads to the successful enforcement by the Commission of a federal court or administrative action
- (4) In which the Commission obtains monetary sanctions totaling more than \$1,000,000.<sup>4</sup>

Many of the proposed rules are devoted to defining these terms.

**PROPOSED RULE 21F-2:  
DEFINITION OF WHISTLEBLOWER AND “POTENTIAL VIOLATIONS”**

Proposed Rule 21F-2 includes in the term “whistleblower” natural persons who provide the Commission with information regarding “potential violations” of the securities laws, in contrast to the statutory language, which defines whistleblowers as those who provide information regarding “violations” of the securities laws. The Commission’s stated purpose for this change is to make it clear at the time of the submission of a tip that the whistleblower is protected by the anti-retaliation provisions of Section 21F.<sup>5</sup> The desire for such early certainty is understandable, but the definition poses the risk that individuals who are more interested in employment protection than in the enforcement of the securities laws may make perfunctory whistleblower tips to avail themselves of the anti-retaliation shield. Indeed, one can imagine a world in which it would be per se malpractice for an employment lawyer not to counsel his client to make a whistleblower tip to the SEC on his way out the door. That risk might be mitigated by adding a requirement that tips be made in good faith for the tippers to qualify for such protection.

**PROPOSED RULE 21F-4(a):  
DEFINITION OF “VOLUNTARY SUBMISSION”**

Proposed Rule 21F-4(a) defines the circumstances under which information is “voluntarily” provided to the Commission, as required for an award under the statute. Information is not voluntarily provided where it has been previously requested by the Commission or another

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<sup>4</sup> *Proposing Release, supra* note 2 at 7, 125.

<sup>5</sup> *Proposing Release, supra* note 2 at 7.

agency, or where an individual is under a preexisting legal or contractual duty to report the violation to the Commission or another agency.<sup>6</sup>

The “previously requested” provisions of Proposed Rule 21F-4(a)(1) and (2) may narrow the scope of whistleblower awards far beyond what the Commission intends. It is the practice of the Commission and other agencies to make very broad requests of organizations during investigations, and to narrow and prioritize responses to those requests through negotiation. Under the proposed definition, the receipt of a broad request or subpoena by an organization would virtually preclude any employee of the organization from receiving an award. While a cheering prospect for organizations under investigation, that is probably not the result the Commission intends.

The Commission has specifically declined to exclude from the category of “voluntary” whistleblowers employees who learn about a potential securities violation from company counsel or others conducting an internal investigation.<sup>7</sup> While this part of the proposal is intended to encourage whistleblowers to come to the Commission or other agencies with information, the effect may be to provide at least as great an incentive to organizations to self-report problems before a whistleblower does, perhaps not an unintended consequence.

For example, assume that a potential securities law violation has occurred at PubliCo that is known to the company’s legal or compliance department and to employees A, B, and C. Without the whistleblower statute or rules, PubliCo was free to investigate and remediate if necessary on a schedule limited mainly by the need to ensure the accuracy of its periodic or other reports. Under the definitions set out in the proposed rules, PubliCo understands that employees A, B, and C now have a financial incentive to go to the SEC as well as protection from retaliation for doing so. If A, B, or C beat PubliCo to the SEC’s door with their information, several negative consequences follow for PubliCo. First, PubliCo is likely to encounter suspicion from the SEC staff and less likely to get credit from the Staff for cooperation in its investigation. Second, PubliCo must react to, rather than shape the first version of events that the Staff hears. Third, and perhaps most important, because A, B, or C have “voluntarily” provided information before it was requested by the Commission they have preserved their ability to collect 10% to 30% of any potential recovery. They therefore have an enormous financial incentive to see a successful enforcement action brought against their organization.

By contrast, if PubliCo self-reports before any whistleblower, it will: 1) receive more credit for cooperation with the Staff; 2) be able to shape the Staff’s initial perceptions of what happened; and 3) almost certainly draw a request for information from the Staff that will prevent any subsequent whistleblowers from being considered “voluntary” providers of information. Such a request from the Staff will virtually eliminate any chances of whistleblower awards and the

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<sup>6</sup> *Proposing Release, supra* note 2 at 11–14, 127.

<sup>7</sup> “Thus, Proposed Rule 21F-4(a)(1) would credit a whistleblower with ‘voluntarily’ providing information if the individual were to approach the Commission staff after being questioned about possible violations by such persons, unless, as noted, the individual’s information is within the scope of a request, inquiry, or demand directed to the employer by one of the designated authorities.” *Proposing Release, supra* note 2 at 12 n.11.

corresponding incentives for employees A, B, and C to see a successful action brought against their employer.<sup>8</sup>

In the end, decisions on whether and when to self-report will be made as they always have been, based on careful judgments as to the facts, nature, and materiality of the potential violation. What seems undeniable is that if the final rule follows the proposal in this respect, a weighty new factor favoring early self-reporting will have been added in many cases. In addition, those judgments will need to be made under even more extraordinary time pressure.

**PROPOSED RULE 21F-4(b):  
“ORIGINAL INFORMATION” AND EXCLUDED SOURCES**

Proposed Rule 21F-4(b) defines the term “original information.” The Commission’s proposal attempts to use this definition to limit the potential for interference of the whistleblower provision with the attorney-client relationship, internal compliance programs, and the work of auditors and supervisors. The proposed rule specifies that information obtained through these relationships will not be viewed as being original information because it is not “derived from independent knowledge” or “independent analysis.”<sup>9</sup>

Information obtained from certain sources can never be considered “original information”: 1) information from attorney-client privileged communications;<sup>10</sup> 2) information obtained in the course of legal representation of a client if used for the attorney’s benefit;<sup>11</sup> 3) information obtained in the course of an engagement by an independent public accountant that is required by the securities laws;<sup>12</sup> and 4) information obtained in violation of criminal law.<sup>13</sup>

To attempt to allow compliance, legal, audit and governance functions within the entity to operate, the proposed rules provide that information from those sources cannot be considered “original information” unless the entity either does not disclose the violation or acts in bad faith.<sup>14</sup> The proposed rules also except information obtained from persons with “supervisory”

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<sup>8</sup> In the event PubliCo acts “in bad faith,” however, the rule does open the door for recovery by a whistleblower otherwise excluded from having “independent knowledge” based on their position of “legal, compliance, audit, supervisory, or governance responsibilities.” The proposed rules will not protect entities that engage in sham investigations or otherwise hinder prompt and thorough investigation. *See Proposing Release, supra* note 2 at 23–24, 129–30.

<sup>9</sup> *Proposing Release, supra* note 2 at 19, 128.

<sup>10</sup> *Proposing Release, supra* note 2 at 20, 129.

<sup>11</sup> *Proposing Release, supra* note 2 at 21, 129.

<sup>12</sup> *Proposing Release, supra* note 2 at 22–23, 129.

<sup>13</sup> *Proposing Release, supra* note 2 at 28, 130.

<sup>14</sup> *Proposing Release, supra* note 2 at 24, 129–30.

responsibilities, an exclusion that has the potential to bar a wide variety of claimants from whistleblower recoveries.<sup>15</sup>

A whistleblower who has received information via one of these otherwise excluded channels within the entity will be considered to have “original information” if the entity does not act within a reasonable time or conducts itself in bad faith. While noting that “reasonable time” is a flexible concept, the SEC has stated there are some ongoing frauds that require “almost immediate” disclosure to the SEC.<sup>16</sup>

### **PROPOSED RULES 21F-9, 10 AND 11: PROCEDURES AND FORMS**

A great deal of thought has gone into the SEC’s Proposed Rules 21F-9-11, which set out procedures and forms for making and resolving whistleblower claims. Although some have argued that the proposed rules are too complex, the rules simply reflect the complexity inherent in such a process. The proposed rules’ anticipation of many issues is a strength, not a weakness.

The list of procedural hurdles to be leapt by the prospective whistleblower is nevertheless daunting, and unlikely to be understood by those who do not make them a subject of professional study.<sup>17</sup> The proposed rules would require a whistleblower to file three forms: first, the initial tip, complaint or referral form (Form TCR); second, a declaration making representations that would affect the whistleblower’s eligibility for an award (Form WB-DEC); and finally, within 60 days of the announcement of a qualifying recovery, a claim form (Form WB-APP).

The last requirement is by far the most burdensome from the whistleblower’s perspective, not because of the form itself, which is relatively simple, but because the whistleblower must be alert to the possibility of an announcement and file the form within 60 days. It is not clear what benefit there is in requiring that Form WB-APP be filed after an announcement, other than possibly some administrative efficiency for the Commission. The requirement poses the risk that otherwise deserving whistleblowers would be barred from recovery on a technicality. The Commission has the option of making an award in spite of failure to follow any of these procedures “in extraordinary circumstances,” but given the brief filing period allowed, issues with the timely filing of Form WB-APP are likely to be anything but extraordinary. The Commission would be better served by permitting filing of the claim form at the same time as the eligibility form.

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<sup>15</sup> Proposed Rule 21F-4(b)(4)(iv), *Proposing Release*, *supra* note 2 at 129.

<sup>16</sup> *Proposing Release*, *supra* note 2 at 26.

<sup>17</sup> The *Proposing Release* includes a flow chart illustrating the steps between an initial tip and a whistleblower award, including appeals. *Proposing Release*, *supra* note 2 at 26.

## CONCLUSION

Given the amount of work that has gone into the whistleblower rules proposal, and the fact that the whistleblower claims legislation was eagerly sought by the Commission, it seems likely that the final rules governing whistleblower claims will be substantially similar to the proposed rules. Within the limits of the statutory language, the SEC's proposed rules for whistleblower claims strike a reasonable balance between encouraging submission of information to the SEC and supporting the interests of entities in addressing their own internal processes. The legislation itself is a vast and risky experiment. Monetary rewards this rich have never before been offered on such a widespread basis for whistleblowers, and the securities laws are not models of clarity. It remains to be seen whether the Dodd-Frank whistleblower provisions will result in a wave of successful fraud prosecutions that would otherwise not have occurred, or simply an unmanageably vast influx of tips for the SEC.

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