SEC ADOPTS FINAL RULES FOR WHISTLEBLOWER CLAIMS; EXCLUSIONS FROM POTENTIAL WHISTLEBLOWERS SIGNIFICANTLY CUT BACK

On May 25, 2011, the Securities and Exchange Commission adopted, by a divided vote of 3-2, final rules[1] governing whistleblower claims under Section 21F of the Securities Exchange Act. Section 21F, enacted as Section 922 of the Dodd-Frank 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.[2] The SEC's whistleblower program will place additional pressure on organizations to quickly assess the need for internal investigation of complaints and self-reporting to the SEC.

During the comment process much attention was given to the question of whether whistleblowers should (or could) be required to report violations internally before reporting to the SEC. The final rules do not include such a requirement, but do provide meaningful incentives to whistleblowers for doing so. More problematic, from a corporate governance standpoint, is the failure of the final rules to exclude from the category of potentially successful whistleblowers the internal and external personnel necessary to keep organizations compliant with the securities laws. Under the final rules, as adopted, any member of the organization who is not a lawyer or an outside auditor, including officers, directors, compliance staff and internal auditors, can make a report to the SEC and a potentially successful whistleblower claim after 120 days have elapsed. These provisions create a potential conflict of interest that threatens to erode organizations' ability to build and maintain successful compliance programs over time.

Rule 21F-3(a) provides 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."[3]

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[1] Final Rule: Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-64545; File No. S7-33-10 (adopted May 25, 2011) [hereafter *Adopting Release*].

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

[3] *Adopting Release*, *supra* note 1 at 245.

INTERNAL REPORTING OF POSSIBLE VIOLATIONS

In its final rules the Commission did not, as many had suggested, require whistleblowers to first report violations internally within their organizations to qualify for an award. The final rule does, however, include new provisions that provide substantial incentives for whistleblowers to report internally before reporting to the SEC.

Rule 21F-4(c)(3) provides the most significant new incentive to internal reporting in the SEC's final rules. Under this new provision a whistleblower who reports possible violations internally before or at the same time as he or she reports them to the SEC will essentially receive credit for any additional information that the organization self-reports to the SEC. Per the Adopting Release:

> The final rule provides that if: (1) a whistleblower reports original information through his or her employer's internal whistleblower, legal or compliance procedures before or at the same time he or she reports them to the Commission; (2) the employer provides the Commission with the whistleblower's information or with the results of an investigation initiated in response to the whistleblower's information; and (3) the information provided by the employer to the Commission "led to" successful enforcement under [the Rule's other criteria], then the whistleblower will receive full credit for the information provided by the employer as if the whistleblower had provided the information to [the SEC].[4]

This provision does, as the Adopting Release states, provide whistleblowers with a meaningful opportunity to enhance their chances of receiving an award by reporting internally as well as to the SEC.

The final rules also provide that the SEC may increase the amount of a whistleblower award in consideration of the whistleblower's having participated in the organization's internal reporting and compliance systems, and may decrease the amount if the whistleblower interfered with those systems.[5]

RULE 21F-2: WHISTLEBLOWER STATUS AND RETALIATION PROTECTION

Rule 21F-2 identifies persons entitled to whistleblower awards and to protection from retaliation under the Exchange Act. Rule 21F-2(a) defines "whistleblower" as a natural person who provides the Commission with information regarding a "possible violation" of the federal securities laws that has occurred, is ongoing, or is about to occur. The new Rule 21F-2(b) specifies that to be entitled to protection from retaliation a whistleblower must have a reasonable belief that the information he or she is providing relates to a possible securities law violation.

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[4] *Adopting Release*, *supra* note 1 at 101.

[5] Rule 21F-6: Criteria for Determining Amount of Award, *Adopting Release*, *supra* note 1 at 257-260.

This provision reduces, but does not eliminate, the risk of meritless whistleblower reports motivated by the desire to take advantage of protection from retaliation under the statute. Under the final rule, the SEC will have authority to enforce the anti-retaliation provisions.

RULE 21F-4(a): DEFINITION OF "VOLUNTARY SUBMISSION"

Proposed Rule 21F-4(a) would have defined "voluntary submissions" to exclude whistleblower submissions that were within the scope of a previous request for information issued by the SEC or another law enforcement agency to the entity.[6] The revised Rule 21F-4(a) broadens what will qualify as a "voluntary submission" by excluding only whistleblower submissions that are within the scope of a previous request to the whistleblower himself, or his representative.[7]

RULE 21F-4(b)(iv)(4): "ORIGINAL INFORMATION," EXCLUDED SOURCES, AND DELAYED SOURCES

Rule 21F-4(b) defines the term "original information" and requires that it be derived from the whistleblower's independent knowledge or independent analysis.[8] Pursuant to Rule 21F-4(b)(4)(i) and (ii), information obtained in an attorney-client privileged communication or in the course of a legal representation can only be the basis for a whistleblower claim where disclosure is permitted under 17 CFR § 205.3(d)(2), state attorney conduct rules or otherwise.[9] Outside auditors are not eligible to base a whistleblower claim on information found as a result of an audit under a separate provision, Rule 21F-8(c)(4).[10] Pursuant to Rule 21F-4(b)(4)(iii), a whistleblower can disclose to the SEC, and base a claim on, information he learned because he was in certain governance, compliance or audit roles only after 120 days have elapsed since he reported the matter internally. Such a whistleblower can report to the SEC and make a claim in less than 120 days where the whistleblower reasonably believes disclosure is necessary to prevent the entity from causing substantial injury or impeding an investigation.[11]

Although the Adopting Release for Rule 21F speaks of "exclusions" from those who will be considered to have provided independent knowledge or independent analysis, under Rule 21F as adopted non-lawyer and non-audit personnel involved in compliance and governance tasks are not excluded from being whistleblowers; they are merely delayed. This presents a troubling potential conflict of interest for many within organizations whose job functions include investigating and remedying compliance issues. Over time it cannot fail to make it more difficult for organizations to build and maintain effective compliance programs.

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[6] 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 11-14, 127 (proposed Nov. 3, 2010).

[7] *Adopting Release*, *supra* note 1 at 29-30.

[8] *Id.* at 248.

[9] *Id.* at 51-72, 248-49.

[10] *Id.* at 261-263.

[11] *Id.* at 249-50.

CONCLUSION

The passage of the Dodd-Frank whistleblower provisions fundamentally changed the landscape for companies dealing with allegations of wrongdoing. The SEC's final rules implementing those provisions will place a premium on robust internal controls to prevent misconduct and swift and thorough internal investigation of issues raised through internal reporting systems. These provisions will undoubtedly put additional pressure on legal and compliance personnel to quickly and accurately assess the need for internal investigation and self-reporting to the SEC. We expect that the whistleblower program will create a significant increase in insider reports to the SEC of possible violations, particularly in such areas as the Foreign Corrupt Practices Act and public company financial reporting. The rules go into effect 60 days after publication in the Federal Register.

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May 27, 2011

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