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Expert Analysis

The New Bounty Hunters: Whistle-Blower Bounty Rules Under the Dodd-Frank Act

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On Aug. 12, 2011, the final rules¹ implementing the whistle-blower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act took effect. Under these rules, the Securities and Exchange Commission must pay awards, subject to certain limitations and conditions, to eligible whistle-blowers who voluntarily provide the agency with original information about a potential federal securities law violation leading to a successful SEC enforcement action resulting in monetary sanctions exceeding \$1 million.

These rules have been among the most controversial to date under the Dodd-Frank Act, in part because many in the business community anticipate they will prompt would-be whistle-blowers to circumvent companies' internal procedures and send reports of potential violations directly to the SEC in hopes of obtaining a "bounty."

In response to these concerns, the SEC has included certain provisions designed to encourage whistle-blowers to report their concerns through internal company procedures first, before reporting to the agency. It remains to be seen what practical impact these provisions will have on whistle-blowers' actions.

The SEC's Office of the Whistle-blower is administering the program. The SEC has demonstrated its commitment to follow through on the mandate provided by Dodd-Frank by posting notices on the office's website regarding actions for which bounties may be available. Whistle-blowers have 90 days from the date of posting of a covered action to come forth and claim their bounty.

In November, the SEC reported to Congress on whistle-blower activity as of Sept. 30. The agency reported 334 whistle-blower reports in the first seven weeks of the program, a significant increase over prior periods. Notably, about 10 percent of reports came from outside the United States.

Moreover, as of the date of its report, the SEC had not yet made any bounty payments to whistle-blowers under the provisions of Dodd-Frank. It seems likely that the





number of whistle-blower reports to the SEC will rise even further once bounties are awarded, given the publicity such awards are expected to receive.

WHO QUALIFIES AS A 'WHISTLE-BLOWER'?

A whistle-blower must be a natural person who, alone or jointly with others, voluntarily provides "original information" (as described below) to the SEC relating to a possible violation of the federal securities laws that has occurred, is ongoing or is about to occur. A company or other entity cannot qualify as a whistle-blower.

In addition, the violation must relate to a provision of the federal securities laws or a rule or regulation promulgated by the SEC. Reporting a violation of a state or foreign law would not qualify a whistle-blower to receive an award under these rules.

WHO IS NOT ELIGIBLE?

Certain people are not eligible to receive whistle-blower awards because of special client relationships with the individuals or entities involved in possible violations of the securities laws or because of pre-existing legal duties of such persons to report information to the SEC. Generally, the following categories of potential whistle-blowers would not be eligible to receive awards under the final rules:

- Members, officers or employees of the SEC, the Department of Justice, a selfregulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization.
- Any person who is a spouse, parent, child or sibling of or who resides in the same household as an employee of the SEC.
- Foreign government officials.
- Attorneys, including in-house counsel, and non-attorneys who obtain information
 through a communication that is subject to the attorney-client privilege or in
 the course of representing a whistle-blower or whistle-blower's employer, unless
 disclosure is allowed under applicable state attorney conduct rules.
- Certain personnel with compliance-related responsibilities, such as employees
 whose principal duties involve compliance or internal audit responsibilities
 (for example, compliance officers).
- Public accountants working on engagements required under the federal securities laws if the information relates to violations by the client or the client's directors, officers or other employees.
- Individuals who obtain information as a result of an audit of a company's financial statements, including quarterly reviews, if submission of such information to the SEC would be contrary to the reporting requirements of Section 10A of the Exchange Act.²

The rules contain an exception allowing public accountants and company personnel with compliance-related responsibilities, including officers and directors, to receive awards as whistle-blowers in certain situations. Such whistle-blowers may be eligible for an award if they have a "reasonable basis" to believe:

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- Disclosure is necessary to prevent the company from engaging in conduct "likely to cause substantial injury to the financial interest or property of the entity or investors."³
- The company is engaging in conduct that will impede an investigation of the misconduct.
- At least 120 days have passed since the information was provided to the company's audit committee, chief legal officer, chief compliance officer or the whistle-blower's supervisor, or since the whistle-blower learned that the information had already been reported internally.

WHAT IS A 'VOLUNTARY' SUBMISSION?

A submission of information by a whistle-blower is "voluntary" if he or she provides the SEC with the information *before* the whistle-blower or his or her representative receives:

- Any request from the SEC.
- A request in connection with an investigation, inspection or examination by the PCAOB or any self-regulatory organization.
- An investigative request by the U.S. Congress, any other authority of the federal government, a state attorney general or securities regulatory authority related to the same subject matter.

A submission to the SEC is also considered "voluntary" if the same information is provided to one of the above-listed authorities prior to the whistle-blower receiving a request from the SEC.

A submission of information will generally not be considered "voluntary" if the whistle-blower is required under a pre-existing legal or contractual duty owed to the SEC or one of the above-listed authorities to report such information to the SEC. Companies, however, cannot simply disqualify all employees from award eligibility by generally requiring them to sign an agreement to report securities violations to the SEC.

WHAT IS 'ORIGINAL INFORMATION'?

"Original information" means information provided for the first time to the SEC after July 21, 2010, which was the date on which the Dodd-Frank Act was enacted, that is:

- Derived from the whistle-blower's "independent knowledge" or "independent analysis."
- Not already known to the SEC from any other source, unless the whistle-blower is the original source of the information.
- Not exclusively derived from an allegation made in a judicial or administrative hearing; in a governmental report, hearing, audit or investigation; or from the news media, unless the whistle-blower is the source of the information.

To be considered "independent knowledge," the information submitted cannot be derived from publicly available sources. A whistle-blower's independent knowledge may be obtained through his or her own experiences, communications or observations, though he or she is not required to have been involved in the possible violation at issue.

The violation must relate to a provision of the federal securities laws or a rule or regulation promulgated by the SEC.

Also, while a whistle-blower's "independent analysis" can come from his or her own examination and evaluation of publicly available information, such analysis must reveal information not generally known or available to the public.

HOW MUCH MONEY?

The final rules require a whistle-blower, or whistle-blowers in the aggregate, who qualify for an award to be paid between 10 percent and 30 percent of the monetary sanctions collected by the SEC based upon the information provided by the whistle-blower, in an amount that exceeds \$1 million.

The final rules give the SEC discretion in determining the appropriate award amount within the 10-30 percentage range and, in situations where there are multiple whistle-blowers, the appropriate allocation of the award among the whistle-blowers.

In exercising its discretion, the SEC may take into consideration the following factors:

Factors that may increase the award amount

- The significance of the information provided by a whistle-blower to the success of the SEC's action or related action, including the reliability and completeness of the information.
- The degree of assistance provided by the whistle-blower and any legal representative of the whistle-blower in the SEC's action or related action, including the amount of cooperation, timeliness of the report and the amount of resources conserved.
- The SEC's law enforcement interest in deterring violations of the securities laws by making awards to whistle-blowers who provide information that leads to successful enforcement actions, including the degree to which an award improves the SEC's ability to enforce the federal securities laws, protects investors and encourages the submission of high-quality information.
- Whether, and the extent to which, the whistle-blower participated in the company's internal compliance system, including timing of the internal report and amount of assistance provided to the internal investigation.

Award amounts: What the SEC considers

May increase the award amount

- Significance of information provided by whistle-blower
- Degree of assistance provided by whistle-blower
- Whistle-blower's participation in company's internal compliance system

May decrease the award amount

- Whistle-blower's culpability in the violations
- Whistle-blower's delay in reporting the violations
- Whistle-blower's interference with company's internal compliance system

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Factors that may decrease the award amount

- The culpability of the whistle-blower, including the whistle-blower's role, education, experience, intent and the amount of financial benefit from the violations.
- Whether the whistle-blower unreasonably delayed reporting the securities violations.
- Whether the whistle-blower interfered with his or her company's internal compliance or reporting system, such as by delaying detection or providing false information.

CAN A WRONGDOER RECEIVE AN AWARD?

Culpable whistle-blowers are not automatically ineligible for an award under these rules since often, in the SEC's view, only those involved in the possible violation have relevant information regarding such violations. The SEC will consider any culpability of the whistle-blower in a securities violation as one of the factors in determining the amount of an award.

Also, in determining whether the required \$1 million threshold has been satisfied for purposes of making an award to the culpable whistle-blower, the SEC will not count any monetary sanctions that the whistle-blower himself or herself is ordered to pay or that are ordered against any entity whose liability is based substantially on conduct that the whistle-blower directed, planned or initiated. The SEC will also not count these amounts toward the total monetary sanctions collected in the action for purposes of calculating any payments to the culpable whistle-blower.

CAN A WHISTLE-BLOWER BE ANONYMOUS?

The final rules allow a whistle-blower to submit information to the SEC anonymously only under certain specified conditions. Any whistle-blower may choose to be represented by counsel, but an anonymous whistle-blower must retain an attorney who will, among other things, certify to the SEC that he or she has verified the whistle-blower's identity. The whistle-blower will, however, be required to reveal his or her identity to the SEC before the agency will pay such person any award.

PROTECTION FROM RETALIATION

The final rules provide that anti-retaliation protection for people who submit reports under these rules is not limited to whistle-blowers who are ultimately determined to be eligible for an award. Rather, the anti-retaliation protections apply to all whistle-blowers who had a "reasonable belief" that the information provided relates to a possible securities law violation that has occurred, is ongoing or is about to occur.

To incentivize the submission of high-quality tips and to discourage the abuse of the anti-retaliation provisions, the "reasonable belief" standard requires that:

- The whistle-blower holds a subjectively genuine belief that the information demonstrates a possible violation.
- That belief is one that a similarly situated employee might reasonably possess.

INTERNAL COMPLIANCE PROGRAMS

As noted above, one of the main concerns surrounding the proposed rules was the effect the whistle-blower program would have on a company's internal compliance program. In the adopting release, the SEC emphasized its goal of "encouraging the submission of high-quality information to facilitate the effectiveness and efficiency of the [SEC's] enforcement program."

As such, a whistle-blower is not required to report information through a company's internal compliance process in order to be eligible for an award. The SEC did not want, however, to undermine the importance of effective internal compliance, legal, audit and similar processes for investigating and responding to possible violations of the federal securities laws.

Several provisions in the final rules are designed to encourage the use of internal compliance processes by whistle-blowers and to promote the continued development of effective compliance programs.

If a whistle-blower reports information through a company's compliance procedure and the company then reports the same and additional information to the SEC within 120 days, the whistle-blower would be deemed to have reported such information to the SEC on the date when he or she originally reported the violation internally, and the whistle-blower would be given credit for both the original and additional information self-reported by the company to the SEC.

In determining the amount of an award, the SEC has the discretion to increase the award amount if a whistle-blower voluntarily reports to and cooperates with internal compliance systems. The SEC can decrease the award amount if a whistle-blower delays reporting or interferes with internal compliance systems.

Steps to consider

- Regularly review, evaluate and update compliance programs and procedures.
- ✓ Create separation of duties.
- ☑ Regularly emphasize to employees the importance of compliance.
- Consistently and evenhandedly apply disciplinary action against anyone who has engaged in, or condoned, wrongdoing.
- Regularly provide training on common regulatory and enforcement pitfalls and on how to use the company's established compliance procedures.
- Educate management regarding the importance of internal whistle-blower complaints and non-retaliation policies.
- Quickly review complaints with legal counsel for federal securities law violations that should be reported to the SEC.

In appropriate cases, upon receiving a whistle-blower complaint, the SEC staff will "contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back." In determining whether to allow a company time to internally investigate a matter, the SEC may consider factors such as the nature of the alleged conduct, the level at which the conduct allegedly occurred, the company's corporate governance culture and its internal compliance programs.

STEPS TO CONSIDER NOW

The whistle-blower provisions of the Dodd-Frank Act and the related SEC rules highlight the importance of robust corporate compliance procedures. Companies should consider taking the following steps to ensure that their compliance programs provide a means of detecting, investigating and responding to possible violations of the federal securities and other applicable laws:

- Regularly review, evaluate and update compliance programs and procedures, including internal complaint mechanisms such as employee hotlines to ensure they are widely publicized to, and understood by, employees (and other third parties, if appropriate); are easy for potential whistle-blowers to use; and are effective in their tracking and prompt resolution of complaints of alleged noncompliance.
- Create separation of duties, such that the personnel who receive and review
 information from whistle-blowers ideally a standalone compliance officer or
 department are not the same people who might have incentives to ignore,
 condone or participate in unlawful conduct.
- Regularly emphasize to employees, in communications from the senior management level, the importance of compliance, thus setting a "tone at the top" that ethical business conduct is paramount in the organization.
- Consistently and evenhandedly apply disciplinary action against management
 or other employees who have engaged in, or condoned, wrongdoing and by
 no means allow lawbreakers or other unethical individuals to continue to serve
 in positions with decision-making authority.
- Regularly provide training on common regulatory and enforcement pitfalls in your industry, as well as on how to use the company's established compliance procedures. Employees are more likely to report internally if they believe that their companies have effective internal compliance programs that take reports seriously and do not retaliate.
- Educate management regarding the importance of recognition of and timely response to internal whistle-blower complaints and non-retaliation policies.
- Develop mechanisms to evaluate quickly, in consultation with legal counsel, whether a possible violation of the federal securities laws has occurred that should be reported to the SEC.

NOTES

- See SEC, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (Aug. 12, 2011), available at http://www.sec.gov/rules/final/2011/34-64545.pdf
- Section 10A of the Exchange Act, among other things, requires public accountants to promptly notify the SEC if the public accountants had informed the appropriate people at the company of material illegal acts that had come to their attention during the audit but the company failed to take appropriate action.
- The SEC noted in the adopting release that it expects that "in most cases the whistle-blower will need to demonstrate that responsible management or governance personnel at the entity were aware of the imminent violation and were not taking steps to prevent it."





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