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ADVISORY | Dodd-Frank Act

November 8, 2010

SEC PROPOSES WHISTLEBLOWER RULES

Last week, the Securities and Exchange Commission (SEC) proposed much-anticipated rules relating to its new whistleblower program mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] In proposing the rules, the SEC indicated that it intends to create a roadmap for potential whistleblowers to provide the agency with high-quality tips, while at the same time minimizing the incentives for whistleblowers to bypass functioning internal compliance processes or violate their professional obligations. There will be debate, however, as to whether the agency has sufficiently resolved this tension, as the proposed rules offer less than the agency's rhetoric on this key point. Furthermore, the proposed rules place significant additional pressure on companies to self-report potential violations of the federal securities laws.

BACKGROUND

The SEC's proposal implements the whistleblower bounty provisions in Section 922 of Dodd-Frank[2] under which it is required to pay awards to individuals who "voluntarily" provide "original information" about a potential violation of the federal securities laws that leads to a successful SEC enforcement action resulting in monetary sanctions exceeding $1,000,000. This new mandate substantially expands the SEC's authority to compensate whistleblowers. Prior to Dodd-Frank, the SEC's authority to pay whistleblowers had been limited to insider trading cases, was discretionary, and was capped at 10 percent of penalties collected. Subject to various conditions, the SEC must now provide cash bounties to whistleblowers of 10 to 30 percent (determined at the SEC's discretion) of monetary recoveries in connection with any violation of the federal securities laws, which include the Foreign Corrupt Practices Act (FCPA). Given the size of recent FCPA resolutions with the SEC and the U.S. Department of Justice, the potential amounts of whistleblower awards in connection with this new program are quite significant.

HIGHLIGHTS OF PROPOSED RULES

The proposed new rules, which would be in new Regulation 21F under the Exchange Act (Rules 21F-1 through 16),[3] both track the statutory language and add plain English explication. A summary highlighting key provisions in the proposed rules follows.

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[1] *See* Rel. No. 34-63237 (Nov. 3, 2010), in which the SEC proposed its new rules (Release). The proposed rules cover only the new whistleblower bounty provisions established by Dodd-Frank, not the related provisions dealing with enhanced protection for whistleblowers against retaliation. The SEC is seeking comment on whether it should promulgate rules regarding the anti-retaliation provisions. The Commodity Futures Trading Commission (CFTC) will propose rules to implement its own whistleblower provisions pursuant to Section 23 of the Commodity Exchange Act, also added by Dodd-Frank.

[2] These provisions are codified in Section 21F of the Securities Exchange Act of 1934 (Exchange Act).

[3] The proposed rules also include three new forms to be used by tipsters under the program: Form TCR (*Tip, Complaint or Referral*), Form WB-DEC (*Declaration of Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934*) and Form WB-APP (*Application for Award for Original Information Submitted Pursuant to Section 21F of the Securities Exchange Act of 1934*).

Determining Who Can Be a Whistleblower and Under What Circumstances

The determination of who can be a whistleblower and under what circumstances revolves around four key definitions: (1) "whistleblower," (2) "voluntary submission of information," (3) "original information" and (4) "leads to successful enforcement."

Whistleblower. A "whistleblower" under proposed Rule 21F-2 is an individual who, alone or jointly with others, provides the SEC with information relating to a potential violation of the federal securities laws. A whistleblower must be an individual, not a corporation or other entity. Some individuals are excluded, such as certain government or regulatory officials and employees (including foreign officials, as defined in the rule), individuals convicted of a crime related to the SEC action or a related action for which the individual otherwise could receive an award,[4] and those who knowingly and willfully make false statements to the SEC or other authorities in connection with the action.[5]

Voluntary submission of information. Under proposed Rule 21F-4, the submission of information to the SEC will not be considered "voluntary" if (1) the would-be whistleblower's employer has already received a request, inquiry or demand from the SEC or another specified authority about a matter to which the would-be whistleblower's information is relevant and (2) the would-be whistleblower has in his or her possession documents or information within the scope of the request, inquiry or demand. Notwithstanding this definition, if an employer fails to provide the would-be whistleblower's documents or information to the requesting authority "in a timely manner" after receiving them, any submission of information thereafter by the would-be whistleblower will be considered "voluntary."

Original information. Proposed Rule 21F-4 also sets forth a definition of "original information," which, among other things, requires information that is derived from "independent knowledge" or "independent analysis." This is a critical definition in the context of the whistleblower program.

The proposed rule delineates numerous sources of information that cannot give rise to "independent knowledge" or "independent analysis." Chief among them are the following:

- information derived from the performance of an engagement required under the securities laws by an independent public accountant where, for example, the submission relates to a violation by the engagement client or the client's directors, officers or other employees;
- information from a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, to whom information was communicated with the reasonable expectation that the person would take steps to cause the entity to respond appropriately to the violation;
- information otherwise obtained from or through an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law;
- attorney-client privileged communications; and

[4] Notably, the proposed rules do not exclude other wrongdoers from becoming whistleblowers (*i.e.*, those who may bear culpability for the conduct being reported to the SEC, but who have not been convicted of a crime in connection with the conduct). In addition, foreign individuals can be whistleblowers, assuming they are not foreign officials or have not acquired their information from foreign officials. These two aspects of the rules present special risks for corporations with exposure under the FCPA, as it is the case, for example, that foreign employees who paid bribes to foreign officials, or foreign third-party vendors who simply learned about the payment of bribes by someone else, could be whistleblowers.

[5] *See* Proposed Rule 21F-8.

- information arising out of a legal representation of a client where, for example, the attorney wishes to make a whistleblower submission on his or her own behalf.

Significantly, both the second and third exceptions above are subject to the caveat that such sources of information may give rise to "independent knowledge" or "independent analysis" if the entity does not disclose the would-be whistleblower's information to the SEC "within a reasonable time or proceeded in bad faith." Thus, if such self-reporting by the entity does not occur within a reasonable time, anyone with legal, compliance, audit, supervisory or governance responsibilities – and any employee who learns information from such persons – can become a whistleblower, subject to the other conditions set forth in the proposed rules.[6]

Leads to successful enforcement. Under Rule 21F-4, there are two different standards for what constitutes successful enforcement. A whistleblower is entitled to an award (1) where the individual provides information that causes the SEC staff "to commence an examination, open an investigation, reopen an investigation that the Commission had closed," and the information "significantly contributed" to the success of the action or (2) where the conduct "was already under examination or investigation," and the information "would not otherwise have been obtained and was essential" to the success of the action.[7]

Determining Amount of Award

Proposed Rule 21F-6 sets forth the criteria for determining the amount of an award to be made to a whistleblower. The first three of the stated criteria in the proposed rule are derived from the statute, while the fourth – "whether the award otherwise enhances the Commission's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers" – was added by the SEC. The Release (but not the proposed rules themselves) specifies that the SEC also will consider a number of other relevant factors, including whether a whistleblower first reports the violation internally.

Proposed Rule 21F-15 provides that for purposes of determining whether the $1,000,000 threshold for an award under the program has been met and for determining the amount of any award that should be made to a whistleblower, the SEC will not take into account any monetary sanctions that the whistleblower himself or herself has been ordered to pay. Likewise, the proposed rule provides that in making such determinations the SEC will not take into account any monetary sanctions ordered against any entity "whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated."

Other Items

Confidentiality and anonymity. Proposed Rule 21F-7 reflects the confidentiality and anonymity provisions contained in the statute, explaining that the SEC will not reveal the identity of a whistleblower or disclose information that could reasonably be expected to reveal the identity of a whistleblower, except under circumstances described by statute or SEC rule. One notable example in this regard is that the SEC may provide the whistleblower's information to foreign securities and law enforcement authorities. The possibility of such disclosure will need to be taken into account by multinationals when evaluating whether and when to self-report to foreign authorities.

[6] Although information obtained by "a means or in a manner that violates applicable federal or state criminal law" may not qualify as "original information" under the proposed rules, there is no similar exclusion for information obtained in violation of foreign criminal laws.
[7] *See* Proposed Rule 21F-4(c).

No immunity. Proposed Rule 21F-14 makes clear that the provisions of Regulation 21F are not intended to, and do not, provide amnesty to individuals who have violated the federal securities laws. Individuals who have participated in wrongdoing are not immune from prosecution for that wrongdoing merely by virtue of the fact that they have provided tips to the SEC pursuant to the new whistleblower program. As described below, however, such wrongdoers may nonetheless be eligible to recover a bounty under the new proposed rules.

Communications without approval of entity counsel. Proposed Rule 21F-16 provides that if a whistleblower who is a director, officer, member, agent or employee of an entity that has counsel has initiated communications with the SEC relating to a potential securities law violation, the SEC staff is authorized to communicate directly with the whistleblower regarding the subject of the communication without seeking the prior approval of the entity's counsel (notwithstanding any professional responsibility rules for attorneys to the contrary). Thus, even when an employee reports allegations that the SEC later deems to be unfounded, the proposed rule would allow the SEC to bypass the in-house legal department in communicating with that employee regarding his or her allegations.

ANALYSIS OF PROPOSED RULES

In the language of the Release and through statements made by the Commissioners at the SEC's open meeting at which the proposed rules were considered, the SEC has shown that it is particularly focused on three key issues.

Issue One: Internal Compliance Processes

The SEC's proposed rules seek to balance the desire to motivate whistleblowers to provide the SEC with high-quality tips against the desire to have companies maintain strong internal corporate compliance processes. The new whistleblower program creates potentially huge incentives for whistleblowers with knowledge of potential securities law violations to report those violations to the SEC as quickly as possible. Employees who delay may learn that someone else has already provided the information. At the same time, the SEC has stated that it appreciates the important role that existing compliance, legal, audit and similar internal processes serve at the vast majority of companies.[8] These processes can be very effective in ferreting out wrongdoing. Indeed, given the SEC's limited resources, and the considerable time and effort needed to pursue each SEC investigation, internal compliance personnel may often be able to address an allegation of a potential violation more quickly and efficiently than the SEC.

The attempt to balance these competing interests is apparent in Proposed Rule 21F-4(b)(7), which provides that if an employee elects to report potential wrongdoing internally, before going to the SEC or another authority, the employee will receive the benefit of a 90-day "look back" period. Under this look back provision, if a whistleblower reports a potential violation to either (1) an authority other than the SEC (e.g., Congress) or (2) internal legal, compliance or audit personnel at the company, and, within 90 days thereafter, reports the potential violation to the SEC, the SEC will deem the information to have been provided to the SEC as of the date of the whistleblower's earlier report.

The 90-day look back period can fairly be criticized as falling short of the SEC's rhetoric regarding internal compliance. Although such a look back period will provide a measure of comfort to would-be

[8] *See, e.g.*, Release, Section II.D at 33-34 ("Compliance with the federal securities laws is promoted when companies have effective programs for identifying, correcting, and self-reporting unlawful conduct by company officers or employees. . . . The Commission does not intend for its rules to undermine effective company processes . . ..").

whistleblowers who may otherwise be disinclined to report internally for fear of losing their chance to be whistleblowers, the provision does nothing to actually create an incentive for internal reporting.

Similarly, the Release sets forth, as a potential factor in determining the size of an award, "whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the Commission." Nonetheless, the Release also notes that this consideration is "not a requirement for an award" greater than 10 percent and whistleblowers will not be penalized if they do not internally report "for fear of retaliation or other legitimate reasons."[9] These comments by the SEC – along with the fact that internal reporting is not set forth in the proposed rules as an explicit criterion to be considered and instead is mentioned only in the Release as a factor to be taken into account – suggest that the SEC's focus may be more on preserving flexibility for itself in determining the amount of the award than on providing actual incentives to report internally.

Issue Two: Company Self-Reporting and Provision of Information

The proposed rules create significant additional pressure on companies to self-report potential federal securities law violations or otherwise promptly provide relevant information to the SEC. This pressure can be seen in numerous places in the proposed rules, including the following:

- When an employer has already received a request, inquiry or demand from a requesting authority at the time of the whistleblower's submission, the proposed rules nonetheless allow for the submission to be considered "voluntary" if the employer has failed to provide to the requesting authority documents or information that the employer received from the whistleblower "in a timely manner" in response to the request, inquiry or demand.
- A person with legal, compliance, audit, supervisory or governance responsibilities for an entity who receives information with the reasonable expectation that he or she will take steps to cause the entity to respond appropriately to the violation, although ordinarily not eligible to be a whistleblower, can nonetheless become a whistleblower if thereafter the entity does not disclose the information to the SEC within a reasonable amount of time.
- A person who obtains knowledge or information from or through an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law can nonetheless become a whistleblower if the entity does not disclose the information to the SEC within a reasonable amount of time.

The implicit message conveyed by the self-reporting conditions thus appears to be that corporate compliance and internal policing are beneficial – but only to a point. In the SEC's view, if the entity fails to self-report, in-house lawyers, compliance personnel, internal auditors, managers and Board members all can become whistleblowers, as can any employee who gathers "original information" from communications with such persons. As a result, there will now be much more pressure on corporations to promptly report wrongdoing uncovered by internal investigations.

Issue Three: Whistleblower Wrongdoing

Under Dodd-Frank, a whistleblower cannot be an individual who has been convicted of a criminal violation related to the SEC action or to a related action for which the individual otherwise could receive an award. Because the statutory exclusion is limited to criminal convictions, the SEC is likely constrained from imposing any *per se* rules barring wrongdoers from becoming whistleblowers.

[9] *See* Release, Section II.E, at 51.

Accordingly, the proposed rules do not prevent payment of a bounty in situations where civil judgments have been leveled against whistleblowers, or where cease-and-desist orders, collateral bars or other penalties have been imposed. Moreover, and of particular importance in the FCPA context, various culpable actors who are not criminally convicted – including, for example, a foreign employee of a U.S. company's foreign subsidiary or a foreign third-party vendor who paid bribes to a foreign official on behalf of a U.S. company – are eligible to become whistleblowers.

Notwithstanding the issues identified above, the SEC has proposed some limits on allowing culpable individuals to benefit from the new whistleblower program. Proposed Rule 21F-15, for example, provides that, in determining whether the $1,000,000 recovery threshold has been satisfied in a particular case and in determining the amount of any award to be granted in a particular case, the SEC will not count any monetary sanctions that a whistleblower (or an entity controlled by the whistleblower) is ordered to pay.

KEY TAKEAWAYS AND RECOMMENDATIONS

- The important task of implementing the whistleblower program in a way that counteracts employees' incentives to bypass internal programs is clearly on the SEC's mind. It is less clear, however, that the SEC has done enough to promote internal reporting. For example, the SEC has not embraced proposals to quantify the benefits of internal reporting. In fact, internal reporting is not even set forth in the proposed rules as one of the criteria to be considered in determining the amount of an award to be made to a whistleblower; it is simply listed in the Release as one of many factors that the SEC says it will consider.
- For situations in which employees report potential violations internally, a 90-day clock will start ticking at the time of such report. The whistleblower must go to the SEC by the end of that period to avoid losing his or her place in line. In order to create an action plan for dealing with the internal report within that timeframe, companies will need to set-up mechanisms to respond to allegations immediately.
- The SEC has been forced to balance its interest in ensuring that individuals who have violated the federal securities laws do not benefit from such actions with mandates imposed by Dodd-Frank limiting the SEC's discretion in this regard. Even though the SEC may factor in an individual's culpability in determining the size of an award, it must still award the culpable whistleblower at least 10 percent of any recovery, assuming that he or she has not been convicted of a crime related to the action. The SEC has stated, however, that it is open to other suggestions on this topic.
- Although these proposed rules do not address Dodd-Frank's anti-retaliation provisions, employers will need to consider those provisions carefully when handling employees, including culpable employees, who may be whistleblowers or would-be whistleblowers.

Overall, the SEC has tried to manage a number of tensions inherent in establishing the new whistleblower program. Congress' statutory mandate obligated the SEC to create a program that would reward individuals, potentially very handsomely, for providing tips directly to the SEC. While the SEC's proposed rules implement that mandate, the agency is struggling to effectuate other important goals, such as preserving internal corporate compliance programs and allowing companies to determine the appropriate time and manner to self-report potential wrongdoing to governmental authorities.

As these rules are still simply proposals, all interested parties should consider providing comments. Indeed, in the Release announcing these proposals the SEC has explicitly invited comments on numerous significant topics including maintaining incentives for employees to report wrongdoing

internally first and ensuring individuals cannot benefit from blowing the whistle on themselves. The SEC will be accepting comments on these proposed rules until December 17, 2010. Given the inherent tensions highlighted by the SEC in announcing its proposed rules, there may well be opportunities to affect the contour and tone of the final regulations.

If you would like to discuss these proposed whistleblower rules or whistleblower issues more generally, please contact the following members of our firm:

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