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ADVISORY | Dodd-Frank Act

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FINAL SEC WHISTLEBLOWER RULES: WHAT WILL THEY MEAN IN PRACTICE?

Last week, by a 3-2 vote, the Securities and Exchange Commission adopted final rules implementing its new whistleblower program under the Dodd-Frank Act. The final rules resolve – at least on paper – controversial issues surrounding who can be eligible for a whistleblower award and under what circumstances.

We now know, for example, that internal reporting for company employees is not required. Instead, the SEC has included various incentives designed to make internal reporting more appealing to employees. Whether those incentives will work remains to be seen. We also now know that directors, officers, and others in positions of trust can be eligible for whistleblower awards in certain circumstances. The universe of such employees is narrower than it was in the proposed rules, but the circumstances in which those employees can receive awards have arguably been expanded, and the pressure on companies remains to self-report potential misconduct to the SEC quickly. Finally, the anti-retaliation protections of the statute are perhaps even broader than initially perceived. Although the SEC has not issued comprehensive rules on those provisions (thus leaving their interpretation in the hands of the federal courts), it has now made clear that anti-retaliation protection depends on what the employee "reasonably believes" about the nature of his or her information.

The ultimate effect of these aspects of the final rules will become clear over time. For now, companies should give careful attention to their compliance cultures and organizational dynamics; at bottom, the final rules highlight the "need for speed" in responding to whistleblower allegations and the wisdom of treating whistleblowers with care and attention. Companies also should consider how best to ensure the confidentiality of their internal investigations as they respond to allegations that have been made. And they should think through the relative risks and benefits of voluntary disclosures to enforcement authorities in light of the powerful incentives that Dodd-Frank provides to whistleblowers.

Key Provisions

Whistleblower Program Basics. The Dodd-Frank Act requires the SEC to pay a cash award to an individual who voluntarily provides the SEC with original information that leads to successful enforcement of the federal securities laws, resulting in monetary sanctions of more than $1 million. The award must be at least 10% and not more than 30% of the amounts recovered in the SEC and any related action. The Act also provides broad protections against retaliation by employers.

Voluntary Submission of Information. The final rules' explanation of what is required for information to be *voluntarily* submitted has not been much discussed but will be important. To be "voluntary" under the final rules, a submission must be made before the individual has personally received an inquiry on the subject from the SEC or other specified authority. An inquiry directed to an individual's employer is not enough to foreclose the individual's eligibility for an award, even when the individual employee possesses information or documents within the scope of the request. This change from

the proposed rules will make it easier for employees to be eligible for an award. Moreover, this change increases the risk that anyone – whether an employee or third party outside the company – who learns that the SEC or other specified authority is investigating may become a whistleblower.

Incentives to Encourage Internal Reporting. The SEC declined to require internal reporting as a condition of award eligibility, as many in the corporate community had suggested, but included in the final rules three incentives to encourage internal reporting:

- *Amount of award.* The final rules require that the SEC consider a whistleblower's involvement with an internal reporting program in determining the amount of the award (within the statutory range of 10% to 30%). Participation in internal compliance programs may increase the award; interference with such programs may decrease it.
- *Extended "lookback period."* Information previously known to the SEC does not qualify as "original." This places a premium on being the first to report information to the SEC. An employee, however, may first report internally to his or her employer and then, if the employee makes a report to the SEC within 120 days, be given credit at the SEC for the date of his or her original internal report. This "lookback" period (extended from the 90-day period in the proposed rules) is intended to give both whistleblowers and companies an opportunity, where appropriate, to resolve matters before involving the SEC.
- *Credit for a company's self-report.* A whistleblower whose internal report leads to a company investigation in whole or in part, and who reports the information to the SEC within 120 days of the internal report, can receive credit for all of the information later self-reported by the company.

Exclusion of "Special Personnel" and Privileged Information. Under the final rules, information obtained as part of an entity's compliance, internal audit, and investigative processes may not generally be used by officers, directors, compliance and internal audit personnel, and retained investigators (collectively, "special personnel"). Special personnel may, however, use such information if they have a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct or that such use is necessary to prevent conduct likely to cause substantial injury to the entity or investors. In addition, special personnel are free to use such information (if not derived from privileged communications) without limitation in a whistleblower submission 120 days after they received it in circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer, or the individual's supervisor was already aware of the information, or 120 days after they reported it to one of those authorities.

Similarly, information obtained through attorney-client privileged communications (whether involving in-house or outside counsel) may not be used in making a whistleblower submission, unless an attorney would otherwise be permitted to disclose such information by attorney conduct rules. The prohibition and exception apply to both attorneys and non-attorneys; in other words, if an attorney is permitted to disclose otherwise privileged information, so too is a non-attorney. Information obtained through an audit of a company's financial statements also may not generally be used in making a whistleblower submission.

Prohibitions Against Retaliation. The final rules' revised definition of a whistleblower encompasses an individual who provides information related to a "possible" securities violation that "has occurred, is ongoing, or is about to occur" (replacing the "potential violation" standard of the proposed rules). In addition, for purposes of the anti-retaliation provisions, an individual need only "reasonably believe" the information provided relates to such a violation; a "reasonable belief" must be both a subjectively genuine belief and a belief that might reasonably be held by a similarly situated employee. The SEC also declined to include a provision confirming that adverse employment actions

may be taken against whistleblowers for reasons independent of their whistleblowing activities. This should be axiomatic from the language of the statute, but now will be subject to case-by-case determinations of whether adverse actions are being taken "because of" whistleblowing activity.

Uncertainties and Ambiguities

The effectiveness of the internal reporting incentives is likely to be an open question for some time. First, it is unclear whether whistleblowers will actually value the potential award premium that might come from internal reporting, even if it is a factor that the SEC considers in determining the amount of an award. Second, while the availability of a "lookback" period will clearly give time for employees and companies to process potential whistleblower issues, a whistleblower who does not immediately report to the SEC is subject to the countervailing risk that another whistleblower will provide information during the "lookback" period that prompts an SEC investigation, and therefore may be entitled to share in the eventual award. Given this tactical consideration (which the well-counseled whistleblower presumably will appreciate), the extended "lookback" period is most likely to be relevant only to a whistleblower who is, for whatever reason, reluctant to involve the SEC, notwithstanding the assurances of anonymity that the final rules provide. And, third, the potential to receive credit for a company self-report to the SEC may seem too speculative for the typical whistleblower. One might question, for example, whether a whistleblower can be confident that, within 120 days, his or her information will trigger a company investigation and that the company will then choose to self-report the resulting findings.

The special personnel exclusions and exceptions are perhaps the most difficult to construe. Is the standard for "reasonable basis to believe" an objective one? If each member of the excluded class is invited to make an individual decision on whether the "belief" exceptions permit immediate reports, is the exclusion illusory? The 120-day exception suggests on its face that the mere lapse of time will allow special personnel to use investigative information for personal gain. But, if the company self-reports before the 120 days have passed, the information will already be known to the SEC when the special employee makes his or her report. Does this mean that the information from the special personnel is no longer "original" as long as the company self-reports within 120 days? It would appear so, but the answer is not obvious from the text of the final rules.

Although the anti-retaliation "reasonable belief" standard has been addressed by courts in the context of the False Claims Act and the Sarbanes-Oxley Act, deciding whether it is permissible to take action against an unsatisfactory employee who may be a whistleblower, even a culpable one, could be difficult.

What Should Companies Do?

- Ensure effective compliance. First and foremost, a company should ensure that it has an effective internal compliance program, one in which internal reporting is invited and facilitated by multiple means, including anonymous reports.
- Foster a "culture of compliance." A "culture of compliance" and setting the right "tone at the top" have never been more important. Communicate policies (including internal reporting and anti-retaliation policies), ensure that the conduct of the entity at all levels conforms to them, and reinforce those policies with employee training.
- Recognize that potential whistleblowers need not be employees. Reporting and response programs should be calibrated to handle complaints from non-employees, including customers, suppliers, distributors, other business partners, shareholders, and members of the public.

- Ensure early involvement of the legal department. Privilege considerations have always been significant; they take on even greater weight in light of the general exclusion of attorney-client privileged information from whistleblower submissions.
- Investigate quickly and decide on a regulatory strategy. Because the whistleblower could choose to report to the SEC at any time, the company should immediately launch an efficient but careful investigation of the core allegations. Ultimately, the goal is to develop enough facts quickly so that the company can assess the merits of the core allegations and determine whether to make an early self-report to the SEC. An early self-report by a company may reduce the level of SEC involvement that might otherwise be triggered by a whistleblower report.
- Handle personnel matters affecting whistleblowers with extreme care. Remember that even if a whistleblower is wrong, he or she may still be protected from adverse employment action.
- Evaluate and communicate with the whistleblower. No two whistleblowers are alike. Some are motivated by morality or ethics, others by money. But many simply want to be heard. Understand the whistleblower's concerns, act on them as warranted, and, if appropriate, let the whistleblower know that his or her concerns are being addressed.

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

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