

SEC Approves New Whistleblower Program

The SEC voted on May 25, 2011 to adopt final rules governing a whistleblower program to reward individuals who provide the agency with high-quality tips that lead to successful enforcement actions. The rules, which implement Section 922 of the Dodd-Frank Act, are effective 60 days from publication in the Federal Register.

As predicted in our [alert memo](#) dated November 5, 2010, the most contentious issue raised during the comment period was whether employees' new financial incentives to complain to the SEC would undercut the effectiveness of their companies' internal compliance programs. The final rules seek to ameliorate this concern by adding counter-incentives for employees to comply with internal procedures, although they do not go so far as to require whistleblowers to report violations internally first. Below is a summary of the key concepts under the new rules and a discussion of what they may mean for existing internal compliance programs.

Key Concepts under the New Rules

The SEC will pay an award to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to a successful enforcement action. An award is payable to whistleblowers only if the SEC recovers a monetary sanction exceeding \$1,000,000, a threshold that includes all amounts "ordered to be paid," including penalties, disgorgement, and interest, whether paid to the SEC or to a disgorgement or other fund.¹ Providing information about any securities law violation may lead to an aggregate award to all entitled whistleblowers of 10 to 30% of the penalties collected in an SEC enforcement action or "related action."²

Whistleblower Status. Rule 21F-2(a) defines a "whistleblower" as "an individual who, alone or jointly with others, provides information to the [SEC] relating to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur." A

¹ The Commission will now aggregate two or more smaller actions that arise from the same nucleus of operative facts to calculate the \$1,000,000 threshold. The Commission expects this will make whistleblower awards available in more cases.

² A "related action" includes federal and state criminal proceedings, as well as proceedings brought by appropriate regulatory agencies or self-regulatory organizations.

whistleblower must be an individual; companies are not eligible.

Voluntary Submission of Information. Rule 21F-4(a) defines a submission as “voluntary” if the whistleblower submits the information before a request, inquiry, or demand that relates to the subject matter of the submission is directed at the whistleblower or anyone representing the whistleblower. A submission is not voluntary if the would-be whistleblower is required to report the information as a result of a pre-existing legal duty, a contractual duty owed to the Commission or another relevant authority, or a duty that arises out of a judicial or administrative order.

Original Information. Rule 21F-4(b) defines “original information” as information (i) derived from the whistleblower’s independent knowledge or independent analysis, (ii) not already known to the SEC from any other source, unless the whistleblower is the original source of the information, and (iii) 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 whistleblower is a source of the information.

Rule 21F-4(b)(4) lists several types of information as not based on the whistleblower’s “independent knowledge” or “independent analysis.” In addition to information obtained in a way that violates applicable federal or state criminal law, the categories of ineligible information include:

- information obtained through attorney-client privileged communications or obtained through a whistleblower’s legal representation of a client; and
- information obtained by individuals, including officers, directors, trustees, and partners: (i) in connection with a company’s internal compliance programs, (ii) involved in a company’s internal audit process, (iii) conducting an investigation into a possible violation of law, or (iv) associated with public accounting firms who learn of a violation in connection with the performance of audit procedures required by the federal securities laws.

Rule 21F-4(b) also creates exceptions to these exclusions. First, traditional exceptions to the attorney-client privilege apply. Thus, if an attorney could ethically submit the information under the same circumstances consistent with applicable state bar rules, she may be eligible for an award.³ Second, individuals acting in a compliance or governance role may be entitled to an award if there is a reasonable basis to believe (i) the disclosure of the information is necessary to prevent conduct that is likely to cause substantial financial

³ The crime-fraud exception is likely to be most applicable here.

injury to the company or investors, (ii) the company is engaging in conduct that will impede an investigation of the misconduct, or (iii) at least 120 days have elapsed since the information was reported to the appropriate internal corporate actors or since the information was received under circumstances indicating that the appropriate actors were already aware of the information.⁴

Successful Enforcement Action. Rule 21F-4(c) defines three situations where the SEC will conclude that the whistleblower's information led to "successful enforcement" of an SEC judicial or administration action or related action. First, the information must be sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen a closed investigation, or to focus on different conduct as part of a current examination or investigation, and the Commission must have brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of the information. This lowers the earlier proposed standard, which required that the information *significantly contribute* to the success of the action. The Commission believes requiring high-quality tips – ones that are specific, credible, and timely – are more likely to lead to successful enforcement actions. Second, if the information was about conduct that was already under examination or investigation by the Commission or another regulatory or oversight body, the submission must "significantly contribute" to the success of the action. This also lowered the previous standard which required the information be *essential* to the success of the action.⁵ The third situation, discussed below, is intended to incentivize the use of internal compliance programs.

Internal Corporate Compliance Programs

Despite controversy and numerous comments from the business community, the final rules do not require whistleblowers to avail themselves of internal compliance programs before reporting to the SEC. Instead, the Commission made several changes to its proposal to add incentives for whistleblowers to use internal compliance programs before or when going to the Commission. If these incentives work as the SEC apparently believes they will, companies often will learn of corporate malfeasance before the SEC is notified. The SEC intends that this will give companies opportunities to address significant concerns as they arise and to respond to the threat of an SEC investigation.

First, and most significant, a whistleblower may receive a significantly greater award

⁴ The Commission noted, however, that companies should not view the 120 days as a "grace period." When considering whether and to what extent to give credit for cooperation with the SEC, the promptness with which companies voluntarily self-report their misconduct will remain an important factor.

⁵ According to the SEC, lowering the standard recognizes that in some cases information voluntarily provided by a whistleblower can play a vital (even if not essential) role in advancing an existing investigation.

for reporting information to her company's internal compliance program than she would for reporting that same information to the Commission. This is because, under Rule 21F-4(c), if the whistleblower uses the company's internal compliance program and the company investigates and reports the results of its investigation to the Commission, *all* the information provided by the company to the Commission will be attributed to the whistleblower, not just the information reported by the whistleblower. The idea is to appeal to an economically motivated whistleblower by encouraging the use of internal compliance programs to leverage the value of information that the whistleblower might otherwise report to the SEC.

Second, the final rules state that a whistleblower's voluntary participation in a company's internal compliance program is a factor that can increase the amount of an award.⁶

Third, the final rules extend the time from 90 to 120 days for a whistleblower to report to the Commission after first reporting internally and still be treated as if she had reported to the Commission at the earlier date.⁷

Fourth, the rules exclude certain categories of individuals – namely attorneys and internal and external personnel engaged in compliance-related matters – from benefiting as whistleblowers. This removes a potential disincentive to report internally, since the individuals tasked with operating those programs are disqualified from becoming a whistleblower and thus sharing in any award.⁸

The Impact of the Whistleblower Rules

It is difficult to predict with any confidence what effect the SEC's whistleblower rules will have on internal compliance programs. Crediting a whistleblower with all the information generated by his or her tips to an internal compliance program certainly provides a substantial incentive for whistleblowers to report internally rather than going immediately to the SEC. But it does not eliminate other disincentives to internal reporting, such as fear of retaliation and ostracism. It is hard to know how these incentives will balance out. Under any circumstances, the motivations of whistleblowers are often varied and complex. Except in unusual circumstances, neither companies nor the SEC have much experience with whistleblowers whose motivations are principally economic.

⁶ Similarly, a whistleblower's interference with internal compliance and reporting may decrease the amount of an award. See Rule 21F-6(a).

⁷ See Rule 21F-4(b)(7).

⁸ This exclusion is subject to various exceptions, as described above.

Additionally, the whistleblower program introduces another party whose motivations are germane – the whistleblower’s lawyer. There is a world of difference between a person who reports wrongdoing with no expectation of profit and one who employs an advocate to help him obtain a monetary award. This will have a profound impact on shaping the universe of complaints that will be reported and, most importantly, how they are pursued once reported. Certainly, some complaints will be adversarial exercises for companies or for the Commission.

There is no way of knowing how many putative whistleblowers will seek representation. To some extent, lawyers for whistleblowers will serve to screen out cases that have a low probability of an ultimate award. They may also pursue complaints in volume in the hopes that some will prove lucrative. It is a safe bet, though, that once reported – either through internal compliance programs or the SEC – they will involve extensive time and effort to bring these complaints to closure.

In the aggregate, the new provision will probably accomplish Congress’ goal of more and improved reporting to the SEC. The ultimate quantity and, more important, quality of the complaints the Commission will field, however, remain to be seen and will be influenced significantly by how the SEC treats the applications for awards that it receives.

What is certain is that companies must, and the SEC will, take very seriously any reports of wrongdoing. In this era of scrutiny of how the SEC responds to tips and complaints, the SEC will have to respond to virtually any complaint from a represented whistleblower or that contains documented evidence. Because the SEC staff will be called upon to explain itself – whether to the Commission’s Inspector General, to the press, or to Members of Congress – there will be significant pressure on the staff to follow up extensively on complaints and to document its responses.

We think it is unlikely that the rules will reduce the importance of internal compliance programs. While it is possible there may be fewer complaints, the addition of significant economic incentives for whistleblowers and the introduction of counsel for potential claimants may turn company responses to complaints into mini-litigations, with the SEC as an interested and unfriendly observer.

Finally, companies should consider whether their compliance programs are sufficiently proactive in contacting employees who may be aware of wrongdoing. To be sure, there is a risk of learning of matters that do not warrant attention but that must be reviewed with some degree of formality. Nonetheless, with the new whistleblower rules, there is an enhanced risk that employees are talking to the government without the knowledge of the company.

* * *



Please feel free to call David M. Becker (+1 202 974 1530) or Shawn J. Chen (+1 202 974 1552), any of your regular contacts at the Firm or any of our partners and counsel listed under “Corporate Governance” or “White-Collar Defense, Securities Enforcement and Internal Investigations” in the Practices section of our website (<http://www.clearygottlieb.com>) if you have any questions.

CLEARY GOTTlieb STEEN & HAMILTON LLP

New York
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

Paris
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

Moscow
Cleary Gottlieb Steen & Hamilton LLC*
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax
* an affiliate of Cleary Gottlieb Steen & Hamilton LLP

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

Cologne
Theodor-Heuss-Ring 9
50688 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

Rome
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

Milan
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

Hong Kong
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

Beijing
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax

Buenos Aires
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
54 11 5556 8900
54 11 5556 8999 Fax