Arnall Golden Gregory LLP

Client Alert

Contact Attorneys Regarding This Matter:

Joseph Alley Jr.
404.873.8688 - direct
404.873.8689 - fax
joseph.alley@agg.com

Aaron M. Danzig
404.873.8504 - direct
404.873.8505 - fax
aaron.danzig@agg.com

Robert F. Dow
404.873.8706 - direct
404.873.8707 - fax
robert.dow@agg.com

SEC Proposes Rules for Implementing the Whistleblower Program Established by the Dodd-Frank Act; Comments Due December 17, 2010

On November 3, 2010, the Securities and Exchange Commission (SEC or Commission) released its proposed rules to implement the whistleblower program established by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] Generally speaking, the whistleblower program requires the Commission to pay an award or bounty to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of securities laws, which then leads to a successful enforcement action. If the Commission recovers over $1,000,000 through penalties, fines or disgorgement of gains, the eligible whistleblower can receive between 10–30 percent of the recovery. Additionally, there are protections against retaliation by employers if an employee is the whistleblower.

The Commission is accepting comments to the proposed rules and responses to various specific questions about the proposed rules. Comments must be submitted on or before December 17, 2010. The final rules are to be implemented by April 2011.

As with any government program, the devil is in the details. The 181-page proposed rules and SEC explanations are comprehensive and define many terms, conditions and procedures whistleblowers must follow to be eligible for a monetary recovery. The rules also define various required terms in the statute, such as who is a "whistleblower," what "voluntary" submission means, and what is "original information." The whistleblower program and proposed rules have raised some controversy as well, most notably a concern that the rules would motivate employees to bypass their company's compliance processes and instead report directly to the Commission in the hopes of obtaining a financial reward.

Key Definitions

The proposed rules define "whistleblower," as a natural person. That is, companies and other legal entities cannot be whistleblowers. In the requests for comments, the Commission asks whether the definition of whistleblower should exclude people who report about their own misconduct. While persons convicted of a crime related to the SEC matter are excluded, those who

1 A copy of the proposed rules can be found at http://www.sec.gov/rules/proposed/2010/34-63237.pdf.

Arnall Golden Gregory LLP
Attorneys at Law
171 17th Street NW
Suite 2100
Atlanta, GA 30363-1031
404.873.8500
www.agg.com

may have culpability but have not been convicted are not specifically excluded. It would seem to be a perverse result if a person engaged in misconduct could blow the whistle on himself and others and then receive a financial reward for doing so. Perhaps the Commission will make this clear in the final rule.

Any submission by a whistleblower must be "voluntary." By this, the Commission proposes to require that a submission be made before the whistleblower or company has received any formal or information request, inquiry, or demand from the Commission, Congress or any other federal, state or local authority. This requirement may be seen as too restrictive. What about situations where a subpoena has been issued, but it is only tangentially related to the matter to which the whistleblower submits information to the Commission? In such a situation, without the whistleblower's submission, it is possible that the Commission would not have learned of the potential violation of securities laws. So shouldn't the whistleblower receive some credit? Another question that arises is whether a whistleblower who has a pre-existing legal duty to report potential issues can provide "voluntary" information?

To qualify for potential recovery, the information provided by the whistleblower must be "original information." This means it comes from the whistleblower's independent knowledge or analysis, is not already known to the Commission and is not exclusively derived from an allegation made in a judicial or administrative hearing. Interestingly, the proposed rules consider a whistleblower's analysis as original information even if it stems from the examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available. Perhaps this is a nod to Harry Markopolos, the Boston fund analyst who analyzed Bernie Madoff's returns and reported to the SEC his belief that Madoff was running a Ponzi scheme.

There are certain important proposed exceptions where information is not considered to come from "independent knowledge" or "independent analysis:"

1. Information learned through privileged attorney-client communications. For example, an in-house attorney cannot learn of information in the course of his or her work, then disclose that information to the SEC and be deemed a whistleblower under the program.
2. A company's legal, audit or compliance employees who learn of information that has been communicated to them with the reasonable expectation that they would take steps to address the situation. So a compliance officer who learns of a potential securities law violation through a hotline tip cannot then provide that information to the SEC and be deemed a whistleblower under this program.
3. Officers, directors, employees and consultants who learn of potential violations as part of their corporate responsibilities in the expectation that they will take steps to address the violations, and people who learn about misconduct through various processes a company employs to identify problems and advance compliance with legal standards would not be considered to have independent knowledge.

However, a person in the second or third categories could still become a whistleblower if the entity or company does not disclose the information to the Commission within a reasonable time, or if the entity proceeds

in bad faith. Thus, the Commission is taking the position that, for example, a compliance officer who learns of a potential problem through her work cannot be a whistleblower unless her company does not self-report within a "reasonable time" or proceeds in "bad faith." There is no clear definition, though, of "reasonable time." Does this mean three months, six months or even longer? Additionally, it is not clear what the Commission means by proceeding in "bad faith." For example, what if the company analyzes the issue, believes that no disclosure to the SEC is required, and that the company does not need to undertake any significant remedial action. Has the company acted in bad faith? Who makes that determination?

The proposed rules also discuss specific forms and procedures for submitting information to the Commission, how to determine if the information is deemed successful to the resolution of the case and how to appeal an award determination. Notably, and unlike the False Claims Act, the whistleblower rules do not actually require a person to file a lawsuit; all that is necessary is to provide the information to the Commission.

In an attempt to set procedures in place to deter false submissions, the proposed rules also require that information be submitted under penalty of perjury, and anonymous whistleblowers must be represented by counsel who must certify that they have verified whistleblower's identity.

Proposed Rules Likely to Cause Significant Spike in Complaints to SEC, Result in Employees Bypassing Company Compliance Programs

The proposed rules also attempt to address what has become the most notable criticism of the whistleblower program—that it will incentivize employees to disregard a company's compliance program and instead report any problems, real or perceived, to the SEC. As the Commission stated in the introduction to the proposed rules:

> Among [the potential competing interests] was the potential for the monetary incentives provided to whistleblowers by Section 21F of the Exchange Act to reduce the effectiveness of a company's existing compliance, legal, audit and similar internal processes for investigating and responding to potential violations of the federal securities laws. With this possible tension in mind, we have included provisions in the proposed rules intended not to discourage whistleblowers who work for companies that have robust compliance programs to first report the violation to appropriate company personnel, while at the same time preserving the whistleblower's status as an original source of the information and eligibility for an award. At the same time, the proposed rules would not prohibit a whistleblower in a compliance function from reporting information to the Commission where the company did not provide the information to the Commission within a reasonable time or acted in bad faith. (Proposed Rules, page 4)

In attempt to address this tension, one of the proposed rules would allow a whistleblower to be eligible for a share of a financial reward if heor she provides information about potential violations to a company's internal compliance department and then, within 90 days, submits the required forms to the Commission.

According to the SEC, "[t]he objective of this provision is to support, not undermine, the effective functioning of company compliance and related systems by allowing employees to take their concerns about potential violations to appropriate company officials first while still preserving their rights under the Commission's whistleblower program." However, this provision still may not properly incentivize people to utilize the company's compliance program because of the potential monetary award the SEC offers.

One way the Commission could more fully support company compliance programs would be to require potential employee whistleblowers to first utilize his or her company's in-house complaint and reporting procedures. However, the Commission ultimately rejected that option:

> Given the policy interest in fostering robust corporate compliance programs, we considered the possible approach of requiring potential whistleblowers to utilize in-house complaint and reporting procedures, thereby giving employers an opportunity to address misconduct, before they make a whistleblower submission to the Commission. Among our concerns was the fact that, while many employers have compliance processes that are well-documented, thorough, and robust, and offer whistleblowers appropriate assurances of confidentiality, others lack such established procedures and protections.
>
> We emphasize, however, that our proposal not to require a whistleblower to utilize internal compliance processes does not mean that our receipt of a whistleblower complaint will lead to internal processes being bypassed. We expect that in appropriate cases, consistent with the public interest and our obligation to preserve the confidentiality or a whistleblower, our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back.
> (Proposed Rules, page 34)

This area will likely generate some significant comment. Indeed, the Commission specifically seeks "recommendations on structures, processes, and incentives that we should consider implementing in order to strike the right balance between the Commission's need for a strong and effective whistleblower awards program, and the importance of preserving robust corporate structures for self-policing and self-reporting." Questions raised by the Commission in this area include:

1. Should the Commission consider a rule that, in some fashion, would require whistleblowers to use employer-sponsored complaint and reporting procedures?
2. What would be the appropriate contours of such a rule, and how could it be implemented without undermining the purposes of Section 21F?
3. Would the proposed rules frustrate internal compliance structures and systems that many companies have established in response to Sarbanes-Oxley?

Corporations who submit comments may argue for a requirement that a potential whistleblower use the company's compliance/hotline procedures prior to contacting the SEC. From a company's perspective, a whistleblower referral to the SEC that requires the company to respond to the SEC, rather than dealing with the potential issue in-house, will significantly increase costs. It may also result in more, and earlier, instances of self-reporting. Additionally, companies may complain that there is no screening mechanism to separate legitimate concerns from frivolous ones because the SEC would have no method to do so without instituting an investigation and/or requesting information from the company.

On the other hand, some commentators have criticized the Commission's plans, in certain cases, to inform the company of the suspected wrongdoing before investigating on its own. In this sense, some have complained that the Commission plans to blow the whistle on the whistleblowers in the sense that disclosing to a company that someone has reported it may result in the whistleblower's outing and may have a chilling effect on others who may bring information to the SEC. However, this concern should be tempered because employees should be bringing information to their in-house compliance department first, and the company should have the opportunity to address any reported issues or problems. The proposed rules also allow the potential whistleblower to make a report to the Commission, but also give the company the opportunity to address the issue first. Of course, this leads to another potential problem—if the company investigates and determines that there is no problem or that the problem is minor and can be rectified, does the company still then have to report it to the SEC?

The Commission staff downplays the "possible tension," but the proposed rules will most likely have a profound effect of incentivizing whistleblowers to report alleged wrongdoing directly to the Commission and therefore reducing the effectiveness of such compliance programs. This conflicts with the emphasis the SEC, the Department of Justice, and other federal agencies place on the importance of robust compliance programs. Unfortunately, the proposed rules do not adequately balance these goals, and it seems likely that their implementation will result in a dramatic increase of complaints to the Commission that more appropriately can, and should, be addressed by a company's compliance program. As a result, companies may see their compliance-related costs increase in responding to Commission inquiries, rather than dealing with those inquiries in-house. At the same time, the Commission may be overwhelmed with a flood of potentially minor or frivolous whistleblower complaints that will take additional resources to assess and will detract from the Commission's duties. With a slew of whistleblower complaints to assess, and without a clear mechanism for sifting out the truly meritorious issues, the Commission may end up missing the types of securities laws violations for which the whistleblower law was developed to help catch.

What Happens Next?

The Commission's proposed rules to implement the whistleblower provisions of the Dodd-Frank Act will likely lead to more referrals to the SEC. It will likely also result in employees circumventing their companies' compliance programs and running directly to the government to obtain a potential whistleblower bounty. The proposed rules contain many points that are still under consideration, such as whether an employee

who is culpable can still participate in a potential bounty and whether an employee should first be required to follow his or her company's compliance policies before reporting to the SEC.

The deadline for filing comments on the proposed rules is December 17, 2010.