SEC ISSUES FINAL RULES IMPLEMENTING NEW WHISTLEBLOWER PROGRAM

May 27, 2011

To Our Clients and Friends:

On May 25, 2011, the Securities and Exchange Commission approved, by a 3-2 vote, the final rules[1] implementing the whistleblower provisions of Section 21F of the Securities Exchange Act of 1934, "Securities Whistleblower Incentives and Protection," enacted as Section 922 of the July 21, 2010, Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] The new rules, which become effective 60 days after their publication in the Federal Register, permit the SEC to move forward with the whistleblower bounty program established by the Dodd-Frank Act, which requires the SEC to pay an award to eligible whistleblowers of between 10% and 30% of the monetary sanctions that the SEC collects in enforcement matters arising from conduct related to the information provided by the whistleblowers in which the SEC obtains more than $1 million in sanctions. The new rules also implement the provisions of the Dodd-Frank Act protecting whistleblowers against retaliation.

As can be seen from the split vote of the SEC and from the more than 240 comment letters and 1,300 form letters received by the SEC during the public comment period, the whistleblower provisions of the Dodd-Frank Act and the SEC's November 3, 2010, proposed rules[3] generated significant controversy from corporations, professional organizations and whistleblower advocates. Many of the concerns expressed by commenters centered around the potential effects of the whistleblower bounty program on existing internal corporate compliance programs. In announcing the final rules, Chairman Schapiro stated that they were "a result of the careful weighing of the comments which improved upon the earlier rules we proposed." Indeed the SEC made a number of revisions to the proposed rules designed to address the competing concerns created by the implications of a bounty program on the internal reporting

---

1 *SEC Rel. 34-64545, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), www.sec.gov/rules/final/2011/34-64545.pdf*

2 *Pub. L. No. 111-203, § 922(a), 124 Stat. 1841 (2010).*

3 *SEC Rel. 34-63237, Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (Nov. 3, 2010), http://www.sec.gov/rules/proposed/2010/34-63237.pdf*

and investigation of potential misconduct. Although Chairman Schapiro described her belief that the final rules "strike[] the correct balance – a balance between encouraging whistleblowers to pursue the route of internal compliance when appropriate – while providing them the option of heading directly to the SEC," it is unlikely that those concerned that the bounty program will undermine compliance programs will agree because the SEC stopped short of requiring whistleblowing employees to report internally to their companies' internal compliance programs before providing information to the SEC. In his statement dissenting from the decision to adopt the final rules, Commissioner Paredes concluded, "I believe we could and should have calibrated the final rule differently, shifting the tradeoffs in favor of ensuring the integrity of internal compliance programs as a complement to government enforcement."

THE SEC WHISTLEBLOWER BOUNTY PROGRAM

Under the statutory mandate in the Dodd-Frank Act, the SEC was required to adopt rules to implement a whistleblower bounty program that would require the SEC to pay awards to eligible "whistleblowers" who "voluntarily" provide the SEC with "original information" in the form and manner required by the rules that leads to a successful enforcement action yielding monetary sanctions of over $1 million. The key aspects of the bounty program as prescribed in the final rules include the following:

Definition of "Whistleblower." Rule 21F-2(a) defines a whistleblower as someone who "alone or jointly with others" provides the SEC with information that "relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur." The rule further limits whistleblowers to natural persons and expressly excludes companies or other entities from being whistleblowers. In rejecting comments that called for a higher threshold relationship between the information provided by the whistleblower and the securities law violation ("probable" or "likely"), the SEC stated that the term "possible violation" (which was changed from "potential violation" in the proposed rules) requires only that the information provided by the whistleblower "indicate a facially plausible relationship to some securities law violation."

"Voluntarily" Providing Information. Under the definition in Rule 21F-4(a), a whistleblower will be found to have provided information to the SEC "voluntarily" if she did so before receiving any request, inquiry or demand relating to the same subject matter by the SEC or in an investigation or similar inquiry by the Public Company Accounting Oversight Board, a self-regulatory organization, Congress, any other federal investigative authority, or a state Attorney General or securities regulatory authority. In approving the final rule with only slight

modifications from the original proposal, the SEC specifically declined to exclude from the definition employees who reported only after being contacted during internal investigations.

"Original Information." Rule 21F-4(b) defines "original information" to include information: (i) derived from the whistleblower's "independent knowledge" or "independent analysis;" (ii) not already known to the SEC from another source (unless it can be shown that such source obtained the information from the whistleblower); (iii) not derived from an allegation made in a judicial or administrative hearing, government report, hearing, audit or investigation, or from news media (again, unless the whistleblower is the original source); and (iv) provided after the Dodd-Frank Act was enacted on July 21, 2010. The rule defines "independent knowledge" as factual information not derived from publicly available sources and "independent analysis" as the whistleblower's own analysis "done alone or in combination with others" which may be based on publicly available information.

Exclusions From "Independent Knowledge" and "Independent Analysis." Rule 21F-4(b)(4) then provides that information will not be considered to be derived from independent knowledge or independent analysis if the information was obtained:

- through a communication subject to the attorney-client privilege, unless disclosure of the information would be permitted by an attorney under the SEC's attorney conduct or state ethics rules;
- through legal representation of a client by the whistleblower or the whistleblower's employer or firm when the disclosure to the SEC is for the whistleblower's own benefit, unless disclosure of the information would be permitted by an attorney under the SEC's attorney conduct or state ethics rules;
- in circumstances not covered by the privilege-related exclusions, above, through one of the following ways: (a) officers, directors, trustees, or partners of an entity who learned the information either through being informed of allegations of misconduct or in connection with an entity's processes for identifying, reporting, and addressing potential non-compliance with the law; (b) employees of an entity whose principal duties involve compliance or internal audit responsibilities and employees of outside firms retained to perform compliance or internal audit work for an entity; (c) employees of outside firms retained to conduct an internal investigation or inquiry into possible violations of law; and (d) employees of

accounting firms who obtained the information about an engagement client in the course of performing an engagement required under the federal securities laws. Rule 21F-4(b)(4)(v), however, contains three exceptions to these exclusions: (1) when the exempted person has a reasonable basis to believe that disclosure of information to the SEC is necessary to prevent the entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors; (2) when the exempted person has a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct; and (3) when more than 120 days have elapsed since the whistleblower either provided the information to the audit committee, chief legal officer or chief compliance officer or received it under circumstances indicating that one of those individuals or the audit committee was already aware of the information.

- by a means or in a manner that violates applicable federal or state criminal law; or
- from any individual who would otherwise be excluded pursuant to any of the above criteria.

Information That Leads to a Successful Enforcement Action. Rule 21F-4(c) states that a whistleblower's information will be considered to have led to a successful enforcement action if: (i) the information was "sufficiently specific, credible, and timely" to cause the SEC to open, reopen or expand an investigation and the SEC brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of the whistleblower's information; (ii) the information related to conduct that was already under investigation by the SEC or other authorities and the whistleblower's information "significantly contributed to the success of the action; or (iii) the information was originally reported by the whistleblower through an entity's internal compliance procedures, was reported by the whistleblower to the SEC within 120 days of the disclosure to the entity, and was subsequently provided by the entity to the SEC (as information or the results of an investigation based on the information) in a manner and with an effect that met the requirements of the first two parts of this subsection.

Determining the Amount of the Award. Determination of the specific amount of an award is left to the discretion of the SEC, but the Dodd-Frank Act mandates that eligible whistleblowers receive an award of at least 10% and no more than 30% of the monetary sanctions collected by the SEC and other enforcement authorities. Rule 21F-6 describes a list of factors that the SEC may consider in making its determination to increase or decrease the award within

the statutory range, including the following: (i) significance of the information provided by the whistleblower to the success of the SEC's enforcement action; (ii) level of assistance provided by the whistleblower, including cooperation with the SEC's investigation, timeliness or delay of the

initial report, SEC resources that were conserved as a result of the whistleblower's assistance, the whistleblower's efforts to encourage others to cooperate and assist the SEC's investigation; remediation efforts undertaken by the whistleblower, and any "unique hardships" experienced by the whistleblower; (iii) the programmatic and policy interests of the SEC in making whistleblower awards; (iv) the extent to which the whistleblower reported internally and assisted or interfered with internal compliance efforts; and (v) the role, involvement and culpability of the whistleblower in the conduct and violations at issue in the SEC's enforcement action.

ATTEMPTS TO BALANCE THE EFFECT ON INTERNAL COMPLIANCE PROGRAMS

Commenters on the proposed rules identified two primary areas in which they believed the rules operated to weaken internal corporate compliance programs and inhibit the efforts of responsible entities to investigate and remediate potential compliance violations.

With respect to the first of these, the incentives in the bounty program to bypass internal compliance reporting mechanisms, the SEC did not, as many commenters proposed, require potential whistleblowers to report to internal compliance programs as a prerequisite for whistleblower eligibility. Instead, the SEC sought to balance the competing desires to avoid negative effects on internal compliance programs with the objective of ensuring that the rules provide the appropriate incentives for whistleblowers to provide information to the SEC. As noted above, the SEC sought to achieve that balance by adopting provisions that would encourage, but not require, voluntary internal reporting, including provisions: (i) permitting a whistleblower to receive credit for information reported to an internal compliance system if the company then reports the information, or the results of an investigation based on the information, to the SEC, even if the original information provided to the company would not have met all the criteria for eligibility; (ii) giving whistleblowers who report internally 120 days in which to report to the SEC and still be credited with the internal reporting date; and (iii) considering as factors that may increase the amount of an award the extent to which a whistleblower reported internally and assisted an entity's internal compliance processes.

According to Chairman Schapiro, the SEC determined that enhancing incentives to encourage voluntary internal reporting was a preferable course "because it is the whistleblower who is in the best position to know which route is best to pursue." However, the fact that those potential

whistleblowers are making the choice of which route to pursue knowing that only one choice – reporting to the Commission – offers the potential for significant financial rewards and failure to report internally carries little or no tangible penalty, the choice presents as little more than a formality. Given the anti-retaliation provisions of the Dodd-Frank Act and the rules and the

specific prohibition in Rule 21F-17 on the use of confidentiality or other similar agreements to prevent communications to the SEC by whistleblowers, there is little that companies can do to impact the choice. The final rules neither prohibit nor permit the use or enforcement of policies mandating internal reporting of suspected compliance violations, but the potential risks of enforcing such policies in light of the ambiguity and the breadth of the anti-retaliation provisions suggests that companies will consider carefully whether and how to implement and enforce such policies.

The second area of concern identified by commenters in the proposed rules involved the ability of non-lawyer compliance, audit and supervisory personnel to report on matters learned in the course of their compliance duties and on others to report information obtained as a result of a compliance inquiry or process and have it still considered as "independent information" or "independent analysis" eligible for an award. The proposed rules excluded such information, but the exclusions were subject to an exception for circumstances in which the potential whistleblower's "company does not disclose the conduct to the [SEC] within a reasonable time or proceeds in bad faith." Responding to comments that these exceptions were vague and, in relying solely on the judgment of the potential whistleblower, effectively eliminated the restrictions, the SEC substantially revised Rule 21F-4(b) to include both the more specific exclusions from "independent information" or "independent analysis" described above and the more detailed exceptions. In the end, however, the exceptions still rely solely on the "reasonable belief" of the compliance professionals or other whistleblowers in circumstances in which every incentive points them toward reporting such information to the SEC at the earliest possible moment. As Commissioner Paredes observed, "I am concerned that, in practice, these exceptions will swallow the general rule that compliance and internal audit personnel are not eligible to receive bounties."

We expect that compliance standards and best practices will evolve to meet the significant issues and challenges posed by the new rules and the SEC's whistleblower bounty program. As companies continue to assess the design, operation and implementation of their compliance programs in light of the new reality and the SEC and courts enforce and interpret the new rules, we will continue to report on significant new developments.

* * *

Please feel free to contact us with any questions about the whistleblower rules, the SEC's bounty program or the Dodd-Frank Act.

Paul R. Berger
+1 202 383 8090
prberger@debevoise.com

Andrew J. Ceresney
+1 212 909 6947
ajceresney@debevoise.com

W. Neil Eggleston
+1 202 383 8140
wneggleston@debevoise.com

Sean Hecker
+1 212 909 6052
shecker@debevoise.com

Matthew E. Kaplan
+1 212 909 7334
mekaplan@debevoise.com

Colby A. Smith
+1 202 383 8095
casmith@debevoise.com

Jonathan R. Tuttle
+1 202 383 8124
jrtuttle@debevoise.com

Bruce E. Yannett
+1 212 909 6495
beyannett@debevoise.com

Mary Jo White
+1 212 909 6260
mjwhite@debevoise.com