

SEC's Proposed Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Employers

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The Securities and Exchange Commission (SEC) has proposed rules to implement the SEC whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) enacted on July 21, 2010. The proposed rules attempt to balance the tension between encouraging whistleblowers to come forward while simultaneously discouraging people from bypassing their company's internal compliance programs.

Morgan Lewis will be submitting comments to the SEC, and will be hosting a number of webcasts before that time to provide a more in-depth overview of the proposed rules and to solicit suggestions for comment. Comments on the proposed rules are due to the SEC by December 17, 2010.

Whistleblowers Protected from Retaliation

One of the key components of Regulation 21F is that the definition of "whistleblower" reflects the SEC's view that the antiretaliation protections of the Dodd-Frank Act do not depend on a finding of an actual violation of securities laws. The proposed regulations define a whistleblower as an individual that "alone or jointly with others . . . provide[s] the commission with information relating to a *potential* violation of the securities laws." This definition tracks the statutory definition, but adds the "potential violation" language. This standard does not require an actual violation for the antiretaliation protections to apply.

In addition, the SEC makes clear that the antiretaliation protections do not depend on whether the whistleblower ultimately qualifies for a monetary award.

Award Eligibility

Section 922 of the Dodd-Frank Act authorizes the SEC to provide monetary rewards of 10% to 30% of the monies recovered to individuals who voluntarily provide the SEC with original information that leads to recoveries of monetary sanctions of more than \$1 million in criminal and civil proceedings.

To be considered for an award, a whistleblower must (1) voluntarily provide the SEC (2) with original information (3) that leads to the successful enforcement by the SEC of a federal court or administrative action (4) in which the SEC obtains monetary sanctions totaling more than \$1 million. The proposed rules relating to an individual's eligibility to receive the award reflect the SEC's attempt to balance its interest in

receiving high-quality information directly from whistleblowers against its desire to encourage whistleblowers to utilize internal compliance procedures.

Voluntary submission. To obtain an award, the proposed regulations require that the whistleblower come forward voluntarily—meaning before the whistleblower receives any request, inquiry, or demand from the SEC, Congress, other government authority, or the Public Company Accounting Oversight Board. The whistleblower’s submission will not be considered voluntary if the whistleblower had a preexisting legal or contractual duty to report the securities violations at issue.

“Original information.” Another key component of the proposed rules is the requirement that the whistleblower provide “original information” to qualify for an award. This “original information” must be provided to the SEC after July 21, 2010, when the Dodd-Frank Act was enacted.

“Independent knowledge or independent analysis.” Any “original information” provided must also be derived from the whistleblower’s “independent knowledge or independent analysis.” The regulations exclude certain categories of information from being treated as derived from independent knowledge or analysis.

For example, under the proposed rules, the SEC would not generally consider information obtained through an attorney-client privileged communication to be derived from independent knowledge or analysis. The carveout for attorneys reflects the SEC’s concern that the monetary incentives of the SEC whistleblower program may deter companies from consulting with attorneys about potential securities laws violations.

Similarly, the SEC’s proposed rules would exclude any information gained through the performance by an independent public accountant of an engagement required under the securities laws, if the information relates to a violation by the engagement client or its directors, officers, or other employees. This exception reflects the SEC’s recognition of the role of independent public accountants and their preexisting duties under securities laws to detect and report illegal acts.

The SEC also will not consider information to be derived from independent knowledge or analysis if the whistleblower obtained the information as a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, and if the information was communicated to the whistleblower with the reasonable expectation that the whistleblower would take steps to cause the entity to respond appropriately to the violation, *unless the entity did not disclose the information to the SEC within a reasonable time or proceeded in bad faith.*

Here, the SEC attempts to reconcile the tension between the potential bounty available to whistleblowers and the SEC’s recognition that effective internal compliance programs promote the goals of federal securities laws. This exclusion ceases to apply if the company does not come forward with the information within a reasonable time or proceeds in bad faith. At that point, the company’s internal compliance officers could submit the information to the SEC and potentially qualify for a bounty.

Similarly, if any individual reports information to the company’s internal compliance team or other similar departments, the individual has 90 days to submit the information to the SEC, while receiving credit as if they had reported the information to the SEC on the date they disclosed it internally. This provision is also designed to promote internal compliance, but does not require internal reporting prior to disclosure to the SEC.

The SEC has considered requiring internal reporting first, and is requesting comment on “all aspects of the intersection between 21F and established internal systems for the receipt, handling, and response to complaints about potential violations of law.” The SEC is also requesting comment as to whether it should give favorable consideration to prior internal reporting in determining the amount of the award.

Another exclusion applies to any other information obtained from or through an entity’s legal, compliance, audit, or similar functions. This would apply to employees who learn about potential violations because a compliance officer made inquiries about the conduct, and not from any other source.

Fraud and misconduct. The proposed rules render persons who engage in fraud or misconduct ineligible for an award. A whistleblower is ineligible for an award if the whistleblower knowingly and willfully makes any false, fictitious, or fraudulent statement or representation or uses any false writing or document knowing that it contains false, fictitious, or fraudulent statements. With respect to misconduct, the SEC will not count towards the \$1 million threshold any sanctions that the whistleblower is ordered to pay, or that are ordered against a company whose liability is based substantially on the whistleblower’s conduct.

The SEC is considering taking the misconduct issue a step further by excluding persons who report their own misconduct from the definition of whistleblower. The SEC has requested comment on whether the definition of “whistleblower” should be limited to those who provide information about potential violations of securities laws “by another person,” which would exclude persons who report their own potential violations. This would mean that the person who has information concerning their own misconduct would not only be disqualified from the bounty; they also would not be considered a whistleblower subject to protection from retaliation.

Additional Rules

In addition to these and other substantive provisions relating to how a person can qualify for an award, the proposed rules describe procedures for submitting information to the SEC and for claiming an award. If the whistleblower satisfies the rules to qualify for an award, the SEC will then decide the amount of the award, which, as previously noted, will be between 10% and 30% of the monetary sanctions that the SEC and other authorities are able to collect. In determining the amount of the award, the SEC will consider, among other factors, whether the award enhances the SEC’s ability to enforce the federal securities laws, protects investors, and encourages the submission of high-quality information from whistleblowers.

Significantly, the proposed rules would prohibit any action to impede a whistleblower from communicating directly with the SEC about a potential violation, such as by enforcing or threatening to enforce a confidentiality agreement.

Submission of Comments

The SEC is accepting comments on these and other issues relating to the new Dodd-Frank whistleblower program until December 17, 2010. Morgan Lewis will be submitting comments to the proposed rules, and will be conducting a series of webcasts in December to provide an overview of these proposed rules and to solicit suggestions for comments. Register for our general webcast, being held on December 9, by visiting http://www.morganlewis.com/documents/m/Events/2010/LE_SEC-Whistleblower_Wcast_3_101504.html. A webcast focused on the pharmaceutical industry will be held on December 7 (http://www.morganlewis.com/documents/m/Events/2010/LE_SEC-Whistleblower_Wcast_2_101504.html).

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact **Sarah E. Bouchard** (215.963.5077; sbouchard@morganlewis.com), **Thomas A. Linthorst** (609.919.6642; tlinthorst@morganlewis.com), **Robert M. Romano** (212.309.7083; rromano@morganlewis.com), or **Christian J. Mixter** (202.739.5575; cmixter@morganlewis.com), or any of the following Morgan Lewis attorneys:

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