November 10, 2010

SEC Proposes Whistleblower Rules

The SEC has proposed rules to implement the whistleblower "bounty" provisions mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act added a new Section 21F to the Securities Exchange Act of 1934, which directs the SEC to pay awards to whistleblowers who voluntarily provide the SEC with original information about securities law violations that lead to a successful administrative or judicial enforcement action resulting in monetary sanctions exceeding $1 million. The proposed rules lay out extensive procedural and substantive requirements that whistleblowers must meet in order to be eligible for awards and the criteria that the SEC will consider in determining the amount of an award, which will range from 10 to 30 percent of monetary sanctions collected.

In the release proposing these rules, the SEC indicated that it is attempting to address two key concerns about the enhanced whistleblower incentive scheme contemplated by the Dodd-Frank Act. One issue is the possibility that these provisions would encourage end-runs around company compliance programs by incentivizing whistleblowers to skip the in-house reporting process altogether in a rush to be the first in line for the SEC payouts. A second related issue is that attorneys, independent auditors and compliance personnel could use information obtained through their positions to make whistleblower claims. To alleviate these concerns, the proposed rules include provisions intended to avoid discouraging whistleblowers at companies with robust compliance programs from first reporting possible violations in-house and to exclude from the whistleblower program those persons with professional obligations to report securities laws violations.

Although the SEC recognizes the possibility that these rules could undermine a company's existing processes for investigating and responding to potential securities law violations and believes that its investor protection mission would not be served by that result, the SEC did not include a requirement that whistleblowers must first use a company's compliance programs or otherwise report any potential violations to the company or an appropriate authority within the company before availing themselves of the whistleblower procedures. Such internal reporting requirements are not without precedent under the SEC's existing rules. For instance, attorneys appearing and practicing before the SEC in the representation of an issuer must report possible material violations of federal or state securities law and other specified violations to the company under Part 205 of Section 17 of the Code of Federal Regulations and independent auditors conducting an audit under Section 10A of the Exchange Act must similarly report certain illegal acts to management and the audit committee or the board of the company. Notwithstanding such precedents, the SEC decided against requiring whistleblowers to first use a company's compliance programs because it believed that there is wide variability in the strength of those programs. Instead, the SEC has attempted to accommodate such programs with the following provisions or guidance in the proposing release:

- The proposing release states that in determining the amount of the whistleblower payout, the SEC will consider higher percentage awards for whistleblowers who first report violations through their compliance programs.

- Whistleblowers would be able to "tack on," or have the benefit of, the earlier date that he or she first provides any information regarding a potential securities law violation to federal, state or self-regulatory authorities, any person with legal, compliance, audit, supervisory or governance responsibilities at the company or otherwise to a company's legal, compliance, audit or other similar functions or processes, provided the whistleblower submits the same information to the SEC within 90 days thereafter.

- Consistent with its past practice, the proposing release states that the SEC expects that its Staff would, upon receiving a whistleblower complaint, give the company an opportunity to investigate the matter and report back.

Under the proposed rules, whistleblowers would be eligible for awards only when they "voluntarily" provide the SEC with "original information" that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than $1 million. "Original information" as defined in the proposed rules must, among other conditions, be derived from the whistleblower's independent knowledge or independent analysis. The SEC will not consider the information to be derived from the whistleblower's independent knowledge or analysis if he or she obtained the knowledge or the information upon which the analysis is based:

- Through a communication that was subject to the attorney-client privilege or resulting from a legal representation by the whistleblower or his or her employer or firm (where the whistleblower seeks to use the information for his or her own benefit under these provisions), unless disclosure of that information is permitted by the SEC's attorney conduct rules, applicable state attorney conduct rules or otherwise. The circumstances in which an attorney may reveal privileged information pursuant to Part 205 and most state attorney conduct regimes are generally rare and limited to circumstances where the disclosure would be necessary to prevent or rectify a material violation of law;

- Through the performance of an engagement required under the securities laws by an independent public accountant (including reviews of interim financial statements included in quarterly reports on Form 10-Q), if that information relates to a violation by the client or the client's directors, officers or other employees (as opposed to, for example, information relating to a possible violation of the accounting firm's obligations with respect to the engagement). The proposing release states that this exclusion would also apply to information gained through another engagement by the independent public accountant for the same client, since the independent public accountant would generally already have an obligation to consider the information from the separate engagement in the SEC-required engagement. This exclusion would not apply to the company's internal audit employees, even if they interact with the independent public accountant;

- Because the whistleblower had legal, compliance, audit, supervisory or governance responsibilities for a company, and the information was communicated to him or her with the reasonable expectation that he or she would take steps to cause the entity to

respond appropriately to the violation, unless the company did not disclose the information to the SEC within a "reasonable time" or proceeded in "bad faith." What constitutes a reasonable time would be a facts-and-circumstances determination. So, for example, an ongoing fraud that poses substantial risk of harm to investors should, according to the rule proposal, be disclosed immediately. If a whistleblower played a role in delaying disclosure, then that fact would play into the SEC's determination of whether the company responded in a reasonable time. Similarly what constitutes bad faith is also a facts-and-circumstances determination, and the proposing release notes that destroying documents, interfering with witnesses or engaging in sham investigations would constitute bad faith;

- Otherwise from or through the company's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law, unless the company did not disclose the information to the SEC within a reasonable time or proceeded in bad faith;

- By a means or in a manner that violates applicable federal or state criminal law; or

- From any person described in the foregoing items.

Under the proposed rules, disclosure of information to the SEC would not be considered voluntary if the person has a pre-existing legal or contractual duty to report securities law violations to Congress, the SEC, any other federal, state or local authority, any self-regulatory organization or the Public Company Accounting Oversight Board. Thus, according to the proposed rules and Section 21F of the Exchange Act, members, officers or employees of any of the foregoing governmental or self-regulatory entities with a duty to report securities laws violations and any persons who obtained relevant information as a result of an audit of financial statements and who would be subject to the audit requirements of Section 10A of the Exchange Act could not receive a whistleblower award.

Finally, the proposed rules provide that no person may take any action to impede a whistleblower from communicating directly with SEC Staff about a potential securities law violation, including enforcing or threatening to enforce a confidentiality agreement. The proposing release states that this prohibition is not intended to prevent professional or religious organizations from responding to a breach of a recognized common-law or statutory privilege by their members.

Whether the foregoing provisions will have the intended effect of protecting a company's existing internal process for investigating and responding to potential securities law violations remains to be seen. What is clear is that these rules increase the incentive for companies to ensure that their compliance programs are robust and functioning properly. As discussed above, ineffective compliance programs will not protect companies from whistleblower claims and may serve as evidence of bad faith action on the part of the companies if facts evidence poor behavior. Chairman Schapiro, in her statement at the SEC meeting approving the proposal of these rules, noted that the Commission receives thousands of whistleblower tips each year, and we expect that, notwithstanding the SEC's efforts to minimize any negative impact on company compliance programs, the number will only increase as a result of this payout program.

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The SEC notes in the proposing release that the rules are intended to be user-friendly. For individuals considering the submission of claims under the program, a close review of the proposed rules is a must as they provide a self-contained guide (complete with forms and in plain English) that details the eligibility, filing and other requirements that must be complied with to perfect a whistleblower claim. We note that whistleblower awards would be available for any information provided to the SEC after the July 21, 2010 enactment date of the Dodd-Frank Act, even with respect to information provided before the adoption of these proposed rules, so long as proper filings are made under the SEC's final whistleblower rules within 120 days of their adoption.

For a copy of the SEC proposal, see http://sec.gov/rules/proposed/2010/34-63237.pdf. Comments are due by December 17, 2010.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman 44-20-7367-1601	Charles E. Davidow 202-223-7380
David S. Huntington 212-373-3124	John C. Kennedy 212-373-3025
Daniel J. Kramer 212-373-3020	Walter G. Ricciardi 212-373-3350
Mark A. Underberg 212-373-3368	Frances F. Mi 212-373-3185

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410