

The New Dodd-Frank Whistleblower Program Takes Shape as the Securities and Exchange Commission Releases Proposed Rules

When the Sarbanes-Oxley Act ("Sarbanes-Oxley") became law in 2002, with its provisions protecting whistleblowers, it was anticipated that employees with knowledge of corporate wrongdoing would report such wrongdoing extensively, and that the protections afforded against retaliation by their employers would provide sufficient incentives to such employees. Apparently the results were not as hoped; certainly the anti-retaliation provisions did not get much of a workout in the ensuing eight years, with just over 600 complaints brought to the Occupational Safety and Health Administration and only a handful of those resulting in decisions on the merits favorable to the complainant. When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Dodd-Frank legislation"), therefore, it was deemed desirable to create a more tangible incentive for potential whistleblowers by offering them "bounties" for reporting wrongdoing to the Securities and Exchange Commission (the "SEC") or the Commodity Futures Trading Commission.¹ Many of the details concerning the implementation and administration of this new whistleblower program were left to the SEC to develop by rulemaking.

¹ The focus of this article is on whistleblowing to the SEC.

On November 3, 2010, the SEC propounded proposed rules for the Dodd-Frank legislation.² A major issue raised by many members of the public is whether and the extent to which the new statutory scheme undercuts existing compliance programs. The SEC's proposed rules address this issue to some degree, along with others including the propriety of allowing those charged with implementing such internal compliance programs to become whistleblowers themselves, and of allowing employees who have engaged in wrongdoing to recover for whistleblowing.

Practical Implications

Under the Dodd-Frank legislation, employees now have significant incentives to report information about securities violations to the SEC, and potential recoveries are sufficient to motivate plaintiffs' lawyers to represent individuals claiming retaliation for engaging in protected whistleblower activity. As a result, employers with potential exposure to securities claims should review existing compliance programs and complaint procedures to ensure they are appropriate

² Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 34-63237, 75 Fed. Reg. 70,488 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pts. 240 and 249).

under the present circumstances. As part of that effort, individuals should be encouraged to report concerns about potential securities violations internally so they can be addressed before they rise to the level of actual violations. Complaint procedures should be revised to make sure that all complaints relating to securities violations will be handled promptly and effectively. Investigations of potential securities law violations should also be handled on a confidential basis to minimize the risk that employees who would not otherwise have information to provide to the SEC might obtain such information.

As further discussed below, the information provided by a whistleblower must have been derived from the independent knowledge or analysis of a whistleblower. However, if the proposed rules are adopted, entities should take into account that information subject to an attorney-client privilege will not be deemed to have been derived through independent knowledge or analysis. Thus, information obtained through investigations conducted for the purpose of rendering legal advice could be outside the scope of information that would support a reward. Similarly, non-privileged information concerning securities violations obtained by individuals involved with internal compliance will not be deemed to have been derived through independent knowledge or analysis, so long as an entity conducts a good faith investigation in response to receipt of the information and reports that information to the SEC within a reasonable time. To ensure good faith investigations and timely reporting, individuals in legal, compliance, audit, governance and supervisory positions should be trained to understand their responsibilities in the event they obtain information about a potential securities violation from someone with a reasonable expectation it will be addressed.

In instances where an individual reports information internally before reporting that information to the SEC, it would be advisable for an entity to conduct an investigation quickly and seek, where appropriate, to persuade the employee that there is no violation of the securities laws to report to the SEC. Even after an individual has reported information to the SEC, the SEC has suggested in the commentary to the proposed rules that “in appropriate cases, consistent with the public interest and [the SEC’s] obligation to preserve the confidentiality of a whistleblower, [the SEC’s] 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.”³ Moreover, the SEC has commented that it would consider a company’s cooperation favorably under such circumstances.⁴

In addition to minimizing the risk of a whistleblower report to the SEC, employers should take several steps to protect against potential retaliation claims. First, efforts should be made to ensure that employees’ complaint-related activities are not considered in connection with any employment-related decisions. Only those with a need to know should be informed of an investigation or its outcome. Managers should be trained to understand company policy as well as their rights and responsibilities in this area. Finally, great care must be exercised before taking any adverse employment action against a whistleblower.

Overview of the Incentive Program

In amending the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (the “Exchange Act”), with the addition of a new Section 21F,⁵ Congress gave whistleblowers significant incentives to bring information to the SEC by requiring the SEC to grant monetary rewards to *qualified individuals* who voluntarily provide *original information derived from the independent knowledge or analysis of a whistleblower* relating to a *violation of the securities laws*, if the information leads to a *successful action* by the SEC or other governmental entity, which is defined as one in which there is a *recovery of more than \$1 million in sanctions*.⁶ Under Dodd-Frank, whistleblower rewards must be between 10% and 30% of the monetary sanctions obtained by the SEC or other governmental entity, including disgorgement, penalties and interest, with the precise amount to be determined by the SEC in its discretion based upon a number of criteria.⁷ Rewards are to be made out of an Investor Protection Fund established by the Dodd-Frank legislation for the purposes of paying

³ 75 Fed. Reg. at 70,496.

⁴ *Id.*

⁵ See Dodd-Frank § 922(a).

⁶ See Exchange Act § 21F(a), (b).

⁷ Exchange Act § 21F(b), (c).

whistleblowers and funding other aspects of the whistleblower program.⁸

Requirement of Independent Knowledge or Analysis

Pursuant to the Dodd-Frank legislation, the information provided by a whistleblower must have been derived from the independent knowledge or analysis of a whistleblower and must not be known to the SEC from another source.⁹ The information cannot have been derived exclusively from allegations made in a judicial or administrative hearing, a governmental report, hearing, audit or investigation, or the media, unless the whistleblower is a source of the information.¹⁰

Under the proposed rules, the SEC will not consider a whistleblower's proffered information as having been derived from his or her independent knowledge or analysis if, in general, the knowledge or the information is obtained: (i) through communication subject to the attorney-client privilege; (ii) through legal representation of a client on whose behalf the whistleblower's services have been retained; (iii) through an engagement of an independent public accountant required by the securities laws, if the information pertains to a violation by the engagement client or the client's directors, officers or other employees; (iv) because the whistleblower was a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, and the information was communicated to the whistleblower with the reasonable expectation that he or she 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; (v) through or from an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law, unless the entity did not disclose the information to the SEC within a reasonable time or proceeded in bad faith; (vi) through means that violate applicable federal or state criminal law; or (vii) from an individual described in (i) to (vi) above.¹¹

⁸ Exchange Act § 21F(g).

⁹ Exchange Act § 21F(a)(3)(A), (B).

¹⁰ Exchange Act § 21F(a)(3)(C).

¹¹ Proposed Rule 240.21F-4(b)(4).

In light of the foregoing, information obtained through an attorney-client, legal or independent accounting relationship will not generally be considered to have been derived through independent knowledge or analysis. Non-privileged information obtained by individuals responsible for or involved with an entity's internal compliance functions will not be considered to have been derived through independent knowledge or analysis unless the entity either fails to disclose the information to the SEC within a reasonable time, which will vary depending upon the circumstances, or acts in bad faith, which may be found where an entity fails to conduct a good faith investigation.¹² As a result of the foregoing, non-privileged information obtained by an individual responsible for or involved with internal compliance relating to a violation of the securities laws will be considered to have been obtained through independent knowledge or analysis if the entity does not proceed in good faith or fails to report the information to the SEC within a reasonable time. This proposed rule applies not just to information obtained by employees with formal compliance roles, but applies also to information obtained by other employees, officers, directors and consultants whom others reasonably expect will take appropriate steps to respond to a complaint, as well as to witnesses questioned during the course of an internal investigation.¹³

Significantly, the commentary to the proposed rules explains that an individual involved with internal compliance who obtains non-privileged information is not eligible for an award, even if the entity does not report the information to the SEC within a reasonable time or proceed in good faith, if the individual played a role in the entity's failure to make a timely report to the SEC.¹⁴ Notably, however, this position is not set forth explicitly in the text of the proposed rules.

Ineligible Parties

Pursuant to the Dodd-Frank legislation, individuals who are ineligible for an award include: (i) whistleblowers who knowingly and willfully provide false information to the SEC; (ii) employees of the Department of Justice, the Public Company Accounting Oversight Board ("PCAOB"), self-regulatory organizations, law

¹² 75 Fed. Reg. at 70,494.

¹³ See 75 Fed. Reg. 70,493-94.

¹⁴ See *id.*

enforcement organizations and certain regulatory agencies; and (iii) individuals who gain the information provided to the SEC through the performance of an audit required under the securities laws if submission of the information would be contrary to the requirements of Section 10A of the Exchange Act, which addresses steps auditors must take in response to possible illegality.¹⁵ Although the legislation provides explicitly that individuals who are convicted of a criminal violation related to the action for which the individual could otherwise receive an award are not entitled to an award, the legislation does not explicitly prohibit an individual who commits a civil violation of the securities laws from recovering.¹⁶

In the proposed rules, the SEC expands upon the foregoing descriptions of individuals who are ineligible to obtain awards. In that regard, the proposed rules also provide that an individual is ineligible for an award if he or she is a foreign government official or a member of a foreign financial regulatory authority, or was one at the time he or she acquired original information about a violation of securities law.¹⁷ Further, as discussed above, by limiting what information the SEC will consider to have been derived from independent knowledge or analysis, the proposed rules have essentially rendered ineligible to receive rewards individuals who receive information subject to the attorney-client privilege and accountants engaged as independent public accountants.

The proposed rules also provide that, to be eligible for an award, an individual must comply with the SEC's procedures for submitting information and making a claim for an award, respond to requests for additional

¹⁵ Exchange Act § 21F(c)(2)(A) and (C); Exchange Act § 21F(i).

¹⁶ Exchange Act § 21F(c)(2)(B). Although an individual who commits a non-criminal securities law violation is not ineligible for awards under the legislation, as discussed below, an individual's culpability is one of the factors the SEC proposes to consider in determining the size of a reward. See 75 Fed. Reg. at 70,500. The SEC would also have the power to limit the size of a reward to a whistleblower pursuant to the proposed rule providing that, in determining whether the \$1 million threshold has been satisfied for purposes of making an award, the SEC may exclude from consideration any monetary sanctions the whistleblower is ordered to pay or that an entity is ordered to pay as a result of conduct the whistleblower directed, planned or initiated. Proposed Rule 240.21F-15.

¹⁷ Proposed Rule 240.21F-8(c)(2).

information and assistance and enter into a confidentiality agreement.¹⁸

Other Issues

Under the SEC's proposed rules, a new "Claims Review Staff" will make a preliminary determination of an award percentage amount of between 10% and 30% of a recovery.¹⁹ The factors the Dodd-Frank legislation allows the SEC to consider in determining the amount of a reward are: (i) the significance of the information provided; (ii) the degree of assistance provided; (iii) the SEC's programmatic interest in deterring violations through the whistleblower program; and (iv) other factors that may be established by rule or regulation.²⁰

The proposed rules provide that one of the "other factors" the SEC may consider is whether an award enhances the SEC's ability "to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers."²¹ This rule affords the SEC broad discretion. In its commentary to the proposed rules, the SEC indicates that it will consider the character of the enforcement action and its priority to the SEC; the dangers to investors or others presented by the underlying violation; the timeliness, degree, reliability, and effectiveness of a whistleblower's assistance; the time and resources conserved as a result of a whistleblower's assistance; whether a whistleblower authorized or encouraged others to assist the SEC who otherwise might not have participated in the investigation or related action; any unique hardships experienced as a result of whistleblowing and assisting in the enforcement action; the extent to which the whistleblower took steps to prevent the violation from occurring or continuing; efforts undertaken by the whistleblower to correct harm caused by the violation; whether the information provided by the whistleblower related to only a portion of the successful claims; the culpability of the whistleblower; and the extent to which

¹⁸ Proposed Rule 240.21F-8(a) and (b).

¹⁹ Proposed Rule 240.21F-10(d).

²⁰ Exchange Act § 21F(c)(1)(B).

²¹ Proposed Rule 240.21F-6.

a whistleblower used internal compliance procedures before reporting the violation to the SEC.²²

Although the proposed rules contemplate the SEC's consideration of the extent to which a whistleblower uses internal compliance procedures before reporting a violation to the SEC, it is important to note that the proposed rules do not require whistleblowers to use in-house compliance procedures prior to reporting potential violations to the SEC. In choosing not to require such use, the SEC explained, "[a]mong 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."²³

In an effort to avoid penalizing whistleblowers who report violations internally before reporting them to the SEC, the proposed rules provide that a whistleblower will not be prejudiced as a result of such internal reporting. In that regard, if a whistleblower chooses to report information to internal compliance or legal personnel before going to the SEC, he or she has the right to use the date of that original report for purposes of determining award eligibility, so long as the same information is provided to the SEC within 90 days thereafter.²⁴ As a result of this rule, a whistleblower can claim an award based upon having provided original information to the SEC even if another person has reported the same information to the SEC before him, so long as the whistleblower had provided the information to internal compliance or legal personnel internally before the other person provided it to the SEC. The proposed rule benefits the SEC insofar as it could result in a reduction in the number of reports the SEC receives, which could occur if a whistleblower's report to internal compliance or legal personnel results in the employer's persuading the whistleblower there is no violation. However, the proposed rule does not provide employers with the ability to avoid a whistleblower claim completely, because even if an employer self-reported immediately after having received an internal report of a violation, the

whistleblower would be deemed to have reported that information to the SEC before the self-report. The potential benefit to an employer is that it would have up to 90 days to investigate a report and persuade the whistleblower there is no violation.

Overview of Whistleblower Protections

In addition to providing incentives to whistleblowers, the Dodd-Frank legislation provides significant protections to whistleblowers. In particular, employers are prohibited from retaliating against employees for any lawful whistleblowing act, including providing information, testifying on behalf of the government or otherwise assisting with an investigation or proceeding relating to a violation of the securities laws.²⁵ Retaliation includes discharging, demoting, suspending, harassing or otherwise discriminating against a whistleblower with regard to the terms of employment.²⁶ Under the proposed rules, employers are also prohibited from impeding employees from communicating directly with the SEC staff about a potential securities law violation, including by enforcing or threatening to enforce a confidentiality agreement, except to the extent such communication would breach an applicable attorney-client privilege.²⁷

Although the Dodd-Frank legislation affords protection against retaliation only to individuals who provide information to the SEC about an actual "violation of the securities laws,"²⁸ the proposed rules broaden the group to which the protections apply by stating that the protections also apply to individuals who provide information about a "potential violation of the securities laws."²⁹ As a result, even though an individual might not be eligible to receive an award due to the quality of information provided, he or she is still entitled to the anti-retaliation protections set forth in Section 21F(h)(1) of the Exchange Act.³⁰

²² 75 Fed. Reg. at 70,500.

²³ 75 Fed. Reg. at 70,496.

²⁴ Proposed Rule 240.21F-4(b)(7). The proposed rule also applies to initial reporting of information to Congress, any other federal, state or local authority, any self-regulatory organization and the PCAOB, as well as to internal legal and compliance personnel.

²⁵ Exchange Act § 21F(h)(1)(A).

²⁶ *Id.*

²⁷ Proposed Rule 240.21F-16(a).

²⁸ Exchange Act § 21F(a)(6), (h)(1).

²⁹ Proposed Rule 240.21F-2(a)-(b).

³⁰ Proposed Rule 240.21F-2(b). Similarly, individuals who are not eligible to receive awards due to a failure to satisfy

Pursuant to Dodd-Frank, whistleblowers who choose to pursue a retaliation claim are afforded the right to a jury trial in federal court, and the relief they may seek includes reinstatement, two times the amount of any back pay owed plus interest, reasonable attorneys' fees and costs.³¹ Whistleblower suits for retaliation must be brought within six years after the date of the alleged discharge or other discrimination, within three years of the date on which an employee discovered or should have discovered such violation and, in any event, no later than ten years after the date on which the violation occurred.³²

SEC's Request for Comment

Reflecting various concerns raised by the proposed rules, the SEC has explicitly requested comments on issues concerning the impact of the proposed rules on internal compliance programs, as well as on the incentives provided to those who administer such programs and to those who engage in wrongdoing. A brief discussion of some of the more significant issues follows.

First, the SEC requests comments on whether the SEC should "consider a rule that, in some fashion, would require whistleblowers to utilize employer-sponsored complaint and reporting procedures" and on whether, in determining the amount of an award, the SEC should consider the extent to which a whistleblower reported a potential violation through internal procedures before reporting it to the SEC.³³ Clearly, the rules should require employees to make reasonable use of any well-developed internal compliance procedures before reporting securities violations to the SEC.

Second, the SEC seeks comments on whether the proposed exclusions of information obtained by individuals with legal, compliance, audit, supervisory

the applicable procedures and conditions are still entitled to the protections. *Id.*

³¹ Exchange Act § 21F(h)(1)(C).

³² Exchange Act § 21F(h)(1)(B)(iii). The statute of limitations under Dodd-Frank is substantially longer than it is under Sarbanes-Oxley, which previously required complaints to be brought within 90 days of a violation and now, under Dodd-Frank, still allows only 180 days. See Dodd-Frank § 922(c)(1); see also Sarbanes-Oxley § 806(b)(2)(D).

³³ 75 Fed. Reg. at 70,496 and 70,500.

and governance responsibilities strike the proper balance.³⁴ By not explicitly prohibiting awards to individuals who obtain information about a securities violation as a result of their responsibility for, or through their involvement with, an internal reporting process, even when such individuals prevent or delay an entity from reporting that information to the SEC, the SEC has not provided the requisite clarity for corporations.

Finally, the SEC requests comments on how it might further restrict the ability of whistleblowers who engage in securities violations to recover rewards based upon their own conduct. Although the proposed rules set forth several different ways in which the SEC may limit the ability of a wrongdoer to recover, the proposed rules do not completely prohibit such recovery. Thus, the SEC asks whether it should define the term "whistleblower" as a person who provides information about potential violations of the securities laws "by another person," and not about violations by the whistleblower himself or herself.³⁵ Certainly a rule that permits wrongdoers to disclose information to the SEC and profit from doing so would create undesirable incentives for wrongdoers to violate the securities laws.

To the extent the proposed rules create such incentives or create disincentives for use of well-established internal reporting and compliance plans, they should be revised. Comments on the proposed rules are due on or before December 17, 2010, and may be submitted using the SEC's Internet comment form (available at <http://www.sec.gov/news/press/2010/2010-213.htm>), via e-mail (rule-comments@sec.gov), through the Federal eRulemaking Portal (<http://www.regulations.gov>), or via mail.

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³⁴ 75 Fed. Reg. at 70,495.

³⁵ 75 Fed. Reg. at 70,489.

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If you have questions regarding the information in this legal update, please contact one of the attorneys listed or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/securities.

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