CLEARY GOTTLIEB Alert Memo

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SEC Proposes Rules for Whistleblower Program

On November 3, 2010, the SEC voted unanimously to propose rules governing a whistleblower program to reward individuals who provide the agency with high quality tips that lead to successful enforcement actions.[1] The proposed rules are intended to implement Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[2] which added new Section 21F to the Securities Exchange Act of 1934. SEC Chairman Mary Schapiro characterized the program as part of an "ongoing effort by the SEC to clamp down on fraud by leveraging third parties to assist in the agency's enforcement work." The comment period for the proposed rules ends on December 17, 2010. Under the Dodd-Frank Act, final rules must be implemented by April 2011.

Section 21F directs the Commission to pay an award to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to a successful enforcement action. These so-called "bounty" awards are payable to whistleblowers only if the SEC recovers a monetary sanction exceeding $1,000,000, a threshold that includes all amounts "ordered to be paid," including penalties, disgorgement and interest, whether paid to the SEC or to a disgorgement or other fund. Prior to the Dodd-Frank Act, the SEC had only limited authority to award bounties in connection with insider trading cases, and the awards were capped at 10% of the penalties collected.[3] Under the new program, providing information about *any* securities law violation may lead to an aggregate award to all entitled whistleblowers of 10 to 30% of the

[1] *See* SEC Rel. No. 34-63237 (Nov. 3, 2010), available at http://sec.gov/rules/proposed/2010/34-63237.pdf.

[2] Pub. L. No. 111-203 (the "Dodd-Frank Act").

[3] The predecessor bounty program had been used only infrequently. In more than 20 years of operation, the program resulted in about $1.16 million in awards, of which $1 million was awarded in August 2010. The predecessor program was also criticized in a March 2010 report of the Office of Inspector General. *See* Office of Inspector General, *Assessment of the SEC's Bounty Program*, Report 474 (Mar. 29, 2010). Among other findings, the report noted that the program was not sufficiently user-friendly, the SEC had not implemented internal policies and procedures to assist the staff in assessing contributions made by whistleblowers and award determinations, and failed to track whistleblower reports and provide status reports to whistleblowers. In part to address these concerns about tracking and administering reports, the proposed rules for the new bounty program contain detailed timelines for the SEC's claims administration process, including administrative appeals of award determinations. The proposed rules would also authorize the SEC staff to communicate directly with whistleblowers, including those who are directors, officers, members, agents or employees of an entity represented by counsel, without having to obtain the consent of such counsel.

penalties collected in an SEC enforcement action or "related action," which includes federal and state law and criminal proceedings and proceedings brought by appropriate regulatory agencies or self-regulatory organizations. Given the recent penalties that have been imposed in the tens (or even hundreds) of millions of dollars for alleged securities law violations, this program, needless to say, creates strong financial incentives for whistleblowers to come forward.

One significant concern among companies and their directors and advisors is that these incentives might well undercut the principal purpose of internal corporate governance and compliance programs, which are designed to encourage employees to bring this sort of information to the attention of responsible company officials to be addressed and remediated as appropriate. The impact of the SEC's bounty program is also expected to be heightened by virtue of the fact that the staff's ability to exercise its subpoena power is no longer subject to the same degree of oversight by the Commission as before. These potential consequences have resulted in high levels of interest in the SEC's approach to implementing the new program.

As discussed below, the SEC sought to address these concerns through various provisions in the proposed rules that would limit the universe of would-be whistleblowers by defining some of the key concepts in ways that tend to promote surfacing compliance issues through a company's internal processes. Whether these elements of the proposed rules adequately address concerns about the incentives created by the new bounty program will be a key item for consideration during the comment period.

Key Concepts under the Proposed Rules

Whistleblower Status. Proposed Rule 21F-2(a) defines a "whistleblower" as "an individual who, alone or jointly with others, provides information to the [SEC] relating to a potential violation of the securities law." This means that employees, agents, counterparties, and even unrelated third parties may qualify as whistleblowers. The proposed rules provide a mechanism for reports to be made on an anonymous basis, so long as the whistleblower is represented by an attorney and provides the attorney's contact details in his or her initial submission. Anonymous whistleblowers are otherwise subject to the same rights and responsibilities as other whistleblowers.

The proposed rules also seek to mitigate the potential for false submissions that risk wasting agency resources by requiring that information be submitted under penalty of perjury. The proposed rules also prohibit awards to persons seeking to profit from blowing the whistle on their own fraudulent conduct.

Voluntary Submission of Information. Proposed Rule 21F-4(a) defines a submission to be "voluntary" if the whistleblower reports the information before receiving any formal or informal request to do so by the SEC or other relevant authorities. For these purposes, an SEC request directed to an employer will also be considered to be directed to any employees with responsive documents or other information. The proposed rules provide that a submission will not be "voluntary" if the would-be whistleblower has a clear duty to

report to the SEC or other relevant authorities any violations of the type at issue (*e.g.*, as members, officers or employees of a regulatory agency, or government contracting officers) or has a contractual obligation to do so (*e.g.*, as part of a cooperation agreement with the SEC or other relevant authorities).

Original Information. Proposed Rule 21F-4(b) defines "original information" as information that is "derived from [the whistleblower's] independent knowledge or independent analysis; not already known to the Commission from any other source, unless [the whistleblower is] the original source of the information; [and] not exclusively derived from an allegation made in a judicial or administration hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless [the whistleblower is] a source of the information." The whistleblower bears the burden of establishing that he or she is the original source of the information. Original information must also be provided to the SEC for the first time after July 21, 2010 (the enactment date of the Dodd-Frank Act).

Proposed Rule 21F-4(b)(4) excludes several types of information from qualifying as being based on the whistleblower's "independent knowledge" or "independent analysis,"[4] including:

- information obtained through attorney-client privileged communications or obtained through a whistleblower's legal representation of a client;[5]
- information obtained by an independent public auditor regarding the company under audit;
- information received by a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, where the information was communicated to that person with the reasonable expectation that he would take responsive action;
- information obtained from or through an entity's legal, compliance, audit, or other functions for identifying, reporting and addressing potential non-compliance; and
- information obtained by a means or in a way that violates applicable federal or state criminal law.

[4] Under the proposed rules, "independent knowledge" is "factual information in your possession that is not derived from publicly available sources. You may gain independent knowledge from your experiences, communications and observations in your business or social interactions." "Independent analysis" is "your own analysis, whether done alone or in combination . . . your examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public."

[5] According to the proposing release, this exclusion would prevent an attorney from acting as a whistleblower, even where the evidence of a securities violation related to conduct by an opposing party. It would not prohibit an attorney, however, from representing his or her client acting as a whistleblower, if the client chose to make a submission to the SEC.

Importantly, if an employee reports a potential securities law violation pursuant to a company's internal compliance program and then, within 90 days, submits the same information to the SEC, the SEC will consider the information to have been provided on the day of the original, internal disclosure.[6] In determining the amount of an award, the proposed rules would allow the SEC to award a higher percentage if the employee took advantage of the company's compliance program.

These exclusions and related provisions are an important component of the SEC's attempt to support internal compliance programs within the overall context of the incentives provided by the bounty program. Even though the proposed rules do not require that a would-be whistleblower use internal compliance processes, these exclusions create an incentive to use them, since they allow employees to do so, while preserving their ability to proceed as whistleblowers in appropriate cases. The third and fourth exclusions described above are particularly significant in this respect, as they would exclude a wide range of internal and external personnel engaged in compliance-related matters from benefiting as whistleblowers.[7]

Successful Enforcement Action. Proposed Rule 21F-4(c) defines two situations where the SEC will conclude that the whistleblower's information led to "successful enforcement" of an SEC judicial or administrative action or a related action.[8] The first situation is when the information caused the SEC to commence an investigation, reopen a closed investigation, or inquire into new or different conduct that is part of an existing investigation, and the information *significantly contributed* to the success of the action. To be a significant contribution to success, the information must at least be of high quality, reliable and specific. "Unsupported" tips would not, for example, be sufficient. The second situation is when the information is about conduct that was already under investigation by the SEC or another governmental authority, but was *essential* to the success of the action and would not otherwise have been obtained. The proposing release notes that awards under this second standard would be rare.

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[6] Comparable provisions permit whistleblowers to preserve their rights where the information is initially provided to specified authorities other than the SEC, including Congress, any other federal, state or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board. The whistleblower has the burden, however, of establishing the effective date of the prior disclosure.

[7] Both of these exclusions are subject, however, to an important caveat: a whistleblower involved in a company's legal, compliance, or audit functions may become eligible to recover, if "the entity fails to disclose the information to the SEC within a reasonable time or if the entity proceeds in bad faith." In other words, the SEC appears to assume that a company's internal compliance program will engage not only in remediation, but also self-disclosure as a matter of course. Needless to say, from a company's perspective, the calculus is often more complex. Moreover, the 90-day period that the proposed rules contemplate when an employee first avails himself of internal compliance processes, as described above, will place additional pressure on these decisions.

[8] In the case of SEC actions, the standard to be applied would be the same whether the action is settled or litigated.

Highly Individualized Determinations

The proposing release acknowledges that bounty awards will be subject to highly individualized review based on four factors: (i) the significance of the information provided to the success of the SEC action or related action; (ii) the degree of assistance provided by the whistleblower and his or her legal representatives; (iii) the SEC's "programmatic interest" in deterring violations of the securities laws through bounty awards; and (iv) whether an award enhances the SEC's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information by future whistleblowers. Within this overall framework, however, the SEC considers that it has broad discretion to weigh a "multitude of considerations" in determining awards.

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Companies regularly make judgments about self-reporting that take into account all the facts and circumstances involved, including the potential for effective and comprehensive remediation, the impact of a violation on the company's public disclosures, and the reasons for the compliance failure, among many other factors. The proposed rules would place a significant premium on a company's processes for making judgments about self-reporting and doing so within a shorter timeframe than ever before. In addition, it is clear that the proposed rules are intended to and would likely increase the incidence of self-reporting.

Companies should develop appropriate investigation protocols that promote prompt and consistent decision-making about whether and how to investigate compliance matters so that self-reporting decisions can be expedited. It is also noteworthy – and helpful in this regard – that the SEC stated in its proposing release that "[w]e expect that in appropriate cases, consistent with the public interest and our obligation to preserve the confidentiality of 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."[9]

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Please feel free to call any of your regular contacts at the Firm or any of our partners and counsel listed under "Corporate Governance" or "White-Collar Defense, Securities Enforcement and Internal Investigations" in the Practices section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[9] The proposing release notes that the company's actions in these cases will be considered in accordance with the SEC's guidance on cooperation with the SEC and that the SEC's approach in this regard is consistent with current practice. *See* SEC Rel. No. 44969 (Oct. 23, 2001).

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax