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SEC Adopts Whistleblower Rules; Whistleblowers May Receive Bounties for Information Provided Since July 21, 2010

[25253]

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TO: COMPLIANCE MEMBERS No. 26-11
INTERNAL AUDIT ADVISORY COMMITTEE No. 5-11
RISK MANAGEMENT ADVISORY COMMITTEE No. 4-11
RISK MANAGEMENT COMMITTEE No. 7-11
SEC RULES COMMITTEE No. 58-11
SMALL FUNDS MEMBERS No. 37-11 RE: SEC ADOPTS WHISTLEBLOWER RULES; WHISTLEBLOWERS MAY RECEIVE BOUNTIES FOR INFORMATION PROVIDED SINCE JULY 21, 2010

On May 25, 2011, the SEC adopted final rules to implement the whistleblower provisions of Section 21F of the Securities Exchange Act of 1934, which was added to the Act by Section 922 of the Dodd-Frank Act. [1] These rules, which are discussed in more detail below, implement a program for the Commission to pay a bounty to eligible whistleblowers of 10-30% of any monetary sanction in excess of $1 million assessed by the Commission in an enforcement proceeding. To be eligible for the bounty, a whistleblower must file forms with the Commission and provide the Commission information that leads to a successful enforcement action. While the rules impose no affirmative duties upon SEC registrants, members should be aware of the Commission's program and its potential impact on their internal compliance programs. [2] The rules will be effective August 12, 2011, though whistleblowers who provided the SEC qualifying information on or after July 12, 2010 and who now submit the necessary forms to the SEC are eligible to collect a bounty.

Overview of the New Rules

The new rules consist of 17 separate sections that govern whistleblower eligibility and qualifications, bounties to be paid, and the procedures that a whistleblower must follow to receive a bounty. According to Rule 21F-3, subject to the rules' eligibility requirements, the Commission will pay an award or awards to one or more whistleblowers who: (1) voluntarily

provide the Commission (2) with original information (3) that leads to the successful enforcement by the Commission of a federal court or administrative action [3] (4) in which the Commission obtains monetary sanctions totaling more than $1 million. The amount of the award may vary from 10-30% at the discretion of the staff (consistent with criteria in Rule 21F-6), though the cumulative amount paid out to multiple whistleblower in connection with the same enforcement proceeding cannot exceed 30%. In addition, consistent with the Dodd-Frank Act, Rule 21F-2(b) expressly protects whistleblowers from retaliation by their employer based upon their whistleblowing.

Though not discussed in the Release, the Commission's whistleblower program will be housed in the SEC's new Office of the Whistleblower within the Division of Enforcement. Sean McKessy is the Chief of this new Office. [4] A new section has been added to the SEC home page, www.sec.gov, with a picture of a whistle, which the public may use to find out more information about the new program or to report information to the SEC.

The Rules' Definitions

Rule 21F-4 defines the operative terms used in Rule 21F-3. These terms include:

Voluntary Submission of Information – This is information that is provided to the Commission before a request, inquiry, or demand that relates to the whistleblower's submission and that is directed to the whistleblower or the whistleblower's representative by the Commission or in connection with any investigation, inspection, or examination by the Public Accounting Oversight Board, a self-regulatory organization (e.g., FINRA), a state Attorney General or securities regulatory authority, an authority of the federal government, or Congress. Information that is required to be reported to the SEC under a pre-existing legal duty will not be considered a voluntary submission.

Original Information – To be "original," the information must be derived from the whistleblower's independent knowledge or analysis and not already known to the SEC from any other source. It must not be exclusively derived from an allegation made in a judicial or administrative hearing, government report, hearing, audit, or investigation, or from the news media (unless the whistleblower is the original source of the information)and it must be provided to the SEC for the first time after July 21, 2010 (the date of enactment of the Dodd-Frank Act).

Independent Knowledge – This is factual information in the whistleblower's possession that is not derived from publicly available sources. Such knowledge may be gained from the whistleblower's business or social experiences, communications, and observations.

Independent Analysis – An independent analysis consists of the whistleblower's own examination and evaluation of information, whether done alone or with others.

Information that Leads to Successful Enforcement – To be considered original information that leads to successful enforcement, the information provided to the Commission must:

- Be "sufficiently specific, credible, and timely" to cause the staff to: (1) either commence an examination, open or re-open an investigation, or pursue different conduct as part of a current exam or investigation; and (2) bring a successful judicial or administrative action based in whole or in part on conduct that was the subject of the whistleblower's original information;
- Have "significantly contributed to the success" of the Commission's judicial or

administrative action; or

- Be reported through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time the whistleblower reported them to the Commission provided that (1) the entity later submitted the whistleblower's information to the SEC or provided the SEC the results of an audit or investigation initiated in whole or in part in response to the whistleblower's information and (2) the information qualifies as original information that leads to successful enforcement as discussed under the immediately preceding two bullets. A whistleblower relying on this provision "must also submit the same information to the Commission" in accordance with the procedural requirements of the new rules within 120 days. See Rule 21F-4 (c)(3).

Monetary Sanctions – the $1 million "monetary sanctions" threshold includes any penalties, disgorgement, and interest ordered to be paid and any money deposited into a disgorgement fund or other fund under the Sarbanes-Oxley Act as a result of a Commission action or a related action.

Persons Who Will Not Be Considered to have Independent Knowledge: Provisions Applicable to Senior Managers, Compliance Personnel, and Auditors

Rule 21F-4(b) provides that, notwithstanding the above definitions, the Commission will not consider information to be derived from a whistleblower's independent knowledge or analysis if the whistleblower obtained the information:

i. Through a communication that was subject to the attorney-client privilege, unless disclosure is otherwise permitted:
ii. In connection with the legal representation of a client on whose behalf the whistleblower or the whistleblower's employer or firm are providing services and the whistleblower seeks to use the information to make a submission to the SEC for the whistleblower's own benefit, unless disclosure is otherwise permitted; or
iii. Because the whistleblower was: [5]
    - An officer, director, trustee, or partner of an entity and another person informed the whistleblower of allegations of misconduct or the whistleblower learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law;
    - An employee whose principal duties involve compliance or internal audit responsibilities, or who was employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity;
    - Employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or
    - An employee of, or other person associated with, a public accounting firm, if the whistleblower obtained the information through the performance of an engagement required of an independent public accountant under the federal securities laws and the information related to a violation by the engagement client or the client's directors, officers, or other employees;
iv. If the whistleblower obtained the information by a means or in a manner that is determined by a United States court to violate applicable federal or state criminal law; or
v. If the whistleblower obtained the information from a person who does not have

independent knowledge based upon the above, unless the information is not excluded from that person's use pursuant to the above, or the whistleblower is providing the SEC with information about possible violations involving that person.

Exceptions to the Above Limitations

A person who would not be considered to have independent knowledge under (iii), above, may, in fact, qualify as a whistleblower pursuant to Rule 21F-4(b)(v). Under this rule, a whistleblower shall not be disqualified from whistleblower status under (iii) above if:

- The whistleblower has "a reasonable basis to believe that disclosure of the information to the Commission 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;"
- The whistleblower has a "reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct," or
- "At least 120 days have elapsed since [the whistleblower] provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or [his or her] supervisor, or since [the whistleblower] received the information, if [the whistleblower] received it under circumstance indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or [the whistleblower's] supervisor was already aware of the information.

Amount of Award; Criteria for Determining the Amount

Rule 21F-5 clarifies that a whistleblower is eligible for 10-30% of monetary sanctions "that the Commission and other regulators are able to collect," with the specific amount "in the discretion of the Commission." Rule 21F-6 lists the factors the staff "may" consider in determining the percentage amount paid to eligible whistleblowers. These factors are divided into two categories – those that may increase the amount of the award and those that may decrease it. These factors are as follows:

Factors that May Increase the Amount of the Award

- Significance of the information provided by the whistleblower considering the nature of the information and the degree to which it supported one or more successful claims brought by the Commission;
- Assistance provided by the whistleblower or the whistleblower's legal representative in the Commission action including: whether the assistance was ongoing, extensive, and timely; the timeliness of the whistleblower's initial report to the SEC or to an internal compliance program or reporting system; resources conserved as a result of the whistleblower's assistance; whether the whistleblower "appropriately encouraged or authorized others to assist" the Commission staff; efforts undertaken by the whistleblower to remediate the harm caused by the violation, including assisting in the recovery "of the fruits and instrumentalities" of the violations; and "any undue hardships experienced by the whistleblower as a result of reporting to or assisting the Commission;"
- The Commission's "programmatic" interest in deterring violations of the securities laws, including the degree to which an award enhances the SEC's ability to enforce the securities laws and protect investors; the degree to which the award encourages the submission of high-quality information to the SEC; whether the subject matter of

the action is a “Commission priority;” whether the whistleblower exposes industry-wide practices; the type of severity of the security violations as well as their extent, age, and duration and their isolated, ongoing, or repetitive nature;
- The danger to investors from the underlying violations including the amount of harm or potential harm; and
- Whether and to what extent the whistleblower participated in internal compliance systems by reporting “the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission;”and whether and to what extent the whistleblower assisted any internal investigation or inquiry concerning the reported securities violations;

Factors that May Decrease the Amount of an Award [6]

- Culpability or involvement of the whistleblower in the violations including: his or her role in the violations; his or her education, training, experience, and position of responsibility at the time of the violations; whether the whistleblower acted with scienter, financially benefitted from the violations, or is a recidivist; the egregiousness “of the underlying fraud committed by the whistleblower;” and whether the whistleblower knowingly interfered with the SEC’s investigation of the violations;
- Unreasonable reporting delay by the whistleblower in either failing to take reasonable steps to report or prevent the violations from occurring or continuing or delaying reporting until the whistleblower learned about a related inquiry, investigation, or enforcement action, unless there was a legitimate reason to delay reporting; and
- Interference with internal compliance and reporting systems in those instances in which the whistleblower interacted with such systems. In considering this factor, the Commission will take into account whether the whistleblower “knowingly”: interfered with the entity’s established legal, compliance, or audit procedures in order to prevent or delay detection of the reported securities violations; made any material false, fictitious, or fraudulent statements or representations that hindered an entity’s efforts to detect, investigate, or remediate the reported violations; or provided any false writing or document knowing that it contained any false, fictitious, or fraudulent statements or entries that hindered an entity’s efforts to detect, investigate, or remediate the reported violations.

The Policies and Procedures of the Commission’s Whistleblower Program

Rules 21F-7 through 21F-14 govern the policies and procedures of the Commission’s whistleblower program. Generally speaking, the steps involved in the process are as follows:

- The whistleblower must provide the SEC information in the form and manner it requires, including providing the Commission additional assistance upon request;
- The whistleblower must submit information concerning a possible securities law violation either online through the SEC’s website or by mailing or faxing new Form TCR (Tip, Complaint, or Referral) [7] to the Commission. [8] Such form must be submitted under penalty of perjury;
- Once the Commission has obtained a judgment or order in a proceeding in which the

monetary sanctions exceed $1 million, the Commission "will cause to be published on the Commission's website a 'Notice of Covered Action.'" A whistleblower who provided information to the Commission relating to such action will have 90 days from the date of this Notice to file a claim on new Form WB-APP, Application for Award for Original Information Provided Pursuant to Section 21F of the Securities Exchange Act of 1934, in order to be considered for an award. The Commission may require a person filing a Form WB-APP to provide additional information that is needed by the Commission staff to determine the whistleblower's eligibility for an award; [9]

- After the SEC's Office of the Whistleblower has reviewed the whistleblower's claim, it will issue a "Preliminary Determination" setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, the whistleblower's proposed award percentage amount;
- If the whistleblower disagrees with this Preliminary Determination, she or he has 30 days to request a meeting with the Office of the Whistleblower or to request that it provide the whistleblower materials that formed the basis for the Preliminary Determination;
- If the whistleblower elects to contest the Preliminary Determination, the whistleblower must submit a written response and supporting materials to the Office of the Whistleblower within 60 days of the date of the Preliminary Determination. If the whistleblower timely contests the Preliminary Determination, the "Claims Review Staff will consider the issues and grounds" advanced by the whistleblower and make a Proposed Final Determination, which will be reported to the Commission. Within 30 days thereafter, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. A Final Order of award will be issued either after the Commission reviews the matter or, if a Commissioner has not requested a review, after the 30-day period for a Commissioner to request a review has expired;
- Failure to contest the Preliminary Determination within 60 days will result in the Preliminary Determination becoming a Final Determination and prevent any further appeals of the award.

These rules also:

- Provide for the confidentiality of submissions made to the Commission under the Commission's whistleblower program (Rule 21F-7);
- Define what persons are and are not eligible for an award (Rule 21F-8); [10]
- Specify the procedures for determining awards based upon related actions (Rule 21F-11);
- Govern the materials that may form the basis of an award determination and that may comprise the record on appeal (Rule 21F-12);
- Describe the process to appeal an award determination (Rule 21F-13);
- Set forth the procedures applicable to the payment of awards (Rule 21F-14);
- Provide that the SEC's program does not provide amnesty to individuals who provide information to the Commission (Rule 21F-15); and
- Specify how any monetary sanctions a culpable whistleblower is ordered to pay impact the determination of the $1 million threshold for monetary sanctions (Rule 21F-16).

Whistleblower Program Forms

The forms required under the rules are Form TCR, which must be filed to report a suspected

violation of law to the SEC and Form WB-APP, which must be filed to claim an award. The Release includes copies of each of these detailed forms and their instructions.

Incentives to Encourage Reporting Through Internal Compliance Systems

As noted above, the Institute's comment letter on the Commission's proposed rules expressed our serious concerns with the rules adversely impacting internal compliance programs by encouraging whistleblowers to report suspected violations of the federal securities laws to the Commission instead of internally. In response to these concerns expressed by the Institute and others, the Release notes,

> . . . we have determined not to include a requirement that whistleblowers report violations internally, but we have made additional changes to the rules to further incentivize whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate. [11]

In support of this statement, the Release states that the following provisions in the final rules will incentivize employees to report internally:

1. The provisions in Rule 21F-6 that "expressly provide . . . that a whistleblower's voluntary participation in an entity's internal compliance and reporting systems is a factor that can increase the amount of the award" and that "a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award;" [12]
2. The provision in Rule 21F-4(c)(3) that enables a whistleblower to receive an award for reporting original information to the entity's internal compliance and reporting systems "if the entity reports information to the Commission that leads to a successful Commission action" and the whistleblower provides the same information to the Commission within 120 days." [13] [Emphasis added.] According to the Release, "[u]nder this provision, all the information provided by the entity to the Commission will be attributed to the whistleblower, which means that the whistleblower will get credit – and potentially a greater reward – for any additional information generated by the entity in its investigation;" [14] and
3. The provision in Rule 21F-4(b)(4) that permits a whistleblower to report to the Commission within 120 days of reporting internally and still be treated as if the whistleblower had reported to the Commission at the time he or she had made the internal report. [15]

By contrast, note the provisions of Rule 21F-4(b)(4)(v), which were discussed above and which permit officers, directors, trustees, partners, compliance and internal audit personnel, and others to claim awards without first reporting internally so long as they either:

1. Have a reasonable basis to believe that disclose 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. Have a reasonable basis "to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct;" or
3. At least 120 days have elapsed since such person provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their

> equivalents), or the person's supervisor, or since the person received the information if he or she received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the person's supervisor was already aware of the information.

While nothing in the rules would preclude an entity from establishing its own incentives to encourage employees to internally report suspected violations of the federal securities laws, Rule 21F-17 expressly prohibits any person from taking "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." This rule additionally provides that, "[i]f you are a director, officer, member, agent, or employee of an entity that has counsel, and you have initiated communication with the Commission relating to a possible securities law violation, the staff is authorized to communicate directly with you regarding the possible securities law violation without seeking the consent of the entity's counsel." [Emphasis added.]

Self-Reporting

Another concern raised in the Institute's comment letter related to provisions in the proposed rules that implicitly required all entities to self-report their violations to the Commission. The current Release expressly notes that Rule 21F-4(b)(4)(v) (which is discussed immediately above and permits senior staff, compliance, and audit personnel, among others, to qualify as whistleblowers),

> . . . is not intended to, and does not, create any new or special duties of disclosure on entities to report violations or possible violations of law to the Commission or to other authorities. The provisions of this rule are solely designed to provide greater specificity to certain types of potential whistleblowers about the circumstances in which their submissions will or will not make them eligible to receive an award. [16]

It also notes that, "when considering whether and to what extent to grant leniency to entities for cooperating in [Commission] investigations and related enforcement actions, the promptness with which entities voluntarily self-report their misconduct to the public, to regulatory agencies, and to self-regulatory organizations is an important factor." [17]

Protection Against Retaliation

Section 922 of the Dodd-Frank Act prohibits adverse employment actions taken because of any lawful act by the whistleblower to provide information to the Commission. In our comment letter on the SEC's proposed rules, we had requested the Commission clarify that this provision will not preclude an employer from taking adverse action against a whistleblower's employment so long as such action was unrelated to the employee's whistleblowing activities. According to the Commission's current Release, they thought such clarification was "unnecessary" because, based on a literal reading of the statute, "adverse employee actions taken for other reasons are not covered." [18]

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endnotes

[1] See Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-64545 (May 25, 2011) ("Release") at http://www.sec.gov/rules/final/2011/34-64545.pdf. The Commission voted 3-2 to adopt the rules, with Commissioners Casey and Paredes voting in opposition to their adoption. In the view of Commissioner Casey, the rules significantly underestimate the negative impact on internal compliance programs and materially overestimate the Commission's "capacity to effectively triage and manage whistleblower complaints." See Statement of SEC Commission Casey on the Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (SEC Open Meeting, May 25, 2011).

[2] Comment letters filed by the Institute and others on the proposed rules expressed our serious concerns with the rules' potential impact on internal compliance programs. While the rules were revised "to create a significant financial incentive for whistleblowers to report possible violations to internal compliance programs before, or at the same time, they report to [the Commission]," the utility of these "incentives" seems questionable. Release at p. 101.

[3] The rules also provide that the Commission may pay an award under the program "based on amounts collected in certain related actions," which include judicial or administrative actions brought by the U.S. Attorney General, an appropriate regulatory authority, a self-regulatory organization, or a state attorney general in a criminal case. The term "appropriate regulatory authority" is defined in Rule 21F-4(f) and, generally speaking, refers to federal banking agencies. For ease of discussion, this memo will only refer to actions brought by the Commission, though, under the rules, such references would include "related actions."

[4] See, however, "SEC Whistleblower Office Does Not Want to Talk to You," Edward Siedel, Forbes (May 12, 2011).

[5] As noted below, however, there are "Exceptions" to these categories of persons, which are discussed next in this memo and which would enable such persons to qualify as a whistleblower.

[6] Note, as discussed in more detail below, these factors will influence the amount of award the whistleblower receives but will not render the whistleblower ineligible to receive at least 10% of the monetary sanctions collected in the judicial or administrative action.

[7] For those whistleblowers wanting to remain anonymous, Form TCR may be filed by the whistleblower's attorney subject to certain conditions set forth in Rule 21F-9.

[8] A whistleblower who submitted original information to the Commission after July 21, 2010 but before the effective date of the Commission's implementing rules (i.e., August 12, 2011) will be deemed to satisfy the rules' requirements so long as a Form TCR is filed within 60 days of the effective date of such rules.

[9] Note that (1) the Commission is under no obligation to notify whistleblowers who filed Form TCR with the Commission that they may be eligible to claim an award once monetary sanctions are imposed based, in whole or in part, on information the whistleblower provided the Commission; and (2) a whistleblower's failure to regularly monitor the Commission's

website for a “Notice of a Covered Action” and timely file Form WB-APP will render the whistleblower ineligible to claim an award. According to the Release, the Commission anticipates “that the Office of Whistleblower’s standard practice will be to provide actual notice to whistleblowers with whom the staff has worked closely.” Release at p. 171.

[10] This rule specifies, for example, that employees of the Commission or other specified federal agencies, FINRA, and other specified persons are ineligible for an award as are person who knowingly provide the SEC false or misleading information.

[11] Release at p. 5.

[12] Release at p. 6. Note, however, that these factors have no impact on a person’s status as a whistleblower and the Commission’s consideration of them is optional when determining whether the whistleblower should be awarded more than the minimum amount of an award (i.e., 10%).

[13] Release at p. 6.

[14] Release at p. 6.

[15] With regard to this provision, the Release notes that it is not intended to suggest that an internal investigation should in all cases be completed before an entity elects to self-report violations, or that 120 days is intended as an implicit ‘deadline’ for such an investigation. Companies frequently elect to contact the staff in the early stages of an internal investigation in order to self-report violations that have been identified. Depending on the facts and circumstances of the particular case, and in the exercise of discretion, the staff may receive such information and agree to await further results of the internal investigation before deciding its own investigative course. This rule is not intended to alter this practice in the future.

Release at p. 77.

[16] Release at p. 76.

[17] Release at p. 76, footnote omitted.

[18] Release at p. 19.
