The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24687

November 4, 2010

SEC Publishes Proposed Whistleblower Rules For Comment; Call To Discuss Scheduled For Thursday, Nov. 18th At 4 P.M. Eastern

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TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 7-10
INTERNAL AUDIT ADVISORY COMMITTEE No. 9-10
RISK MANAGEMENT COMMITTEE No. 18-10
SEC RULES COMMITTEE No. 49-10
SMALL FUNDS COMMITTEE No. 21-10 RE: SEC PUBLISHES PROPOSED WHISTLEBLOWER RULES FOR COMMENT; CALL TO DISCUSS SCHEDULED FOR THURSDAY, NOV. 18TH AT 4 P.M. EASTERN

Section 922 of the Dodd-Frank Act required the Securities and Exchange Commission to implement a process to provide a monetary reward to "whistleblowers" (i.e., a person or persons "who provide information relating to a violation of the securities laws to the Commission") who meet certain specified conditions. The SEC has proposed for comment rules to implement this provision. [1] The proposed rules and the Institute's concerns with them are briefly summarized below.

Comments on the proposal are due to the SEC by December 17th. The Institute will hold a conference call on Thursday, November 18th at 4 p.m. Eastern to discuss the proposal. If you plan to participate on the call, please let Gwen Kelly know by email (gwen.kelly@ici.org) no later than Friday, November 12th. If you are unable to participate in the call but have comments on the proposal, please provide them to Tami Salmon prior to the call by phone (202-326-5825) or email (tamara@ici.org).

THE PROPOSED RULES

Much of the substance of the proposed rules was dictated by the amendments in section 922 of the Dodd-Frank Act to newly created Section 21F in the Securities Exchange Act of 1934. Indeed, the rules' definitions, award provisions, and procedural and processing requirements follow the statute's requirements. Generally speaking, the rules would

implement the statute's requirements that the Commission establish a program whereby "whistleblowers" that provide "original information" to the Commission that results in the successful enforcement of a "covered judicial or administrative action," or a "related action," may receive monetary awards of between 10-30% of the "monetary sanctions" imposed in such action provided these sanctions exceed $1 million. In addition to the term "whistleblower," the statute and rules define the terms: "original information"; "covered judicial or administrative action" (which includes any such action brought by the SEC under the securities laws); "related action"; and "monetary sanctions," among others. The specific percentage amount of the award is within the SEC's jurisdiction so long as the total amount paid to all whistleblowers does not exceed 30% of the monetary sanction.

To be eligible to claim such an award, the whistleblower [2] must file several proposed forms with the SEC: Form TCR (i.e., Tip, Complaint or Referral), which sets forth the whistleblower's identity and original information; Form WB-DEC (i.e., Whistleblower's Declaration of Original Information), which will be used to determine the whistleblower's eligibility for a whistleblower award; and Form WB-APP (i.e., Whistleblower's Application for Award of Original Information), which will be used to make a claim for a reward. [3]

Pursuant to the proposed rules, there are seven categories of persons who would be ineligible to receive awards under this program. [4] These are persons who receive the information:

1. Through a communication subject to the attorney-client privilege;
2. As a result of the legal representation of a client, if they attempt to make their own whistleblower claim based on the information;
3. Through the performance of an engagement required under the securities laws by an independent public accountant if the information relates to a client violation;
4. Because the recipient was "a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, and the information was communicated [to such person] with the reasonable expectation that [such person] would take steps to cause the entity to respond appropriately to the violation, unless the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith" [emphasis added];
5. "From or through an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with the law unless the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith" [emphasis added];
6. In a manner that violates applicable federal or state criminal law; or
7. From any individual described in 1-6, above.

According to the Release, these exceptions are intended to recognize that, while the definition of "original information" does not require persons to have direct, first-hand knowledge of potential violations, the SEC does not intend to create incentives for certain persons who receive information based on their job functions or responsibilities "to circumvent or undermine the proper operation of the entity's internal processes for responding to violations of the law." [5] The Release also notes that this approach

> . . . is intended to strike a balance between two competing goals. On the one hand, it is designed to facilitate the operations of effective internal compliance programs by not creating incentives for company personnel to seek a personal financial benefit by 'front running' internal investigations and similar processes that are important components of effective company compliance programs. On

> the other hand, it would permit such persons to act as whistleblowers in circumstances where the company knows about material misconduct but has not taken appropriate steps to respond. [6]

This theme is repeated later in the Release:

> The Commission does not intend for its rules to undermine effective company processes for receiving reports on potential violations that may be outside of the Commission's enforcement interest, but are nonetheless important for companies to address.
>
> Given the policy interest in fostering robust corporate compliance programs we considered the possible approach of requiring potential whistleblowers to utilize in-house complaint and reporting procedures, thereby giving employers an opportunity to address misconduct, before they make a whistleblower submission to the Commission. Among 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.
>
> We emphasize, however, that our proposal not to require a whistleblower to utilize internal compliance processes does not mean that our receipt of a whistleblower compliant will lead to internal processes being bypassed. We 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. . . . This has been the approach of the Enforcement staff in the past, and the Commission expects that it will continue in the future. Thus, in this respect, we do not expect our receipt of whistleblower complaints to minimize the important of effective company processes for address allegations of wrongful conduct. [7]

During the Commission's open meeting on the proposal, Chairman Shapiro and each of the Commissioners expressed their interest in ensuring that the proposed rules do not adversely impact internal compliance programs. [8] The Release seeks comment on this issue as well as on all aspects of the proposal except those that track the statutory language.

THE INSTITUTE'S CONCERNS

In preparing a comment letter, the Institute plans to focus on the proposal's potential adverse impact on existing internal compliance programs. Notwithstanding the language quoted above from the Release, the rule text itself does not appear quite as deferential to internal compliance programs as the Release language seems to indicate. Also, as noted above, the rules appear to impose upon firms an obligation to report violations to the Commission, which is not currently required by law. Moreover, the rules fail to take into account that certain violation of law – e.g., certain recordkeeping violations – may qualify as a violation of the securities laws but not rise to the occasion of being a "material violation" or the type of "wrongful conduct" that would warrant application of the proposed rules. Exacerbating this concern is the ever-increasing amount of the fines being leveled by the

Commission. The November 18th call to discuss the proposal will largely focus on these issues. We will be most interested in knowing whether members share these concerns and, if so, what recommendations we should make in our comment letter to address them.

Tamara K. Salmon
Senior Associate Counsel

endnotes

[1] See Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-63237 (Nov. 3, 2010) (the "Release"), which is available at: http://www.sec.gov/rules/proposed/2010/34-63237.pdf.

[2] Whistleblowers who want to remain anonymous may have an attorney fill out these forms on their behalf so long as the attorney provides certain information, makes certain representations, and complies with certain specified requirements.

[3] Pages 151-181 of the Release consists of these three proposed forms and their instructions.

[4] See proposed Rule 21F-4(b)(4) and the Release's discussion at pp. 19-31.

[5] Release at pp. 24-25. "This would include officers, directors, employees, and consultants who learn of potential violations of part of their corporate responsibilities in the expectation that they will take steps to address the violations, as well as persons who gain knowledge about misconduct otherwise from or through the various processes that companies employ to identify problems and adverse compliance with legal standards."

[6] Note, however, that (1) Section 21F-4(b)(4)(iv) and (v) appear to condition taking "appropriate action" on the entity reporting the misconduct to the SEC (which is not a requirement of current law) and (2) the rules' provisions are not limited to "material misconduct."

[7] Release at pp. 34-35.

[8] See the statements of Chairman Shapiro and Commissioners Aguilar, Paredes, and Walter from the opening meeting on November 3, 2010, which are available on the Commission's website at: http://www.sec.gov/news/speech.shtml. Commissioner Casey made similar comments.

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