Divided SEC Adopts Rules Implementing Dodd-Frank Whistleblower Award Provisions

On May 25, 2011, the Securities and Exchange Commission ("SEC" or "the Commission") adopted the final rules (the "Rules")[1] implementing Section 21F of the Securities Exchange Act of 1934 ("Exchange Act"), "Securities Whistleblower Incentives and Protection." Adoption of the Rules was by a 3-2 vote. Section 21F was added to the Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2] and requires that the SEC shall pay an award to one or more whistleblowers who have "voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action." A "covered judicial or administrative action" is an action brought by the SEC under the Federal securities laws those results in monetary sanctions exceeding $1,000,000.[3]

This memorandum provides an overview of the Rules issued by the SEC in a 305-page release.

I. Definitions

A. "Whistleblower"

The Rules define the term "whistleblower" as someone who provides information to the SEC, pursuant to procedures set forth in the Rules, relating to a "possible" violation of the Federal securities laws.[4]

To be eligible for an award, a whistleblower must "voluntarily" submit "original information" in accordance with the provisions stipulated in the Rules[5]. However, even if one is not eligible for an award, whistleblowers will be entitled to the anti-retaliation protection under the Exchange Act[6] if they "possess a reasonable belief that the information ... relates to a possible securities law violation ... that has occurred, is ongoing, or is about to occur."[7]

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1 *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, 17 CFR Parts 240 and 249, Release No. 34-64545 (May 25, 2011) (the "Adopting Release") available at http://www.sec.gov/rules/final/2011/34-64545.pdf.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

3 Exchange Act Section 21F(b)(1) and Section 21F(a)(1).

4 Rule 21F-2(a)(1). The final rule modified the rule as proposed, which referred to information relating to a "potential violation," to a "possible violation ... that has occurred, is ongoing, or is about to occur." The change was meant to provide greater clarity as to who is eligible for whistleblower protection, regardless of the outcome of the investigation. The SEC interprets "possible violation" as requiring a "facially plausible relationship to some securities law violation," thereby weeding out "frivolous submissions. SEC Commissioner Troy A. Paredes expressed concern at the SEC open meeting on May 25, 2011 that this phrasing would result in the SEC being "inundated with allegations, not all of which will be fruitful for [the SEC] to pursue." However the majority of the Commissioners felt that Rule 21F-2(b)(1) protects against this eventuality by creating a "reasonable belief" standard which requires a "subjectively genuine belief that information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess."

5 Set forth in Rules 21F-4, 21F-8 and 21F-9.

6 Section 21F(h)(1)(A) of the Exchange Act provides: "No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower[.]"

7 Rule 21F-2(b)(1)(i).

1. "Voluntarily"

The Rules deem a submission to be made "voluntarily" so long as it is made before any "request, inquiry, or demand that relates to [the] subject matter of the submission is directed to [the whistleblower] or anyone representing [the whistleblower]" from the SEC, the Public Company Accounting Oversight Board ("PCAOB") or any other self-regulatory organization, or "in connection with an investigation by Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority."[8]

Submissions will not be deemed voluntary:

- if they are first furnished in response to a request or inquiry by the SEC or other regulatory authority, even if furnishing the information in response to the request is not compelled by subpoena or other applicable law;[9] or

- if the information is required to be reported to the SEC by a preexisting legal or contract duty owed to the SEC or one of the other regulatory authorities listed in the Rules or is required by judicial or administrative order.[10]

2. "Original Information"

The Rules define "original information" as information that is:

(i) derived from the independent knowledge or independent analysis of the whistleblower;

(ii) not already known to the SEC from another source, unless the whistleblower is the original source;

(iii) not exclusively from information publicly available; and

(iv) provided to the SEC for the first time after July 21, 2010, the date of enactment of Dodd-Frank.[11]

The Rules further define "independent knowledge" as "factual information ... not derived from publicly available sources," and define "independent analysis" as the "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public."[12]

B. Exclusions from whistleblower status

One of the most hotly contested debates during the commenting process was the scope of the exclusions from whistleblower status in light of Congressional intent in enacting Exchange Act Section 21F, and the Rules

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8 Rule 21F-4(a)(1). Notably, the Commission declined to include internal compliance investigation requests in the Rule 21F-4(a)(1) list.

9 Rule 21F-4(a)(2).

10 Rule 21F-4(a)(3). The Commission rejected suggested modifications which would have precluded "voluntariness" in situations in which the whistleblower had already become aware of an investigation, but not yet been requested to provide information by a regulator. Adopting Release at 32-33.

11 Rule.21F-4(b)(1). This definition tracks the definition of "original information" in Exchange Act Section 21F(a)(3).

12 Rule 21F-4(b) (2) and (3).

contain a list of exclusions. The Commission will not consider information by sources within any of the enumerated exclusions to be based on the "independent knowledge or analysis of a whistleblower," and the source of the information will not be eligible for an award.

1. Attorney-client privilege and other attorney conduct

Information obtained from a communication protected by attorney-client privilege is excluded from whistleblower eligibility as not being derived from independent knowledge or independent analysis.[13] Similarly, a whistleblower may not receive an award due to information obtained through legal representation of a client of the whistleblower or the whistleblower's employer.[14] Neither of these exclusions will apply in circumstances where an attorney is permitted to disclose otherwise privileged information. Such circumstances may include instances in which the attorney-client privilege has been waived or when reporting is permitted under the SEC's rules of practice[15] or is otherwise permitted by state bar rules.

The proposed form for submitting information asks the whistleblower to "identify with particularity any information … that was obtained from an attorney or in a communication where an attorney was present."[16]

2. Responsible company personnel, compliance processes, and independent public accountants[17]

The Rules list four additional categories of people who cannot meet the criteria for "independent knowledge or analysis." They are:

- All officers, directors, trustees, or partners of an entity in circumstances where they obtained the information because someone else informed them of potential misconduct, or if they learned of a possible violation through the entity's internal compliance mechanisms.[18]

- Employees who work primarily for the entity's internal compliance or audit processes, as well as employees of outside firms retained for internal compliance or audit services for the entity.[19]

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[13] Rule 24F-4(b)(4)(i).

[14] Rule 24F-4(b)(4)(ii).

[15] Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer, 17 CFR § 205.3(d)(2).

[16] The Commission felt that the Rules "send a clear, important signal to attorneys, clients, and others that there will be no prospect of financial benefit for submitting information in violation of an attorney's ethical obligations." Adopting Release at 61.

[17] Rules 21F-4(b)(4)(iii)(A)-(D).

[18] The Commission narrowed the scope of this exclusion as originally proposed by removing non-officer supervisors because the Commission believed this would create "too sweeping an exclusion of persons who may be in a key position to learn about misconduct." The Commission also made explicit that this exclusion should not operate as a general bar against officers, so long as the officer discovers the information by means other than internal compliance or employee allegations. Adopting Release at 71-72.

[19] This rule differs from the rules concerning attorneys and officers in that the manner by which the internal compliance or audit employees discover a possible violation is irrelevant: the rule excludes internal compliance and audit employees *per se,* subject to the exceptions set forth in Rule 21F-4(b)(4)(v).

- Information submitted by employees of firms retained to conduct internal investigations into possible violations by the entity.

- Information learned by employees of a public accounting firm through an audit or other engagement required under federal securities law.[20]

There are, however, a number of exceptions to the four categories of exclusions listed above.[21] If one of the exceptions applies, then the whistleblower may be eligible to receive an award notwithstanding the fact that the whistleblower falls within one of the excluded categories. The exceptions are:

- If the designated person has a "reasonable basis to believe that the disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors."[22]

- If the designated person has a "reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct."[23]

- If the information is provided to the Commission 120 days after the whistleblower brought the possible violation to the attention of the audit committee, chief legal officer, or chief compliance officer.[24]

3. Exclusion of information obtained through violation of criminal law

Information that a whistleblower obtained by a means or in a manner that violates applicable federal or state criminal law is also excluded from the definition of "independent knowledge." The SEC stated that it did not believe individuals should be rewarded for violating a federal or state criminal law.[25]

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[20] E.g., broker dealer annual audits pursuant to Rule 17a-5 of the Exchange Act.

[21] Rule 21F-4(b)(v).

[22] The Commission justified the exception based on a belief that it is in the public interest to accept whistleblower submissions and reward whistleblowers who provide information that allows the Commission to "take enforcement action to prevent substantial injury to the entity or to investors." Adopting Release at 74.

[23] Examples of such conduct are: destroying documents, improperly influencing witnesses, or engaging in other improper conduct that may hinder an SEC investigation. Adopting Release at 75. Commissioner Paredes in his open meeting remarks opined that this and the other exceptions could potentially "swallow the general rule that compliance and internal audit personnel are not eligible to receive bounties." Paredes suggested that "it may not be difficult for an individual to assert the reasonable belief required to fall within one or both of these exceptions, even if the belief is not well-founded in fact."

[24] The 120 day period begins running "either from the date the whistleblower informed other senior responsible persons at the entity, or his or her supervisor, about the violations, or from the date the whistleblower received the information, if the whistleblower was aware that these other persons already knew of the violations." The Commission noted that the 120 day period "is not intended to, and does not, create and new or special duties of disclosure on entities to report violations or possible violations of law to the Commission or to other authorities." The Commission also stated that the requirement is not intended as an implicit deadline for any internal investigation. Adopting Release at 76-77.

[25] Rule 21F-4(b)(4)(iv). Adopting Release at 77.

C. "Information that leads to successful enforcement"

The Rules define "information that leads to successful enforcement" as any information:

- "[S]ufficiently specific, credible, and timely" that would cause the SEC to "commence an examination, open an investigation, reopen an investigation that the Commission had closed" or to inquire into new conduct regarding an open investigation, so long as the action was brought "based in whole or in part on conduct that was the subject of [the whistleblower's] original information."[26] The Commission has stated that it does not "anticipate a rigid, mechanical application of this standard" and will mainly assess the degree to which the persons, entities, and conduct correspond between the submission and the action.[27]

- About conduct already under investigation if the submission "significantly contributed to the success of the action."[28] The Commission clarified its position on this standard somewhat, stating that factors it will consider are: whether the information reduced the amount of time or resources necessary to carry out the action or added successful claims to the action.[29] The Commission also made explicit that, in most cases, there will be no award for a whistleblower who was aware of an inquiry or demand by the SEC or other enforcement agency and who withheld or delayed providing responsive documents to the SEC.[30]

- Information reported to internal compliance which reaches the Commission by the actions of either the whistleblower or by internal compliance personnel may be attributed to the whistleblower if it meets either of the above two criteria.[31]

II. Criteria for Determining the Amount of an Award

In general, determining the amount of an award is within the SEC's discretion,[32] although it must be at least 10 percent and no more than 30 percent of the total monetary sanctions that the SEC is able to collect.[33] If more than one whistleblower contributes to the same or related action, the aggregate award to all whistleblowers must fall within the 10 percent to 30 percent window.[34]

As determined by the Commission, factors that may increase the amount of an award are:

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26 Rule 21F-4(c)(1).

27 Adopting Release at 98.

28 Rule 21F-4(c)(2).

29 Adopting Release at 100.

30 *Id*.

31 Rule 21F-4(c)(3).

32 Rule 21F-5(a).

33 Rule 21F-5(b).

34 Rule 21F-5(c).

- The significance of the information provided by the whistleblower, including its relation to the underlying action, the reliability and completeness of the information, and the degree to which the information supported a successful claim or claims.[35]

- The assistance provided by the whistleblower.[36] The factors the Commission may consider under this prong are:

    - Whether the whistleblower provided ongoing assistance and the depth of his or her assistance;
    - The timeliness of the initial report;
    - Resources conserved as a result of the whistleblower's assistance;
    - Whether the whistleblower encouraged others to provide assistance to the investigation;
    - Efforts of the whistleblower to lessen the harm caused by the violations; and
    - Any hardship suffered by the whistleblower as a result of providing the information.

- The Commission's interest in promoting whistleblower submissions in given circumstances. Under this factor, the Commission will consider whether an award will encourage high-quality tipping, whether the subject matter of the action is a "Commission priority," and the potential harm to investors from the underlying conduct.[37]

- The extent to which the whistleblower participated in internal compliance mechanisms at the entity.

Factors that may decrease the amount of an award are:

- The whistleblower's personal culpability in the conduct underlying the action.[38] The Commission will also consider whether or not the whistleblower interfered with any portion of the investigation.[39]

- Whether the whistleblower unreasonably delayed reporting the violation.[40]

- Whether the whistleblower interfered with or undermined the entity's internal compliance mechanism.

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35 Rule 21F-6(a)(1).

36 Rule 21F-6(a)(2).

37 Rule 21F-6(a)(3).

38 Rule 21F-6(b)(1).

39 Rule 21F-6(b)(1)(vii).

40 Rule 21F-6(b)(2).

III. Confidentiality of Submissions[41]

The Commission may not disclose information that "could reasonably be expected to reveal the identity of a whistleblower," subject to the following exceptions:

- If such disclosure is required to a defendant or respondent in a judicial or administrative action;[42]
- If the SEC determines that such disclosure is "necessary to accomplish the purposes of the Exchange Act ... and to protect investors," it may provide relevant information to the Department of Justice, regulatory authorities, self regulatory organizations, state attorneys general in connection with a criminal investigation, state regulatory authorities, or the PCAOB.
- The SEC may also provide information to foreign securities and law enforcement agencies. In those circumstances, the SEC will determine what assurances of confidentiality are appropriate in a given situation.[43]
- The Commission is permitted to make disclosures in accordance with the Privacy Act of 1974.[44]

IV. Procedures for Submitting Information[45]

To be eligible for an award, a whistleblower must either submit information through the SEC website or complete Form TCR (Tip, Complaint, or Referral).[46] Form TCR allows for multiple whistleblowers to make a joint submission on a single form.

The Rules require that the whistleblower submit the information under penalty of perjury in order to be eligible for an award. However, anonymous submissions are permitted, provided that an attorney representing the whistleblower submits the information pursuant to and certifies that he or she knows the identity of the whistleblower.[47]

V. Procedure for Making a Whistleblower Award Claim[48]

After a successful enforcement action has been completed, the SEC will post a "Notice of Covered Action" on the SEC website. A whistleblower has 90 days from the date of the posting to file an award claim. In

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41 Exchange Act Section 21F(h)(2) and Rule 21F-7(a).

42 Rule 21F-7(a)(1).

43 Rule 21F-7(a)(2).

44 Rule 21F-7(a)(3). The Privacy Act (5 U.S.C. § 552a) prohibits the disclosure of information from a system of records absent the written consent of the subject individual, unless the disclosure is pursuant to one of twelve statutory exceptions.

45 Rule 21F-9.

46 Rule 24F-9(a).

47 Rules 21F-9(b) and (c).

48 Rule 24F-10.

order to submit a claim for a whistleblower award, the whistleblower must submit the claim on Form WB-APP.[49] The Claims Review Staff will then evaluate all timely Form WB-APPs, and send the whistleblower an initial assessment, entitled Preliminary Determination.[50] The whistleblower will then have a 30 day period within which he or she may contest the Preliminary Determination.[51] Failure to submit a timely response will result in the Preliminary Determination becoming a Final Order.[52]

If the whistleblower does file a timely response, the Claims Review Staff will review the issues raised in the response as well as any supporting documents and will then make a Proposed Final Determination.[53] At this time, the Office of the Whistleblower informs the Commission of the Proposed Final Determination, and if within 30 days no Commissioner requests a review of the determination, it becomes a Final Order.[54] If a Commissioner does request a review, the entire Commission will review the record and issue its Final Order.[55]

The Commission will also allow the whistleblower to request that the Office of the Whistleblower make available for the whistleblower's review the materials which were used as the basis for the Preliminary Determination.

A Final Order by the Office of the Whistleblower may be appealed to a Federal appellate court. However, when the Commission makes an award between 10 and 30 percent of the monetary sanction of the underlying action, and bases its determination in the factors set forth in the Rules, the Final Order award amount is not appealable.[56]

VI. Materials Used in Determining Award Amounts

In determining if an award is appropriate and to what extent, the Claims Review Staff will use all publicly available materials relating to the action, including the complaint, the notice of hearing, the final judgment, any transcripts, any items that appear on the docket, and any appellate decisions.[57] The staff will also review the claimant's Form TCR, Form WB-APP, and other materials provided by the whistleblower.[58] The staff will look at any sworn declarations from SEC staff or from third parties.[59]

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[49] Despite several comments suggesting that the process for claiming an award should be made simpler and less formal by modeling it after *qui tam* cases under the False Claims Act, the Commission declined to do so, taking the position that such a process might unfairly favor whistleblowers who worked closely with the SEC on a particular matter, while not providing "full and fair opportunity" to other submissions worthy of an award. Adopting Release at 171-172.

[50] Rule 24F-10(d).

[51] Rule 24F-10(e)(1)(i).

[52] Rule 24F-10(f).

[53] Rule 24F-10(g).

[54] Rule 24F-10(h).

[55] *Id.*

[56] Rule 21F-13(a).

[57] Rule 21F-12(a)(1).

[58] Rule 21F-12(a)(2)-(3).

[59] Rule 21F-12(a)(4) and (6).

VII. No Amnesty for Whistleblowers

The Rules state that providing information to the Commission under the Rules will not provide amnesty to any whistleblower. While the Rules state that the Commission will take any cooperation into consideration, it will still pursue an action against a whistleblower if it deems doing so appropriate.[60] Furthermore, in determining whether an action meets the $1,000,000 threshold for a whistleblower to be eligible for award, the Commission will not take into account any monetary sanctions paid by the whistleblower, or if the sanction is "based substantially on conduct that the whistleblower directed, planned, or initiated."[61]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

[60] Rule 21F-15.

[61] Rule 21F-16.

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