

Corporate and Securities Update

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SEC Proposes Whistleblower Reward Program

On November 3, 2010, the Securities and Exchange Commission (the "SEC") proposed new rules and forms¹ to implement the whistleblower provisions of Section 21F² of the Securities Exchange Act of 1934 (the "1934 Act") added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Enacted in July 2010, the Dodd-Frank Act established a whistleblower reward program that requires the SEC to pay monetary awards to eligible whistleblowers who voluntarily provide the SEC with original information regarding the violation of the federal securities laws and this information leads to the successful enforcement of a covered judicial or administrative action by the SEC or of certain related action resulting in monetary sanctions of more than \$1.0 million. The provisions of the Dodd-Frank Act also prohibit retaliation by employers against individuals that provide the SEC with information about securities violations. Proposed Regulation 21F implementing Section 21F of the Exchange Act contains definitions of certain critical terms, the procedures for applying for awards under the whistleblower program, the SEC's process for making decisions on claims as well as a general explanation of the scope of the whistleblower program. The SEC's Whistleblower Office is designated to administer the SEC's whistleblower program. Comments on the proposed rule must be submitted to the SEC on or before December 17, 2010, and the SEC intends to adopt final whistleblower rules in the first quarter of 2011.

Definition of Whistleblower

The proposed rules define a "whistleblower" as an individual who, alone or jointly with others, provides "original" information to the SEC relating to a potential violation of the securities laws. Under the SEC's definition, a whistleblower must be a natural person. A company or other entity is not eligible to be a whistleblower. The proposed rules clarify that the anti-retaliation protections apply regardless of whether the whistleblower satisfies all the conditions to qualify for an award. The term "potential violation" is intended to clarify that the anti-retaliation protections of the Dodd-Frank Act are not dependent on the ultimate adjudication that the conduct identified by the whistleblower constituted a violation of the securities laws.

Requirements for Payment of the Award to the Whistleblower

The new rules include requirements for the payment of awards to whistleblowers. Under these rules, awards are payable only if:

- the whistleblower voluntarily provides the SEC with original information;
- such information leads to the successful enforcement by the SEC of a federal court or administrative action; and
- the action results in the SEC obtaining monetary sanctions totaling more than \$1.0 million.

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, available at <http://www.sec.gov/rules/proposed.shtml>.

2. See §922 of the Dodd-Frank Act.

The SEC will also pay an award based on amounts collected in a related judicial or administrative action brought by the U.S. attorney general, a state attorney general (in a criminal case), an appropriate regulatory agency³ or a self-regulatory organization. In order for the SEC to make an award in connection with a related action, it must determine that the same original information that the whistleblower gave to the SEC also led to the successful enforcement of the related action. If the SEC determines that the criteria for an award are not satisfied, or if the SEC is unable to obtain sufficient and reliable information about the related action to make such determination, the SEC will deny an award in connection with the related action.

Original Information/Voluntary Submission Component. Information is considered “original” if it is derived from the whistleblower’s independent knowledge⁴ or analysis, is not already known by the SEC from another source and, unless the whistleblower is the source of such information, is not derived from an allegation made in a judicial or administrative hearing, in governmental investigation or from the news media. Such information must have been provided to the SEC for the first time after July 21, 2010 (the date of the enactment of the Dodd-Frank Act).

The voluntary component of the criteria requires that a whistleblower provide the SEC with the information before the whistleblower or the whistleblower’s representative (such as an attorney) receives any formal or informal request, inquiry or demand from the SEC, Congress or any other federal, state or local authority, any self-regulatory organization or the Public Company Accounting Oversight Board. For this purpose, a request inquiry or demand made to an employer is considered directed to the employer’s employees who possess documents or other information that is within the scope of the request to the employer. As a result, whistleblower submissions from such employees would not be considered “voluntary” and the employees would not be eligible for an award. Disclosure would also not be voluntary under the proposed rules if the individual had a duty to report violations of the type at issue.

Successful Enforcement Component. In order for the award to be made, the SEC must make a determination regarding whether the original information provided by the whistleblower led to the successful enforcement of a judicial or administrative action. This condition will require that the SEC make certain determinations regarding the whistleblower’s

assistance and whether the information significantly contributed to the successful enforcement. The proposed rule would distinguish between situations where the whistleblower’s information causes the SEC Staff to begin an investigation, and situations where the whistleblower provides information about conduct that is already under investigation. In the latter case, awards would be limited to the rare circumstances where the whistleblower provided essential information that the SEC Staff would not have otherwise obtained in the normal course of the investigation.

The new rule establishes a two-part test for determining whether original information voluntarily provided by a whistleblower led to successful enforcement of a SEC action. First, the information must have caused the SEC Staff to commence an examination, open an investigation, reopen an investigation that had been closed, or to inquire concerning new and different conduct as part of an open examination or investigation. Thus, the proposed rule applies when the whistleblower gave the SEC Staff information related to conduct or activities that the SEC Staff was not already investigating or examining, and that information was a principal motivating factor behind the SEC Staff’s decision to investigate the whistleblower’s allegations. Second, if the whistleblower’s information caused the SEC Staff to start looking at the conduct for the first time, the proposed rule would require that the information “significantly contributed” to the success of an enforcement action filed by the SEC. This requires that the whistleblower’s information be high quality, reliable and specific, as well as meaningful to the SEC’s successful enforcement.

If information that a whistleblower provides to the SEC consists of “independent analysis” rather than “independent knowledge,” the evaluation of whether this analysis “led to successful enforcement” would turn on whether it significantly contributed to the success of the action. This would involve, for example, considering the degree to which the analysis, by itself and without further investigation, indicated a high likelihood of unlawful conduct that was the basis, or was substantially the basis, for one or more claims in the SEC’s enforcement action.

In connection with an ongoing examination or investigation, the SEC proposed a separate, higher standard for cases in which a whistleblower provides original information to the SEC. In this situation, the information will be considered to have led to the successful enforcement of a judicial or

3. An appropriate regulatory agency includes the SEC, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.

4. Independent knowledge includes factual information not obtained from publicly available sources.

administrative action if the information would not have otherwise been obtained and was essential to the success of the action. The SEC has admitted that this standard will be applied in a strict fashion and that awards under this standard would be rare.

In considering the relationship between information obtained from a whistleblower and the success of an enforcement action, the SEC will apply the same standards in both settled and litigated actions. Specifically, in a litigated action the whistleblower's information must significantly contribute, or, in the case of conduct that is already under investigation, be essential, to the success of a claim on which the SEC prevails in litigation. For example, if a court finds in favor of the SEC on a number of claims in an enforcement action, but rejects the claims that are based upon the information the whistleblower provided, the whistleblower would not be considered eligible to receive an award. Similarly, in a settled action the SEC would consider whether the whistleblower's information significantly contributed, or was essential, to allegations included in the SEC's federal court complaint, or to factual findings in the SEC's administrative order.

Calculating Monetary Sanctions. For purposes of calculating whether monetary sanctions in a SEC action exceed the \$1.0 million threshold required for an award payment pursuant to Section 21F of the Exchange Act, as well as determining the monetary sanctions on which awards are based, the SEC proposed to interpret the term "action" to mean a single captioned civil or administrative proceeding. This approach is consistent with the most common meaning of the term. An "action" would include all defendants or respondents and all claims that are brought within that proceeding without regard to which specific defendants or respondents, or which specific claims, were included in the action as a result of the information that the whistleblower provided. Sanctions that are imposed in separate judicial or administrative actions will not be aggregated for purposes of determining whether the \$1.0 million threshold is satisfied.

If all of the conditions are met for a whistleblower award in connection with a SEC action or a related action, the SEC will then decide the amount of the award pursuant to the procedures set forth in Regulation 21F. The aggregate amount of the award will be at least 10 percent, and will be capped at 30 percent, of the monetary sanctions that the SEC and the other authorities are able to collect. The percentage awarded in connection with a SEC action may differ from the percentage awarded in connection with a related action. If the SEC makes awards to more than one whistleblower in connection with the same action or related action, the SEC will determine an individual percentage

award for each whistleblower, but the total amount awarded to all whistleblowers as a group will be within the 10 – 30 percent range described above.

Determination of the Amount of the Award to the Whistleblower

The rule outlines the following four critical factors the SEC will consider in determining the amount of the awards:

- the significance of the information provided by a whistleblower to the success of the SEC action or related action;
- the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the SEC action or related action;
- the SEC's programmatic interest in deterring violations of the securities laws by making awards to whistleblowers that provide information that leads to successful enforcement actions; and
- whether an award otherwise enhances the SEC's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers.

The determination of award amounts pursuant to the foregoing criteria involves highly subjective reviews of the circumstances leading to the award. These four criteria afford the SEC broad discretion to weigh various considerations in determining the amount of any particular award, including, but not limited to, the considerations listed below:

- the character of the enforcement action, including whether its subject matter is a SEC priority, whether the reported misconduct involves regulated entities or fiduciaries, the type and severity of the securities violations, the age and duration of misconduct, the number of violations, and the isolated, repetitive, or ongoing nature of the violations;
- the dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or threatened by the underlying violations, and the number of individuals or entities harmed;
- the timeliness, degree, reliability, and effectiveness of the whistleblower's assistance;
- the time and resources conserved as a result of the whistleblower's assistance;
- whether the whistleblower encouraged or authorized others to assist the SEC Staff who might otherwise not have participated in the investigation or related action;

- any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action;
- the degree to which the whistleblower took steps to prevent the violations from occurring or continuing;
- the efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the authorities in the recovery of the fruits and instrumentalities of the violations;
- whether the information provided by the whistleblower related to only a portion of the successful claims brought in the SEC or related action;
- the culpability of the whistleblower including whether the whistleblower acted with scienter, both generally and in relation to others who participated in the misconduct; and
- whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the SEC⁵.

Depending upon the facts and circumstances of each case, some of the considerations listed above may not be applicable or may deserve greater weight than others.

Confidentiality of Whistleblower's Submission of Information

The proposed rule provides that the SEC will not reveal the identity of a whistleblower or disclose other information that could reasonably be expected to reveal the identity of a whistleblower under certain specified circumstances. For example, when disclosure is required to a defendant or respondent in a federal court or administrative action that the SEC files or in another public action or proceeding filed by an authority to which the SEC may provide the information. When it is necessary to achieve the purposes of the Exchange Act and to protect investors, the SEC may also disclose the identity of a whistleblower to the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the Public Company Accounting Oversight Board, or foreign securities and law enforcement authorities, each of which, other than foreign authorities, is subject to the confidentiality requirements of Section 21F of the Exchange Act.

Anonymous submissions are permitted under certain specified conditions, including the following:

- anonymous whistleblowers be represented by an attorney in connection with both the submission of information and the claim for an award, and that the attorney's contact information be provided to the SEC at the time of the whistleblower's initial submission (the purpose of this requirement is to prevent fraudulent submissions and to facilitate communication and assistance between the whistleblower and the SEC's Staff);
- anonymous whistleblowers and their counsel follow the required procedures outlined in the proposed rules; and
- anonymous whistleblowers disclose their identity, pursuant to the procedures set forth in the proposed rules, before the SEC will pay any award.

Procedures for the Whistleblower's Submission of Information to the SEC

The proposed rules outline specific procedures required for submitting original information to the SEC and making a claim for a whistleblower award. These procedures include a requirement that the whistleblower, upon request, agree to provide explanations and other assistance including, but not limited to, providing all additional information in the whistleblower's possession that is related to the subject matter of the submission. The proposed rule also requires that whistleblowers, if requested by the SEC Staff, provide testimony or other acceptable evidence relating to whether they are eligible for or otherwise satisfy any of the conditions for an award. Finally, the proposed rules authorize the SEC Staff to require that a whistleblower enter into a confidentiality agreement in a form acceptable to the Whistleblower Office, including a provision that a violation of such agreement may result in the whistleblower being ineligible for an award. In some cases, a confidentiality agreement may be required if it becomes necessary or advisable for the SEC Staff to share non-public information with a whistleblower either during the course of the investigation, or as part of the claims process set forth in the proposed rules.⁶

Ineligible Applicants. The categories of individuals who are ineligible for an award under the SEC's new program include any person:

5. This last consideration is not a requirement for an award above the 10 percent statutory minimum and whistleblowers will not be penalized if they do not avail themselves of this opportunity for fear of retaliation or other legitimate reasons. However, to emphasize the important role that corporate compliance programs should play in preventing and detecting securities violations, the SEC will consider higher percentage awards for whistleblowers who first report violations through their compliance programs.

6. See proposed Rule 21F-10 and 21F-11.

- who is, or was at the time he or she acquired the original information, a member, officer, or employee of the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization;
- who is, or was at the time he or she acquired original information, a member, officer, or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority;
- who is convicted of a criminal violation that is related to the SEC action or to a related action for which the person otherwise could receive an award;
- who obtained the information provided to the SEC through an audit of a company's financial statements, and making a whistleblower submission would be contrary to the audit requirements of Section 10A of the Exchange Act;
- who acquired the information provided to the SEC from any of the individuals described in the foregoing bullet points;
- who is the spouse, parent, child or sibling of a member or employee of the SEC, or who resides in the same household as a member or employee of the SEC; and
- who in his or her whistleblower submission, other dealings with the SEC, or dealings with another authority in connection with a related action, knowingly and willfully makes any false, fictitious, or fraudulent statement or representation, or uses any false writing or document, knowing that it contains any false, fictitious, or fraudulent statement or entry.

Submission Process and New Forms. The proposed rules establish a two-step process for the submission of original information under the whistleblower award program. The first step is the submission of information either (i) online through the SEC's Electronic Data Collection System, an interactive, web-based database for submission of tips, complaints and referrals, or (ii) in paper format by filling out Form TCR (Tip, Complaint or Referral).⁷ Both methods of submission elicit substantially similar information about the whistleblower and the alleged violation.

The second step requires the whistleblower to complete a proposed Form WB-DEC, *Declaration Concerning Original Information Provided Pursuant to §21F of the Securities*

Exchange Act of 1934, signed under penalty of perjury. Form WB-DEC would require a whistleblower to answer certain threshold questions concerning the whistleblower's eligibility to receive an award. The form also would contain a statement from the whistleblower acknowledging that the information contained in the Form WB-DEC, as well as all information contained in the whistleblower's submission, is true, correct and complete to the best of the whistleblower's knowledge, information and belief. Moreover, the statement would acknowledge the whistleblower's understanding that the whistleblower may be subject to prosecution and ineligible for an award if, in the whistleblower's submission of information, other dealings with the SEC, or dealings with another authority in connection with a related action, the whistleblower knowingly and willfully makes any false, fictitious, or fraudulent statements or representations, or uses any false writing or document knowing that the writing or document contains any false, fictitious, or fraudulent statement or entry. Under the new rules, if information is provided by an anonymous whistleblower, the attorney representing the whistleblower will have to certify to the SEC that the attorney verified the identity of the whistleblower, reviewed the whistleblower's Form WB-DEC for completeness and accuracy, and will retain the whistleblower's original, signed Form WB-DEC in the attorney's files.

Procedures for Making a Claim for a Whistleblower Award

The proposed process for submitting a claim for award would begin with the publication of a "Notice of a Covered Action" on the SEC's website. Whenever a judicial or administrative action brought by the SEC results in the imposition of monetary sanctions exceeding \$1.0 million, the Whistleblower Office will cause this notice to be published on the SEC's website, subsequent to the entry of a final judgment or order in the action that by itself, or collectively with other judgments or orders previously entered in the action, exceeds the \$1.0 million threshold, or in the absence of such judgment or order, within 30 days of the deposit of such monetary sanctions into a disgorgement or other fund. A claimant will have 60 days from the date of the Notice of Covered Action to file a claim for an award based on that action, or the claim will be barred.

Specifically, a claimant would be required to submit a claim for an award on proposed Form WB-APP, *Application for Award for Original Information Provided Pursuant to*

7. The SEC anticipates that, by the time it adopts final rules to implement Section 21F, whistleblowers will be able to submit information to the SEC online through the Electronic Data Collection System. The Commission is separately submitting a request to the Office of Management and Budget for Paperwork Reduction Act for the approval of the Electronic Data Collection System.

§21F of the Securities Exchange Act of 1934. Form WB-APP requests information concerning a whistleblower's eligibility to receive an award at the time the whistleblower files his claim. The purpose of the form is, among other things, to provide an opportunity for the whistleblower to "make his case" for why he is entitled to an award by describing the information and assistance he has provided and its significance to the SEC's successful action.

Once the time for filing any appeals of the SEC's judicial or administrative action has expired, or where an appeal has been filed, after all appeals in the action have been concluded, the Whistleblower Office and designated SEC Staff would evaluate all timely whistleblower award claims submitted on Form WB-APP. Following that evaluation, the Whistleblower Office would send any claimant a preliminary determination setting forth a preliminary assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount. The proposed rules also provide for a process for claimants to contest the SEC Staff's preliminary determination or appeal the SEC's final order.

Conclusion

It is anticipated that the new SEC's whistleblower award program will increase the level of whistleblower reporting of potential violations. Given the potential negative side effects of this SEC program for public companies, companies should consider the following steps:

- *Set the tone at the top.* The CEO and board need to make it clear throughout the organization that whistleblowers who bring potential violations to the company

are highly regarded by senior management. Bringing potential violations to the company should be strongly encouraged and the CEO should clarify such activity will be rewarded by senior management and not punished.

- *Develop incentives for whistleblowers to report potential violations through the company's internal process.* Since whistleblowers are frequently viewed as villains because their actions may cause significant issues and public embarrassment for the company, they are often reluctant to bring these issues to the company's attention. Given the incentives provided by the SEC's reward program, the company should consider the development of a series of its own incentives to reward whistleblowers for utilizing the company's whistleblower program to address concerns and potential violations of law.
- *Keep whistleblowers in the loop regarding the company's internal investigation progress.* Many whistleblowers go outside of their organization to the SEC or another regulatory authority when they believe the company ignored, did not adequately address or refused to investigate their concerns. As a result, it is critically important that the whistleblower is kept in the loop regarding the company's progress (without revealing the details of the investigation or findings that may jeopardize the investigation). In addition, it is important that the whistleblower is assured by the General Counsel or other person investigating the matter that the company is taking the whistleblower's concerns seriously and addressing any issues or violations of law raised by the whistleblower. ■

Questions

Any person who has a question regarding the issues raised in this *Corporate and Securities Update* may obtain additional guidance from a member of our Public Companies Group (www.blankrome.com).

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