

US REGULATORY UPDATE

SEC Issues Final Whistleblower Rules

On May 25, 2011, the US Securities and Exchange Commission ("SEC") by a divided vote of 3-2 adopted final rules implementing the controversial whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").¹ The Dodd-Frank Act amended the Securities Exchange Act of 1934 to add Section 21F, which requires the SEC to pay whistleblowers awards (subject to limitations and conditions) of 10% to 30% of any sanctions collected when they voluntarily provide the SEC with original information about a violation of the US securities laws that leads to a successful SEC enforcement action resulting in sanctions exceeding \$1 million. The final rules define eligibility for an award and set forth the procedures whistleblowers must follow to be eligible for an award.

The rules create significant incentives for whistleblowers to report suspected securities law violations to the SEC and usher in a new era of increased regulatory risk for companies. Significantly, the rules do not require the whistleblower first to report the matter to the company's internal compliance apparatus. The rules place a premium on prevention, and indirectly incentivize companies to voluntarily disclose issues earlier and more often.

Background

The SEC designed the final rules to reward individuals who provide the SEC with tips regarding corporate misconduct that lead to successful enforcement actions. According to the SEC, the whistleblower program is intended primarily to reward individuals who act early to expose violations and who provide significant evidence that helps the SEC bring successful cases. The rules prohibit employment retaliation against those alleging misconduct and forbid interference with a whistleblower's attempts to contact the SEC.

In addition, the Office of the Whistleblower, led by Sean McKessy, has now been staffed, and the Investor Protection Fund, from which bounties will be paid to eligible whistleblowers, is fully funded.

Effective Date

The final rules will become effective 60 days following publication in the Federal Register, which likely will occur shortly.

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¹ "SEC Adopts Rules to Establish Whistleblower Program," SEC Press Release (May 25, 2011), available at: <http://sec.gov/news/press/2011/2011-116.htm>; Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (May 25, 2011), available at: <http://sec.gov/rules/final/2011/34-64545.pdf> ("Adopting Release").

Final Rules

The SEC initially proposed whistleblower rules on November 3, 2010², and received more than 240 comment letters and approximately 1300 form letters in response. As a result, the SEC made a number of revisions and refinements to the proposed rules, though the framework previously established is largely the same.

Among the most significant changes in the final rules are the following:

Internal Compliance. One of the most contentious issues in the proposed rules was the impact of the whistleblower provisions on internal compliance programs. Commentators argued that the proposed rules incentivized whistleblowers to bypass established internal compliance reporting systems and go directly to the SEC to ensure that they were eligible for an award. The SEC decided not to include a requirement that whistleblowers report violations internally. Instead, it made the following modifications "to further incentivize whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate."³

- The criteria for determining the amount of an award now expressly provide that (1) a whistleblower's voluntary participation in a company's internal compliance and reporting systems is a factor that can increase the award amount, and (2) a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.
- Whistleblowers can receive an award for reporting information to a company's internal compliance department if the company reports information to the SEC that leads to a successful SEC enforcement action. All information provided by the company to the SEC will be attributed to the whistleblower, which means the whistleblower could obtain a larger award based upon additional information provided by the company.
- The time for a whistleblower to report to the SEC after first reporting internally has been extended from 90 days to 120 days. If the company does not report the information to the SEC, a whistleblower reporting to the SEC within this timeframe will still be eligible for an award.

Despite the changes, a whistleblower still has an incentive to bypass internal compliance in order to deprive the company of voluntary disclosure credit, which may thereby increase the sanction and thus the whistleblower's potential bounty pool.

Among the SEC's concerns about requiring the use of internal reporting systems was that while many employers have well-documented, thorough, and robust compliance programs that offer appropriate confidentiality to whistleblowers, others do not.⁴ Therefore, the SEC believes that there may be instances where internal disclosures could be inconsistent with effective investigation or the protection of whistleblowers, and that the whistleblowers are in the best position to assess whether or not to report violations internally. Also, the SEC expects that in appropriate cases the SEC staff will contact a company upon receiving a whistleblower complaint and give the company the opportunity to investigate and report back. Whether the SEC will in fact give the company such an opportunity in practice remains to be seen.

Procedures for Submitting Information and Claims. The final rules have simplified the process for submitting information, replacing the proposed two-step process with a single form to be submitted by a whistleblower under penalty of perjury.

Aggregation of Smaller Actions. The proposed rules stated that awards would be available only when the SEC had successfully brought a single judicial or administrative action in which it obtained sanctions of more than \$1 million. The final rules now provide that the SEC will aggregate amounts from two or more smaller actions that arise from the same nucleus of operative facts.

² "US Regulatory Update: SEC Expected to Issue Final Whistleblower Rules," Clifford Chance Client Briefing (December 2010), available at http://www.cliffordchance.com/publicationviews/publications/2010/12/us_regulatory_updatesecexpectedtoissuefinal.html.

³ Adopting Release at 5.

⁴ Adopting Release at 91-92. Other reasons provided by the SEC for not requiring internal reporting include the SEC's belief that (1) there are a significant number of whistleblowers who would respond to the financial incentive offered by the whistleblower program by reporting only to the SEC but would not come forward either to the SEC or the company if the financial incentive was coupled with a mandatory internal reporting requirement; (2) the adopted approach should encourage companies to strengthen their internal compliance programs to promote internal reporting as potential whistleblowers are more likely to report internally when they believe the company has a good internal compliance program that will take their information seriously and not retaliate; (3) internal compliance programs are valuable but are not substitutes for strong law enforcement; and (4) requiring whistleblowers to report internally would not be consistent with the language or legislative intent of Section 21F. *Id.* at 103-05.

Exclusions from Award Eligibility. The final rules also bar certain parties from qualifying for a whistleblower award. Subject to exceptions, generally individuals who obtain information in attorney-client privileged communications and other legal, compliance, and internal audit employees are ineligible for a payout under the program.

Conclusion

While the rules bring some measure of finality to what has been a contentious topic since the passage of the Dodd-Frank Act last summer, many companies are only beginning to comprehend the strain that "bounty hunting" employees will place on their businesses. The new rules remain subject to legislative and legal challenges. For example, Representative Michael Grimm (R-NY) has signaled his intention to introduce legislation to require whistleblowers to report internally.

Nevertheless, companies must be prepared to handle increased numbers of allegations of misconduct from employees who now have a significant financial incentive to make such allegations. At the same time, companies should understand and implement the broad anti-retaliation and whistleblower protection provisions mandated in the new rules. Finally, companies should have a system in place that is robust enough to conduct proper risk assessment and yet agile enough to make voluntary self-disclosure if necessary before the opportunity to receive the credit from self-disclosure is lost.

This client memorandum does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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