CARLTON FIELDS

The Impact of the New SEC Whistleblower Rules

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Introduction On May 25, 2011, the Securities and Exchange Commission announced new regulations aimed at incentivizing individuals who have information about possible violations of SEC rules to come forward with this information.[1] The new rules provide the long awaited details of the whistleblower provisions provided for in the Dodd-Frank Wall Street Reform and Consumer Protection Act that was enacted on July 21, 2010. Entitled "Securities Whistleblower Incentives and Protection"[2], the rules implement Section 21F of the Securities Exchange Act of 1934 and become effective on August 12, 2011. The potential for individuals to receive large cash rewards for their information, while being protected from retribution and not being required to report this information to their company's internal compliance department, is expected to significantly increase the number of tips brought to the Commission and might undermine companies' ability to police themselves. **A "Bounty" for Whistleblowers** Under the new rules, the Commission will pay eligible whistleblowers a percentage of the penalty that is imposed on violators of SEC rules when original information provided by the whistleblower leads to successful enforcement by the SEC. This "bounty", as some have referred to it, can range from 10% to 30% of the penalty imposed by the Commission on the guilty party. The Commission outlines factors that they will consider in either increasing or decreasing the award, but the amount of the ultimate reward is up to the discretion of the Commission.[3] In order for the whistleblower to be eligible for the reward, the penalty must be equal to or greater than one million dollars. The original announced rule did not include an allowance for aggregation of smaller claims, but the SEC included in the new rules the ability to aggregate smaller penalties that arise out of the same nucleus of operative fact to meet the $1 million baseline. **Protection from Retribution** The new rules create a cause of action for whistleblowers who suffer retaliation from employers, which can be used whether or not the whistleblower's tip ultimately leads to an actual penalty or reward. To be eligible for this protection, whistleblowers must swear under penalty of perjury that the information that they submit is truthful to the best of their knowledge. Also, to protect against potential frivolous claims, the Commission must determine that the whistleblower has a reasonable belief that the information that they report concerns a violation of SEC rules. **Original Information** An individual is eligible to be considered a whistleblower if the

person provides original information to the SEC about a possible violation that has occurred, is ongoing, or is about to occur. The information normally cannot be from a publicly available source, besides in certain cases where the whistleblower conducts their own independent analysis to expose violations through the use of publicly available information. There are restrictions that may remove an individual's status as a whistleblower under the new rules. For instance, in some cases a mere tip may not be enough, and the Commission may base eligibility on the individual providing additional explanations and giving the Commission all information that is in his possession. Information is not considered original if it is not provided voluntarily, or if the information is submitted out of a pre-existing obligation to report violations to the SEC, such as where the individual is performing a required audit. An exception to this rule occurs where the individual reporting to the SEC would be consistent with the audit requirements of Rule 10A of the Securities and Exchange Act of 1934.[4] For example, an allegation that a firm did not follow the procedures outlined in Section 10A, possibly by failing to assess or investigate illegal acts or make a report to the Commission, might qualify for a reward under the whistleblower rules. **Restrictions on Privileged Information** In order to preserve the attorney client privilege, and to encourage individuals to seek advice from counsel about potential violations, information that is subject to attorney client privilege cannot be the basis of an award. Also, the SEC notes that it could be possible for a litigant to use a protective order to hide information regarding violations of law from an enforcement agency. Therefore, whistleblowers that provide information that an opposing party in private litigation may contend comes within the scope of a protective order are not excluded. Information that comes from an officer, director, auditor, or similar responsible personnel is generally ineligible for an award. The reason for this exclusion is mainly a concern that the bounty might create an incentive for responsible individuals to engage in "front running" certain complaints that they receive, and thus putting their own interests ahead of their duties to the company. There are, though, certain exceptions to these rules. When the individual has a reasonable belief that the entity is impeding or substantially delaying the investigation, or that the information provided will prevent the entity from committing substantial harm, then the Commission, in consideration of public policy, might accept the information and reward the whistleblower despite her position. **Culpable Conduct by the Whistleblower** Whistleblowers who have engaged in culpable conduct presented a dilemma for the Commission in shaping the final rules. On one side of this issue is the value of the information that a culpable whistleblower could present to the SEC. On the other side is the public policy concern of allowing individuals to benefit from their own wrongdoing. In the final rules the Commission decided that the information that these individuals could possess was too important to strictly exclude. In consideration of the public policy concern, the final rules do not allow penalties levied on the whistleblower himself to count towards the $1 million baseline. Also, the Commission will take the culpability of the whistleblower into account when determining the amount of the reward. The SEC does not however want to encourage individuals to break laws in order to participate in the whistleblower program. Therefore, Information that an individual obtains through means determined to be in violation of federal or state law is ineligible for a reward. **Interaction with Internal Compliance Procedures and Effect on Companies** Since these regulations were first proposed in

November of 2010, they have generated significant controversy; much of it focusing the interaction of the new rules with the internal compliance processes of companies. The SEC received a large amount of comment letters from various groups on both sides of this issue.[5] Commenters from the corporate community expressed concern that the financial incentive of reporting to the SEC will divert whistleblowers from reporting internally. The Commission received comments expressing concerns that companies would experience significant costs once the rules go into effect. These costs include harm to entities and investors from learning about violations after an SEC investigation is already ongoing, increased defense and litigation costs from being forced by the Commission to defend against possibly non meritorious claims that ordinarily would have been dealt with internally, and increased harm to entities and investors when non-securities law violations go unreported to the entity. The Commission argued that the rules should encourage companies who would like to have their employees report internally to institute stronger and more reliable internal compliance systems. Also, the Commission points to admittedly inconclusive academic evidence that whistleblowers may be motivated by non financial factors as well, such as cleansing their conscience, punishing wrongdoers, self preservation and simply "doing the right thing" for the sake of a general increase in social welfare.[6] The SEC release states that the Commission understands that the financial incentives could divert certain whistleblowers away from reporting internally, and that this might impair the usefulness of internal compliance programs, which play an important role in achieving compliance with the securities laws.[7] Ultimately though, the Commission decided in their final rules that despite the potential costs to companies, the most effective way to achieve the Commission's purpose of enforcing securities laws would be to allow a whistleblower to go directly to the SEC with their information and bypass reporting internally if they so choose. In an attempt to temper some of the negative effects, the Commission states that it will take certain factors relating to internal compliance into account when calculating the whistleblower's reward.[8] The rules however, do not state exactly how much of an effect reporting internally will have on the ultimate reward. Therefore, the significance of these provisions remains to be seen. When presented with information that might otherwise have gone through a company's internal compliance system, the SEC will decide whether or not to allow the company to investigate the matter and report back to the Commission. Final discretion lies with the Commission though, showing that the SEC will hereafter play a much larger role in matters that in the past would have been dealt with internally. **Timing of Reporting** The rules provide a "lookback period" of 120 days, during which an individual who first reported internally could report the violations to the Commission and get credit for reporting to the SEC at the date that he reported internally. Although the Commission included this provision to incentivize the use of internal compliance systems, the efforts of these systems will still be undermined somewhat as the SEC will be involved in most, if not all potential complaints going forward. The rules state that an individual who presents their information "before or at the same time" (but no later than 120 days after the time) that they alert the SEC will still be eligible for the reward if the tip eventually leads to sanctions. The use of the phrase "before or at the same time" shows that the Commission will have to be alerted by the individual at some point in order for them to be eligible for the reward. **Conclusion** The new rules should greatly increase the number of tips that the Commission receives.

However, the quality of this new information and the capacity of the SEC to effectively deal with this increase remains to be seen. Companies should be most concerned with the potential undermining of the internal compliance systems that they already have in place. Although the Commission acknowledges possible negative effects that the rules may have, they ultimately decided that their main interest in enforcing the securities laws takes precedent over these concerns. Companies should expect increased involvement from the SEC in matters that in the past may have been dealt with internally. In preparation for the new rules and to reduce the risk of future SEC involvement, companies may also benefit from evaluating the strength and effectiveness of the compliance systems that they already have in place. If you have questions about this memo or the effect of these rules on your company's compliance plan, please contact Kevin J. Napper or Adam P. Schwartz at 813-223-7000. *Christopher Davis is a contributing author for this article.*

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[1] Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 ("Implementing Release"). [2] Pub. L. No. 111-203, § 922(a), 124 Stat 1841 (2010). [3] Positive factors include: Significance of the information provided by the whistleblower, the nature of the information, assistance provided by the whistleblower, the law enforcement interest in deterring violations of securities laws and participation in internal compliance systems. Negative factors include: culpability, unreasonable reporting delay and interference with internal compliance systems (Rule 21F-6). [4] 15 USC § 78j-1. [5] The Commission received over 240 comment letters and approximately 1300 form letters from various groups regarding all of the new rules. To review comments, see: http://www.sec.gov/comments/s7-33-10/s73310.shtml. [6] See Implementing Release, page 230 (citing Anthony Heyes & Sandeep Kapur, An Economic Model of Whistleblower Policy, 25 J. L. ECON. & ORG. 157, 159 (2009) and Aaron S. Kesselheim et al., Whistle-Blower's Experience in Fraud Litigation Against Pharmaceutical Companies, 362 NEW ENGLAND J. MED. 1832, 1834 (2010). [7] See Implementing Release, pg 106. [8] In order to encourage utilization of internal compliance programs, the amount of an award can be increased if the individual first reports internally, and it can be decreased if the whistleblower interferes with internal compliance efforts. If an individual provides information which in turn leads to the discovery of additional violations by the company's internal investigation, the whistleblower gets credit for the later information which can lead to a greater reward if the SEC later issues sanctions.

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