WSGR ALERT

NOVEMBER 2010

SEC SEEKS COMMENT ON A NEW WHISTLEBLOWER BOUNTY PROGRAM PROPOSED UNDER THE DODD-FRANK ACT

On November 3, 2010, the Securities and Exchange Commission (SEC) unanimously approved a set of proposed rules establishing a new bounty program implementing the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] According to the SEC, the proposed rules reflect "the consideration of a number of potentially competing interests, and balance the need to encourage whistleblowers to come forward without promoting unintended consequences."[2]

In this WSGR Alert, we outline the key provisions of the proposed rules. We also summarize the substance of the comment we intend to submit to the SEC stating the reasons why we believe the new rules do not strike an appropriate balance between incentivizing whistleblowers to report wrongdoing to the SEC and encouraging companies to maintain robust internal compliance programs.

Key Provisions of the New Whistleblower Program

Expanded Bounty Payments. The new whistleblower rules substantially expand the scope and amount of the SEC's bounty program. Prior to the Dodd-Frank Act, the SEC's bounty program was limited to insider-trading cases, and the amount of an award was capped at 10 percent of the penalties collected in the action. The new whistleblower program rewards individuals who provide information to the SEC about any securities law violation with a minimum of 10 percent up to a maximum of 30 percent of any monetary sanction imposed over $1 million. The whistleblower award may be based upon monetary sanctions imposed in an enforcement action commenced by the SEC, as well as monetary sanctions imposed in a "related action" commenced by another government agency.

Information Provided Must Be Original and Voluntary. The program applies to all "original information" received after July 22, 2010. Original information must be based upon the whistleblower's independent knowledge or analysis, and not derived from public sources or from information already known to the SEC. The information must be provided voluntarily, i.e., in circumstances in which the whistleblower is not already under a legal obligation to provide the information.

No Requirement to Report Internally First. The proposed rules do not require employees to report a potential violation through a company's internal reporting system before providing the information to the SEC. If, however, a whistleblower reports the information internally to the company first, the whistleblower will have the benefit of the internal reporting date as long as the whistleblower submits the same information to the SEC within 90 days of the initial disclosure. The proposed rules also provide that the SEC may contact a company after receiving a tip, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back.

Wrongdoers, Attorneys, and Compliance Personnel Are Not Eligible. Under the proposed rules, individuals who are involved in a securities law violation or whose job is to investigate and uncover corporate wrongdoing are excluded from the bounty program. Thus, lawyers who gain information from their clients, accountants who learn of securities law violations through required audits, and compliance staff and persons "who are in positions of responsibility for an entity" that receive information through internal reporting mechanisms typically would not get bounties. For individuals within this latter category, however, the proposed rules permit a reward if the company does not disclose the information to the SEC in a "reasonable time" or proceeds in bad faith.

New Bounty Fund and Staff. The SEC has announced that it is creating a new six-person unit to handle tips from prospective whistleblowers and work with the Enforcement Division. The SEC has transferred $452 million to a newly created

[1] Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 34-63237, File No. S7-33-10 (Proposed Rules), available at http://www.sec.gov/rules/proposed/2010/34-63237.pdf. A summary of the Dodd-Frank Act's whistleblower bounty provisions is set forth in our July 19, 2010, WSGR Alert, available at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/pdfsearch/wsgralert_whistleblower_bounty.htm.

[2] *See* Press Release, "SEC Proposes New Whistleblower Program Under Dodd-Frank Act" (Nov. 3, 2010), available at http://www.sec.gov/news/press/2010/2010-213.htm.

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Investor Protection Fund that will support the new program and staff.

Patterned after the IRS Bounty Program. The new whistleblower program is patterned, in part, after the whistleblower bounty program adopted by the Internal Revenue Service (IRS). The IRS whistleblower office received 83 claims in its first year; in the second year, 1,890 claims were made alleging $65 billion in underreported income. The IRS program led to an increase in law firms specializing in IRS whistleblower claims, and the same result is likely with the SEC's program. As of October 1, 2010, a reported 25 claims already had been made under the Dodd-Frank Act's whistleblower provisions, and five actions had been commenced.

Substance of Wilson Sonsini Goodrich & Rosati's Comment to the SEC: The Proposed Rules Will Undermine Corporate Compliance Programs by Discouraging Employees from First Reporting a Potential Violation Internally

In the proposed rules, the SEC states the following:

> Corporate compliance programs play a role in preventing and detecting securities violations that could harm investors. *If these programs are not utilized or working, our system of securities regulation will be less effective.* Accordingly, the Commission believes that encouraging whistleblowers to report securities violations to their corporate compliance programs is consistent with the Commission's investor protection mission.[3]

We agree. Yet, the SEC's proposed rules, as drafted, will discourage employees from utilizing corporate compliance programs.

The proposed rules do *not* require an employee to provide information to a company through its internal compliance program before reporting that information to the SEC. Indeed, the proposed rules provide no incentive for an employee to report internally first. The proposed rules suggest the SEC may "give credit in the calculation of award amounts to whistleblowers who utilize established internal procedures for the receipt and consideration of complaints about misconduct," but there is, at present, no provision for any such "credit" in the rules.[4,5]

Under the proposed rules, internal reporting processes are likely to be bypassed for two reasons. First, bounty payments will be made *only* if monetary sanctions exceed $1 million. A whistleblower may believe that reporting internally first will give a company the opportunity to investigate, remediate, and self-report to the SEC, thus earning cooperation credit. This could minimize or perhaps even eliminate any monetary sanction and, with it, any potential bounty.

Second, the substantial potential bounty payout even at the lower end of the scale may lead to a race among whistleblowers to get to the SEC first. On July 15, 2010, the SEC announced that Goldman Sachs would pay a record $550 million for having misled investors about a subprime mortgage collateralized debt obligation the firm marketed.[6] Under an enforcement settlement of this magnitude, the minimum bounty payout would extend into seven figures. Whistleblowers will not want to risk coming in second, thereby losing any prospect of such a bounty.

Thus, the SEC's proposed new whistleblower program will encourage employees to bypass internal reporting procedures, undermining the internal compliance programs companies established to comply with the 2002 Sarbanes-Oxley Act.[7] Companies that, at significant expense and effort, have implemented robust internal compliance programs will be hindered in their ability to detect potential wrongdoing before there are serious consequences.[8] This result is inconsistent with the very reason Congress sought to encourage companies to establish internal compliance programs in the first instance—to prevent and detect wrongdoing that could harm investors. As a result, the SEC's proposed new whistleblower program, as drafted, fails to strike an appropriate balance between incentivizing whistleblowers to report wrongdoing to the SEC and encouraging companies to maintain robust internal compliance programs.

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[3] *See* Proposed Rules at 51-52 (emphasis added).

[4] *See* Proposed Rules at 35 n.40.

[5] Notably, the rules seek comment about whether the SEC should enhance awards to whistleblowers who first utilize internal compliance procedures. *See* Request for Comment No. 27, Proposed Rules at 52 ("Should we include as a criterion the consideration of 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 Commission?").

[6] *See* Press Release, "Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO" (July 15, 2010), available at http://www.sec.gov/news/press/2010/2010-123.htm.

[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §301, 116 Stat. 776 (2002) (requiring audit committees of publicly held U.S. companies to establish procedures for (a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters).

[8] *See* Final Rule, Standards Relating To Listed Company Audit Committees, Release Nos. 33-8220; 34-47654; IC-26001; File No. S7-02-03 (Apr. 9, 2003), available at http://www.sec.gov/rules/final/33-8220.htm ("The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences").

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Comment Period on Proposed Rules

The proposed rules seek public comment through December 17, 2010. Comments may be posted online at http://www.sec.gov/cgi-bin/ruling-comments?ruling=s73310&rule_path=/comments/s7-33-10&file_num=S7-33-10&action=Show_Form&title=Proposed%20Rules%20for%20Implementing%20the%20Whistleblower%20Provisions%20of%20Section%2021F%20of%20the%20Securities%20Exchange%20Act%20of%201934.

For any questions or more information on these or any related matters, please contact a member of Wilson Sonsini Goodrich & Rosati's securities litigation practice.

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