PRYOR CASHMAN LLP

LEGAL UPDATE

July 2011 *By: Stephen M. Goodman and Robert W. Ray*

SEC ADOPTS FINAL RULES TO ESTABLISH WHISTLEBLOWER PROGRAM

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), adopted in July 2010, added a new Section 21F to the Securities Exchange Act of 1934, entitled "Securities Whistleblower Incentives and Protection." On May 25, 2011, the Securities and Exchange Commission ("SEC" or "Commission") adopted final rules implementing the provisions of Section 21F. The final rules go into effect August 12, 2011.[1]

The SEC whistleblower program, modeled after the provision of the federal False Claims Act,[2] is intended to encourage individuals to expose securities law violations by providing qualifying whistleblowers with a monetary award. Specifically, the rule provides that an individual will be considered for an award of between 10% and 30% of total monetary sanctions collected if the SEC (or certain other agencies) brings an action or group of related actions based on the whistleblower's original information and if the aggregate amount collected from these actions exceeds $1,000,000.

A number of commentators expressed concern when the SEC's proposed whistleblower rules were first proposed that the rules would eviscerate internal compliance programs which companies had been required to adopt by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Because of the financial incentives offered by the whistleblower rules, an employee with knowledge of a violation could be encouraged to bypass the employer's compliance process and go to the SEC directly. If this became accepted practice, critics said, it would render internal compliance procedures meaningless, leaving the employer to learn of the violation first from the SEC investigator responding to the employee's information. Some went so far as to suggest that exhaustion of the internal compliance process should be a prerequisite to qualification for an award.

As a result of these comments (which continued to be expressed by the dissenting commissioners in the 3-2 vote adopting the final rules), the SEC made a number of adjustments designed to encourage (but not require) employees to take advantage of internal compliance mechanisms. However, despite the changes in the final rules, discussed below, it seems likely that the incentive program as finally adopted will have a negative effect on participation in employers' compliance programs. For some suggestions as to how to minimize this negative effect, see

[1] Pub. L. No. 111-203, § 922(a), 124 Stat 1841 (2010); "Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934," SEC Release No. 34-64545 (May 25, 2011) *available at:* http://sec.gov/rules/final/2011/34-64545.pdf; "SEC Adopts Rules to Establish Whistleblower Program," SEC Press Release (May 25, 2011) *available at:* http://www.sec.gov/news/press/2011/2011-116.htm.

[2] 31 U.S.C. §§ 3729-33. The False Claim Act only applies to financial fraud against the government. In contrast, the Dodd-Frank Act is much broader and applies to fraud committed by any company that falls within the jurisdiction of the SEC or the CFTC.

"Potential Impact and Recommendations" below.

QUALIFYING FOR AN AWARD

Whistleblower

Only persons who fit within the specific definition of a whistleblower and have a "reasonable belief" that a securities violation has occurred will qualify to receive an award under the Act. Furthermore, only a qualifying whistleblower will be entitled to the protection of certain anti-retaliation provisions adopted as part of the Act and the SEC's rules.

A whistleblower is defined as an individual or a group of individuals (but not an entity) who provides the SEC with information that pertains to a "possible"[3] violation of federal securities law (or a rule or regulation promulgated by the Commission) that "has occurred, is ongoing, or is about to occur." The submission must be in accordance with SEC procedures.

Voluntary Production of Information

The whistleblower must "voluntarily" disclose the information. A disclosure will be considered voluntary if the whistleblower makes his or her submission to the SEC *before* a request or demand is received which seeks information related to the subject matter of the whistleblower's submission. The whistleblower's disclosure will still be considered voluntary unless the previously-issued request or demand was specifically directed to the whistleblower or a representative of the whistleblower. Furthermore, the voluntariness of the submission will only be affected by previously-received requests emanating from particular agencies.

Thus, broad demands previously delivered to the whistleblower's employer (as opposed to the individual whistleblower) would not preclude a subsequent submission from the individual from qualifying as voluntary. Even a demand specifically directed to the individual must come from the SEC, a state securities authority, the Public Company Accounting Oversight Board, a self-regulatory organization (such as FINRA or a stock exchange), Congress, a federal agency, or a state attorney general. Thus, a prior demand directed to the individual that is issued by state regulators *other than* securities regulators would not make the individual's disclosure to the SEC involuntary.

Original Information

The whistleblower must provide the SEC with "original" information. Information will be considered original if it is based on the whistleblower's independent knowledge or independent analysis. It is not required, however, that the information be based on the individual's first-hand observations. Also, the information disclosed by the whistleblower must not be known already to the SEC and it must not have been procured entirely from governmental or judicial proceedings or from the news media – unless the whistleblower was the original source of the information detailed in governmental or judicial proceedings or the news media. In the latter case, the published information would still be considered "original" and the whistleblower may still qualify for an award.

[3] The Commission adopted the term "possible" violation over "potential" or "likely" violation because it felt the latter term would make it difficult to assess promptly whether to accord an individual whistleblower status. Information regarding "possible" violations would qualify if it indicates "a facially plausible relationship to some securities law violation." *See* SEC Release No. 34-64545 at 13.

Successful SEC Enforcement

The information provided to the SEC must ultimately "lead to" a successful enforcement action. Information will be considered to have led to successful enforcement under three situations: (1) If the SEC opens a new investigation, reopens a closed investigation, or opens a new line of inquiry in an existing investigation due to the highly specific and credible nature of information provided; (2) if the information provided significantly aids the SEC in achieving success in an investigation already underway; or (3) if the whistleblower supplies information to his/her employer through its internal compliance program before or at the same time he/she provides information to the SEC, the employer subsequently provides the information to the SEC, and the information provided to the SEC by the employer satisfies prong (1) or (2) described above.

Monetary Sanctions Exceeding $1 Million

Finally, in order for an award to be payable, the enforcement action (or actions) commenced by the SEC (or other specified "related" agencies) must result in the recovery of monetary sanctions in excess of $1,000,000.

Further Limitations On Who Can Qualify

The final rules provide that certain individuals are excluded from award consideration. Generally, officers, directors, trustees, and partners cannot qualify for an award. Nor can compliance personnel, internal audit personnel, or individuals specifically retained to conduct inquiries into potential violations of law. Such individuals are presumed to have obtained knowledge of the purported violation as a result of their positions or special relationships with the company. However, one of these individuals may still qualify as a whistleblower if he or she possesses a reasonable basis to believe that disclosure is necessary to prevent conduct that is likely to cause substantial financial injury to the company or its investors.

In addition, information acquired by an attorney that is subject to the attorney-client privilege cannot be used to qualify for an award unless an exception to the ethical rules applicable to the attorney permits disclosure.

Anti-Retaliatory Provisions

To further encourage disclosure of relevant information, the final rules provide whistleblowers with protection against retaliation by the alleged offender. The rules specifically prohibit the company from taking retaliatory measures in response to a disclosure and provide whistleblowers with a private cause of action in the event they suffer discrimination or termination. In addition, the SEC retains the power to enforce the anti-retaliation provisions itself.

Internal Reporting Not Required

As noted above, one of the most controversial features of the new SEC rules is that internal reporting of potential violations continues to be voluntary. It is not a pre-condition to qualifying for an award. Instead, the final rules permit whistleblowers to bypass internal reporting obligations and report suspected violations directly to the SEC. According to the adopting release, the SEC believed a greater number of credible tips could be generated by not mandating internal reporting.[4] However, the SEC has tried to address concerns about undercutting internal compliance efforts by providing several incentives to encourage internal reporting.

First, if the whistleblower initially reports the violation internally and the company then commences its own investigation, all

[4] *See* SEC Release No. 34-64545 at 5.

information a company subsequently reports to the SEC will be attributed to the initial whistleblower. Thus, even if the original tip from an employee might not have "led to" a successful proceeding, the employee can point to the entire company disclosure as the basis for the investigation's success and therefore as justification for an award. Second, internal reporting is specifically cited among the factors to be considered by the SEC in determining whether to make a larger award, while interference with internal compliance procedures would be considered as a factor favoring a smaller award.

Despite these incentives, however, the final rules leave open the door to the possibility that whistleblowers could choose to bypass internal reporting.

Potential Impact And Recommendations

The SEC anticipates that the impact of the new rules will prove substantial. It predicts it will receive upwards of 30,000 tips in the coming year.[5]

For companies who have already invested heavily in implementing compliance programs, the new whistleblower rules increase the pressure to ensure that these programs are robust, transparent and user-friendly. Of course, there will always be employees who only act because of the prospect of cash. However, companies can take advantage of the fact that a whistleblower will be given the benefit of any additional information which the company may uncover and report as a result of his or her tip. If the company is able to convince most of its employees that senior executives will deal with reports of potential violations quickly and effectively and without retaliation, the prospect of this additional benefit, plus the possibility of a higher award, may in fact encourage internal reporting. And if the company can successfully elicit such reports, it will gain a distinct advantage in terms of having an opportunity to ascertain relevant facts before the SEC gets involved and, if reporting to the SEC is deemed necessary, being able to position itself more effectively in its dealings with the agency.

Without strong and frequently communicated support for internal compliance from the top, however, the ordinary employee may be tempted to conclude that the company's compliance program exists only on paper. If he or she believes that reports of violations will go nowhere or will get bogged down in internal procedures—or that subtle (or not so subtle) penalties may result from internal reporting—the likelihood is that the incentives in the rules designed to encourage internal disclosures will be ignored. In that case, the employee will more likely bypass internal reporting and go directly to the SEC. It is thus in the company's interest to do all it can to support internal disclosure.

***

The foregoing is intended to summarize the SEC's proposed new rules regarding whistleblowers who report possible SEC violations. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at (212) 326-0146 or Robert W. Ray at (212) 326-0832.

[5] *See* SEC Release No. 34-64545 at 209.

About the Authors

Stephen M. Goodman
Partner

Direct Tel: 212-326-0146
Direct Fax: 212-798-6340
sgoodman@pryorcashman.com

Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and other technology.

Mr. Goodman has also written on topics ranging from export controls relating to biotechnology research to raising seed capital for entrepreneurial companies and has lectured on various aspects of pharmaceutical/biotech collaboration agreements. His most recent article is "If You Smell Smoke, When Do You Report the Fire? The Impact of the Matrixx Case on Disclosure of Adverse Event Reports" (*BNA Pharmaceutical Law & Industry Report*, May 27, 2011).

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.

Robert W. Ray
Partner

Direct Tel: 212-326-0832
Direct Fax: 212-798-6313
rray@pryorcashman.com

Robert W. Ray is a partner in Pryor Cashman's Litigation Group, with special emphasis on white collar criminal defense, corporate governance and compliance, internal investigations and general litigation, including civil RICO and commercial fraud. Bob's experience and expertise include matters involving securities regulation, commodities trading, insurance transactions, money laundering, forfeiture, the Sarbanes-Oxley Act, the Bank Secrecy Act, environmental compliance, health care fraud, antitrust, the False Claims Act and the Foreign Corrupt Practices Act. He has also litigated at all levels in New York state courts.

Bob joined the Independent Counsel's office in Washington, D.C. in 1995 and succeeded Kenneth Starr as Independent Counsel in October 1999. While Independent Counsel, Bob was responsible for, among other things, the *In re Madison Guaranty* investigations, which concluded with published final reports on matters involving FBI files, the White House Travel Office, Whitewater and Monica Lewinsky. Prior to succeeding Starr, Bob supervised, conducted and participated in complex, long-term and multi-defendant federal prosecutions involving public corruption, organized crime, violent crime and narcotics trafficking at all levels and stages in federal courts.

From 1989 through 1995, Bob was an Assistant U.S. Attorney in the U.S. Attorney's Office for the Southern District of New York. Prior to that he was a judicial law clerk for the Honorable Frank X. Altimari in the U.S. Court of Appeals for the Second Circuit.

Bob is a 1985 *cum laude* graduate of Washington and Lee University School of Law, where he was a member of the *Washington and Lee Law Review*, was chosen as the best oralist at the John W. Davis Moot Court Competition (as well as being runner-up for best brief), and was a quarter finalist in the William and Mary Moot Court Competition. During 2004-2007, Bob served on Washington & Lee's alumni advisory body as a member of the Law Council.