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Alert
SEC Update

SEC Issues Proposed Regulation Implementing Dodd-Frank Whistleblower Bounty Provisions

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On November 3, 2010, the U.S. Securities and Exchange Commission ("SEC") issued proposed Regulation 21F (with related commentary) to implement the whistleblower bounty provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The SEC has invited and is accepting comments on the proposed regulation until December 17, 2010. Dodd-Frank requires that the SEC issue final regulations by April 15, 2011. This Alert focuses specifically on how the proposed regulation addresses and impacts internal corporate compliance programs.

Under the Dodd-Frank whistleblower bounty provisions, a whistleblower who voluntarily provides "original information" to the SEC regarding a violation of federal securities laws that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million will be eligible for an award of 10 to 30 percent of the amount of the sanctions. Such awards are available for any successful action brought by the SEC under federal securities laws, including matters brought against foreign issuers and matters involving the Foreign Corrupt Practices Act. Moreover, the anti-retaliation provisions of Dodd-Frank protect a whistleblower even if the whistleblower's tip does not lead to a successful action or the whistleblower otherwise fails to qualify for an award.

In the commentary accompanying the proposed regulation, the SEC recognizes that the monetary incentives provided to whistleblowers under the bounty provisions may encourage employees to bypass internal corporate processes for reporting allegations of wrongdoing and thereby reduce the effectiveness of internal compliance, legal, audit and other internal processes for preventing, detecting and responding to such allegations. In weighing this concern, the SEC considered requiring whistleblowers to avail themselves of internal processes before reporting alleged violations to the SEC, but ultimately decided not to impose such a requirement due to the belief that many companies lack established procedures and protections relating to whistleblowers.

Instead, the SEC has included provisions in Proposed Regulation 21F that it maintains are designed to "not discourage" employees from first reporting potential violations of securities laws to internal compliance personnel and to promote the effective functioning of internal compliance and related systems. This includes the following:

- A whistleblower will be ineligible for an award unless he has provided information or documents to the SEC before his employer has received a formal or informal request from the SEC or other authority about the matter in question.

- A whistleblower will be ineligible for an award unless he provides "original information" derived from his own "independent knowledge or analysis." With some exceptions discussed below, information will not be considered derived from the whistleblower's "independent knowledge or analysis" under the following circumstances:
  - the information is subject to the attorney-client privilege;
  - the information, privileged or not, was obtained as a result of the legal representation of a client by an attorney or an attorney's firm;
  - the information was obtained through the performance of an engagement required under the securities laws by an independent public accountant;
  - the information was communicated to a person with legal, compliance, audit, supervisory, or governance responsibilities for a company, with the reasonable expectation that the person would take steps to respond to the allegation;
  - the information was obtained through a company's legal, compliance, audit, or similar processes for identifying, reporting and addressing potential violations of law; and
  - the information was obtained by a means or in a manner that violates federal or state criminal law.
- A whistleblower who provides information to legal or compliance personnel within his company may wait up to 90 days before reporting the matter to the SEC without compromising his ability to obtain an award. In the SEC's view, this will provide a company with a reasonable opportunity to investigate and respond to the matter before reporting it to the SEC.

In determining the amount of a whistleblower's award, the SEC will consider, among a long list of factors, whether and to what extent the whistleblower reported the potential violation through his company's internal processes before reporting it to the SEC. In that regard, the SEC further notes in its commentary that it "will consider higher percentage awards for whistleblowers who first report violations through their compliance programs."

Legal, Compliance or Audit Whistleblowers

As noted above, proposed Regulation 21F excludes from the definition of "independent knowledge or analysis" information that is obtained in a number of sensitive contexts, including information obtained by attorneys and independent public accountants. The regulation also excludes from its coverage information obtained by a company's legal, compliance, audit, supervisory, or governance personnel or through a company's legal, compliance, audit, or similar processes. Unlike the other exclusions, however, these two exclusions give way if a company is aware of the alleged violation and does not disclose it to the SEC within a "reasonable time"[1] or if the company acts in "bad faith."[2] Under those circumstances, a company's own legal, compliance or audit employee could become eligible to receive a substantial award for disclosing information to the SEC.

The Whistleblower "Grace Period"

Under the proposed regulation, a whistleblower who first reports a potential violation to a company must then report it to the SEC within 90 days in order to preserve his "place in line" for an award. The SEC maintains that this provision is meant to encourage whistleblowers to report violations through internal legal, compliance, audit or similar processes, and is not intended to undermine such programs. Moreover, the SEC believes that 90 days is sufficient time for a company to investigate the merits of an allegation and respond to it, including making a decision whether it is in the best interests of the company to

1 According to the commentary, what constitutes a "reasonable time" will depend on all of the facts and circumstances of the particular case, including the nature of the alleged violation.

2 Bad faith could be found if a company destroyed evidence, interfered with witnesses, or otherwise took steps to prevent or hinder a legitimate, timely and appropriate investigation of the alleged violation.

disclose the alleged violation to the SEC. Although this provision does not create an obligation for a company to disclose an alleged violation to the SEC, it effectively puts the company on notice that the whistleblower likely will report it to the SEC no more than 90 days after he reports it to the company.

Use of Internal Processes is a Factor in Determining Award Amount

The proposed regulation details four criteria for determining the amount of a whistleblower award: (1) the significance of the information provided by the whistleblower to the success of the enforcement action; (2) the level of assistance provided by the whistleblower; (3) the SEC's programmatic interest in deterring future securities violations by paying the award; and (4) whether the award enhances the SEC's "ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers. With respect to the fourth factor, the commentary includes a non-exhaustive list of ten "permissible considerations" that the SEC may take into account in determining the amount of an award. One of the considerations is "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 [SEC]." Although this is not a prerequisite to an award, the SEC states that it will consider increasing the amount of a whistleblower's award for violations that were first reported through an internal compliance program.

Conclusion

In connection with the issuance of proposed Regulation 21F, the SEC has acknowledged that the bounty provisions could undermine the effectiveness of internal compliance programs and has made an effort to mitigate this potential harm. The SEC has specifically requested comments on how to strike the appropriate balance between encouraging effective internal corporate compliance programs and self-reporting and maintaining a robust whistleblower program.

If you are interested in discussing the proposed regulation or receiving further information about it, please contact any of the attorneys in Weil's White Collar Defense & Investigations, Public Company Advisory or Financial Regulatory Reform practices, or the authors:

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