The SEC's Whistleblower Program

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Overview

- Dodd-Frank amended the Securities Exchange Act of 1934 to add Section 21F providing awards to whistleblowers in SEC actions
  - SEC rules went into effect in August 2011
- Rules provide for payments of 10-30% of sanctions where: whistleblower **voluntarily provides original information** about a violation of the federal securities laws that leads to a **successful enforcement action** in which the SEC recovers **monetary sanctions over $1 million**
- Monetary sanctions defined very broadly to include penalties, disgorgement, and interest – and can aggregate actions in determining amount
- Rules allow whistleblowers to provide information relating to any violation of the federal securities laws – not just (as before) insider trading
- Potential for huge awards – for example, whistleblower reporting FCPA violations that result in joint SEC/DOJ settlement of $100 million could receive $30 million

Overview continued

- SEC's Office of Whistleblower, along with Office of Market Intelligence, began handling complaints on August 12, 2011
- No awards have been made to date, but first award expected any day
- SEC reports it is not overwhelmed with tips, but SEC officials recently claimed enforcement was struggling to keep up with complaints
- Receiving approximately 7 tips per day; 2-3 are worth investigating
- SEC officials report that the quality of tips has significantly improved under the program
  - receiving detailed complaints from individuals with first-hand knowledge
  - enforcement staff recently informed us at a small group meeting that this is permitting them to issue narrow subpoenas targeting the identified conduct
    - have already seen this in practice – cases where SEC subpoenas are extremely precise and detailed and use "inside" terminology and phrases that indicate an understanding of the internal workings of company that SEC would not otherwise have

Overview continued

- Controversial decision by Commission not to require whistleblowers to first report internally does not appear to be undermining corporate compliance programs
  - Office of Whistleblower reports that "significant majority" of whistleblowers first report internally
- Too early to identify meaningful trends and conclusions regarding who whistleblowers are and types of complaints
- Annual report (covering initial seven weeks of the program) did not provide data on who provided complaints (employee, former employee, or third party) and the % of anonymous tips
- Report identified most common complaints as manipulation (16.4%), offering fraud (15.6%), and corporate disclosure and financials (15.3%); less than 4% involved FCPA; but 23.7% were categorized as "other" and whistleblower selects category so hard to say whether this data is meaningful
- SEC currently targeting certain whistleblowers
  - call on website for whistleblowers who are knowledgeable about RMBS fraud
  - have also said complaints involving failure to disclose are a "sweet spot" since these cases are hard to uncover without an insider providing the facts

Requirements for Bounty: Who Qualifies as a Whistleblower?

- Must be a natural person – company or other entity not eligible
- May act alone or jointly
- Need not be employee – can be third parties (consultants, competitors, etc)
- Need not be within or from United States
  - 10% (34) of first 334 tips came from outside U.S.
- No materiality requirement – information need only have "facially plausible" relationship to federal securities law violation
- May be anonymous – but then must act through an attorney
- May be culpable (to a degree) – but culpability affects size of award
- Generally attorneys, officers and directors, auditors and compliance personnel excluded (see slide 7) – although exceptions

Requirements for Bounty: When is a Submission Voluntary?

- Whistleblower must come forward ***before*** receiving (directly or through an attorney) any **formal or informal** request, inquiry or demand from:
  - SEC
  - PCAOB, FINRA or any other SRO
  - Congress, the CFTC or any other federal authority
  - State attorney general or securities regulator
  - but request from other state agency or foreign regulator will not disqualify whistleblower
- Request to employer will not be considered a request to employee
  - however, SEC has said that individuals who wait until after their employer receives a request "will not face an easy path to an award"

Requirements for Bounty: What is Original Information?

- Must be derived from “independent knowledge” or “independent analysis”
  - may not be derived from public sources **unless** whistleblower’s evaluation reveals unique or original analysis
  - whistleblower does not need to have first-hand knowledge – could have learned the information from someone else (as long as the source of the information is not excluded by the rules)
- Generally, information subject to the attorney-client privilege, obtained by an officer or director, or obtained by compliance or audit personnel is excluded on policy grounds
  - for this reason, information learned through a company’s internal investigation will typically not qualify as original information because it will have come from an excluded source
    - but if have independent knowledge of the conduct, then can qualify

Requirements for Bounty: What is Original Information? continued

- But exceptions where information from these excluded sources will qualify
  - reasonable basis to believe disclosure is necessary to prevent substantial injury to the financial interest of the company or investors;
  - company is engaging in conduct that will impede an investigation; or
  - (for information not subject to attorney-client privilege) 120 days have elapsed since the person reported internally to the audit committee, CLO, CCO or supervisor or received the information under circumstances indicating that one of those individuals were already aware and failed to act

Requirements for Bounty: When Does Information Lead to Successful Enforcement Action?

- Where the conduct is ***not*** already under investigation or examination
  - information is **sufficiently specific, credible and timely** to cause the SEC staff to commence a new investigation, reopen a closed investigation or to inquire about different conduct under a current investigation
- Where the conduct ***is*** already under investigation or examination
  - information **significantly contributes** to the success of the SEC action (e.g., saves a significant amount of time or resources, or enables additional successful claims)
- Whistleblower reports internally and the company's internal investigation produces information meeting one of the above criteria
  - in this scenario, conduct uncovered by company can satisfy "led to" requirement
- Where whistleblower has already submitted information, second whistleblower is eligible for award if he or she provides information that "materially adds" to what Commission already knew

Anti-Retaliation Provisions

- Whistleblowers are effectively a “protected species” under the rules
- Anti-retaliation provisions much broader than bounty provisions
  - protect employees even if complaint does not result in action or employee is not entitled to an award as long as employee had a “reasonable belief” that a “possible violation” occurred, is ongoing, or is about to occur
  - SEC’s interpretation is that the whistleblower does not even need to make a report to the Commission if whistleblower is otherwise protected by Sarbanes-Oxley
- Moreover, Dodd-Frank gives SEC authority to bring a proceeding or an action to enforce the retaliation provisions
- BUT, rules only prohibit retaliation “because of” report to SEC; does not prohibit discipline based on underlying culpable conduct
  - e.g., if whistleblower participated in scheme to cook the books, company can discipline whistleblower for her participation

Internal Reporting and Incentives

- SEC did not require whistleblowers to first report internally to company
- However, rules seek to incentivize internal reporting in three ways
  - whistleblower's "place in line" for award preserved for 120 days;
  - whistleblower gets extra "credit" for reporting internally in determining award; AND
  - whistleblower gets credit for everything company's internal investigation turns up
- Appears incentives are working
  - Chief of Whistleblower Office reports that "significant majority" of whistleblowers report internally first and he would be "hard pressed" to think of one that did not
  - empirical evidence suggests that whistleblowers typically report internally first
  - potential whistleblowers who know about the SEC program will likewise know about the benefits of internal reporting and the anti-retaliation provisions

Incentive for Reporting Internally: Credit for Internal Investigation

- Reporting internally can help whistleblower qualify for an award *and* increase amount of award
- Example: whistleblower reports internally that she thinks there are revenue recognition issues in Subsidiary A; company investigates and uncovers specific evidence of revenue recognition issues at Subsidiary A and discovers evidence of similar issues at Subsidiary B
  - had whistleblower gone directly to SEC, she may not have had sufficient "specific" and "credible" evidence to qualify for award, but since she first reported internally, the evidence uncovered by the company can be used to qualify her for award
  - whistleblower will also now be entitled to receive 10-30% of monies received from actions against both Subsidiary A and B; if she had reported directly to SEC, would only qualify for award based on action against Subsidiary A

Entities Cannot Seek to Limit Information Potential Whistleblowers Could Provide to SEC

- Whistleblower rules prohibit confidentiality agreements or contractual limitations designed to prevent individuals from reporting to SEC – applies to both employees and third parties
- Limits steps companies can take to protect themselves from whistleblowers
  - threat that third parties engaged by company—such as consultants, vendors, etc—will provide information learned through engagement to SEC
  - some plaintiffs' attorneys have even suggested this means that companies cannot enforce confidentiality agreements against employees who steal documents or information from the company to provide to the SEC
    - uncharted territory – rules only exclude information obtained in violation of criminal laws, and not civil laws, and some courts have found that criminal laws are not the proper vehicle in such situation

Enforcement Implications: Potential Scenarios

- Companies may encounter a range of scenarios
  - Whistleblower complains to company first (internal report)
  - Whistleblower complains to company and SEC simultaneously
  - Whistleblower complains only to SEC

Enforcement Implications: Internal Report

- 120-day look back increases pressure to investigate quickly and may change and complicate calculus for deciding whether and when to report a whistleblower complaint to the SEC
- In most situations, company will want to report within 120-day period where complaint has merit and certain or near-certain that whistleblower will go to SEC
  - better for SEC to learn of conduct from company than from whistleblower
  - permits company to control and define the issues, rather than playing “catch up” if whistleblower gets to SEC first
  - company may be eligible for self-reporting credit under SEC’s cooperation guidelines
- This means that as soon as company receives report, must
  - aggressively, quickly, and thoroughly investigate allegations
  - quickly understand conduct and “get ahead” of whistleblower

Enforcement Implications: Internal Report
continued

- In some situations company will want to report well before expiration of 120-day period—issues to consider
  - gravity and materiality of allegations
  - whether senior management and/or board members are the subject of the allegation
  - degree to which initial findings are problematic
- Company will also want to report early where there are signs that the whistleblower is headed to the SEC
- But company may not want to report when it believes complaint to be entirely without merit (or to relate to a matter outside the federal securities laws)
  - if SEC inundated with self-reports, risk that value of self-reporting will decrease
  - but company should fully document the nature and scope of investigation and be prepared to walk staff through issues if they do come calling

Enforcement Implications: Whistleblower Goes Directly To SEC

- Adopting Release says SEC will continue general practice of notifying companies about complaint and allowing them to investigate and report back
  - in deciding whether to permit company to self-investigate, SEC says will consider nature of alleged conduct, level at which conduct occurred, and company's existing culture related to corporate governance
    - SEC has also said that it will also consider "what role, if any, internal compliance had in bringing the information to management's or the Commission's attention"
    - thus, SEC unlikely to permit company to self-investigate where whistleblower tells SEC brought matter to attention of CLO, CCO or audit committee and they failed to take action
  - So, should take steps to avoid these situations by
    - encouraging internal reporting
    - fully examining reports
    - and documenting reasons for closure/resolution

SEC Has Great Discretion in Applying Whistleblower Rules

- Many discretionary areas:
  - amount of award
    - whether to aggregate actions; what are related actions
    - dividing award among multiple whistleblowers
    - potential increase in award where whistleblower first reports internally
    - potential increase in award because of expanded company investigation
    - amount of award where whistleblower is culpable
  - when to permit attorneys or compliance/audit personnel, etc., to be whistleblowers
  - whether to permit companies to self-investigate
  - whether to give credit for self-reporting where company initially alerted to conduct by an internal report
  - whether to exercise authority to bring actions to enforce anti-retaliation provisions of rules
  - whether and to what extent SEC will utilize “stolen” information or data that was otherwise obtained improperly

Strategy: What to do Now

- Reexamine whistleblower policies and procedures
  - many policies adopted after Sarbanes-Oxley were limited to accounting, internal control and auditing matters within the audit committee's purview – consider broadening to cover all violations of the federal securities laws
  - ensure policies emphasize the value the company places on employees coming forward, and that policies are easy to understand and use
  - policies can mention SEC program's incentives for internal reporting but should avoid—explicitly or implicitly—discouraging individuals from reporting directly to SEC
  - consider requiring employees to periodically complete and sign certifications as to their knowledge of unethical or unlawful conduct at the company
- Ensure employees know about the company's whistleblower program
  - publicize whistleblower program/hotline through training sessions, emails, internal memos, posters, and employee handbook
  - educate employees about anti-retaliation provisions
  - be prepared to answer questions from employees about company and SEC programs
  - consider permitting anonymous reporting from employees

Strategy: What to do Now continued

- Review and strengthen existing procedures to prevent retaliation or the appearance of retaliation
  - performance management or disciplinary action against a whistleblower should first be reviewed by HR and Legal
  - involve HR and Legal in decisions concerning compensation, performance reviews and promotion to ensure that whistleblowers do not have any legitimate claim that they are being treated less favorably
  - set up a direct line of communication between whistleblowers and HR so that whistleblowers can flag situations where they feel they are being treated inappropriately
- Review and strengthen existing procedures for logging, evaluating, investigating, signing off and, where appropriate, responding to complainants or the disposition of complaints. Document the involvement of the audit committee or board where warranted
  - do not apply a “materiality” filter in assessing the merits of a complaint
  - ensure that all tips are fully vetted and none slip through the cracks
  - be careful when dismissing whistleblower complaints that may appear on the surface to more clearly implicate HR or other concerns

Strategy: What to do Now continued

- Take a holistic approach to internal compliance under the board's oversight
  - re-examine compliance programs in important substantive areas, such as FCPA, that can be the subject of whistleblowing
  - re-examine policies and processes at regular intervals, with results reported to the appropriate board committee or full board
- Consider "cultural measures" to encourage internal reporting
  - thoroughly investigate any complaints
  - appoint a chief compliance officer
  - regularly communicate with and provide meaningful training for employees about internal compliance policies and procedures and complaint mechanisms, with special training for supervisors
  - have the board, CEO and other top management make it a priority to communicate the seriousness with which they regard compliance and the importance they place on employees coming forward with concerns