

Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS

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SEC Adopts Final Whistleblower Rules

The Securities and Exchange Commission ("SEC") recently approved final rules to create a whistleblower program that rewards individuals whose tips lead to successful enforcement actions of violations of the securities laws. The new whistleblower program implements Section 922 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The new rules are implemented under a new Section 21F (Securities Whistleblower Incentives and Protection) of the Securities Exchange Act of 1934, as amended, and go into effect on August 12, 2011. The SEC Release implementing the final rule is available at: <http://www.sec.gov/rules/final/2011/34-64545.pdf>.

Dodd-Frank Act Requirement

The Dodd-Frank Act requires the SEC to adopt rules that provide for the payment of rewards to individuals who provide the SEC with original information that leads to successful enforcement actions. Prior to Dodd-Frank, the SEC's reward-paying program was limited to insider trading cases and the amount of an award was capped at 10 percent of the penalties collected. Under the new rules, persons who provide information to the SEC about a violation of any securities law may be eligible to receive between 10 percent and 30 percent of amounts that the SEC recovers through enforcement actions resulting in monetary sanctions of more than \$1 million.

Whistleblower Qualifications

To qualify as a whistleblower under the newly adopted rules, an individual must: (1) voluntarily provide to the SEC, (2) original information, (3) that leads to the successful enforcement by the SEC of a federal court or administration action, (4) in which the SEC obtains monetary sanctions totaling more than \$1 million. A whistleblower is generally deemed to have provided information voluntarily if he or she has provided information prior to any request from the government, a self-regulatory organization or the Public Company

Accounting Oversight Board. Information is generally considered original if it is based upon the whistleblower's independent knowledge or independent analysis, not already known to the SEC, and not derived exclusively from certain public sources. A whistleblower's information can be deemed to have led to a successful enforcement action if:

- The information is sufficiently specific, credible, and timely to cause the SEC to open a new examination or investigation, reopen a closed investigation, or open a new line inquiry in an existing examination or investigation;
- The conduct was already under investigation when the information was submitted, and the information significantly contributed to the success of the action; or
- The whistleblower reports original information through his or her employer's internal whistleblower, legal, or compliance procedures before or at the same time it is passed along to the SEC, the employer provides the whistleblower's information (and any subsequently-discovered information) to the SEC, and the employer's report satisfies prongs (1) or (2) above.

In determining whether the SEC obtains monetary sanctions totaling more than \$1 million, the new rules

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permit aggregation of multiple SEC cases that arise out of a common nucleus of operative facts as a single action. Such cases may include proceedings involving the same or similar parties, factual allegations, alleged violations of the federal securities laws, or transactions or occurrences.

Avoiding Unintended Consequences

Certain individuals will generally not be considered for whistleblower awards under the new rules, including:

- Any person who has a pre-existing legal or contractual duty to report their information to the SEC;
- Attorneys (including in-house counsel) who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules);
- Any person who obtains the information by means or in a manner that is determined by a US court to violate federal or state criminal law;
- Foreign government officials;
- Officers, directors, trustees, or partners of an entity who are informed by another person (such as by an employee) of allegations of misconduct or who learn the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law (such as through the company hotline);
- Compliance and internal audit personnel; and
- Public accountants working on SEC engagements, if the information relates to violations by the engagement client.

Notwithstanding the foregoing, in certain circumstances, compliance and internal audit personnel and public accountants could become whistleblowers when:

- The whistleblower believes disclosure may prevent substantial injury to the financial interest or property of the entity or investors.
- The whistleblower believes that the entity is engaging in conduct that will impede an investigation.

- At least 120 days have elapsed since the whistleblower reported the information to his or her supervisor or the entity's audit committee, chief legal officer, chief compliance officer; or at least 120 days have elapsed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people are already aware of the information.

Other persons, such as employees of certain agencies and people who are criminally convicted in connection with the conduct, are already excluded by other provisions of Dodd-Frank. In order to prevent wrongdoers from benefitting by, in effect, blowing the whistle on themselves, the SEC also will not pay culpable whistleblowers awards that are based upon either:

- The monetary sanctions that such culpable individuals themselves pay in the resulting SEC action or
- The monetary sanctions paid by entities whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.

Providing Information and Seeking Reward

Unless the SEC waives the submission procedures established by the rule based on a showing of extraordinary circumstances, a whistleblower (or anonymously through an attorney) must submit information through the SEC's website or by mailing or faxing a Form TCR. The SEC may require additional information, such as explanations, additional information in the whistleblower's possession or other assistance. The claim procedures set forth in the rules provide opportunities for whistleblowers to fairly present their claim before the SEC makes a final determination.

Reporting through Internal Compliance Programs

The new rules do not require that employee whistleblowers report violations internally in order to qualify for an award, but allow for such internal reporting while preserving the whistleblowers' rights under the SEC program. This provision was intended to strengthen incentives that had been proposed and add certain additional incentives intended to encourage employees to

utilize their own company's internal compliance programs when appropriate to do so. For example, the rules:

- Make a whistleblower eligible for an award if the whistleblower reports internally and the company informs the SEC about the violations;
- Treat an employee as a whistleblower, under the SEC program, as of the date that employee reports the information internally as long as the employee provides the same information to the SEC within 120 days. Through this provision, employees are able to report their information internally first while preserving their "place in line" for a possible award from the SEC; and
- Provide that a whistleblower's voluntary participation in an entity's internal compliance and reporting systems is a factor that can increase the amount of an award, and that a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.

Anti-Retaliation Protection

Under the new rules, a whistleblower who provides information to the SEC is protected from employment retaliation if he or she possesses a reasonable belief that the information being provided relates to a possible securities law violation that has occurred, is ongoing, or is about to occur. The rules make it unlawful for anyone to interfere with a whistleblower's efforts to communicate with the SEC, including threatening to enforce a confidentiality agreement. The prohibitions against impeding whistleblower communications or taking retaliatory action may be enforced by the SEC in a judicial action or administrative proceeding. SEC staff is permitted to communicate directly with whistleblowers who are officers, directors, or employees of an entity that is represented by counsel where the individual has initiated communication with the SEC related to a possible violation. Thus, a company's counsel will not be informed of, or be permitted to participate in, SEC contacts with whistleblowers regardless of their position with the company.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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