

Leading the News

Whistleblowers

SEC Adopts Final Whistleblower Rules That Encourage Use of Internal Reporting

In a controversial and much-anticipated action, a divided Securities and Exchange Commission May 25 voted 3-2 to adopt final rules to establish a whistleblower reward mandated under the 2010 financial overhaul legislation.

Although the SEC did not give in to the powerful business lobby to make it mandatory for whistleblowers to report wrongdoing through internal compliance procedures, it did depart from its original proposal in several ways to encourage whistleblowers to approach their employers first. However, the dissenting commissioners—Kathleen Casey and Troy Paredes—argued that the final rules still do not adequately preserve the role of corporate compliance programs.

Similarly, the business lobby and defense bar asserted that the final rules still could significantly impact corporate programs. Employers' attorneys warned that companies should beef up their corporate programs with the advent of the new program, and ensure that they can react swiftly to potential allegations of wrongdoing. Attorneys representing whistleblowers, meanwhile, applauded the SEC final rule as protective of employees who suspect corporate wrongdoing (see related article in this issue.)

The final rules go into effect 60 days after they are submitted to Congress or published in the *Federal Register*, the SEC said.

At the same hearing, the SEC also voted 3-2 to propose a rule to bar certain “felons and bad actors” from being able to participate in private offerings pursuant to Rule 506 of Regulation D under the 1933 Securities Act.

Dodd-Frank Act. Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act directs the SEC to reward whistleblowers who voluntarily provide “original information” from 10 percent to 30 percent of monetary penalties where the penalties reach over \$1 million. In November, the SEC proposed rules to implement the provision (216 DLR A-12, 11/9/10).

The proposal has come under fire from the business and whistleblower communities, as well as lawmakers. While industry representatives said the proposed program could erode corporate compliance programs, whistleblower advocates said it would subject informants to unnecessary burdens and complications (249 DLR C-1, 12/29/10). Meanwhile, Sen. Charles Grassley, a strong whistleblower advocate, criticized the proposal as “overly complex and overly restrictive,” while industry advocate Rep. Michael Grimm (R-N.Y.) is poised to introduce a bill that would make payment of a reward dependent on an informant approaching his or her employers first (91 DLR A-15, 5/11/11).

Balancing Act. SEC Chairman Mary Schapiro, in her opening statement at the meeting, acknowledged that the rulewriting process for the program has been challenging. She noted that the commission received 240 comment letters and more than 1,300 form letters on the proposed rules.

“I believe that the final recommendation strikes the correct balance—a balance between encouraging whistleblowers to pursue the route of internal compliance when appropriate—while providing them the option of heading directly to the SEC,” she said. “This makes sense as well because it is the whistleblower who is in the best position to know which route is best to pursue.”

“I believe that the final recommendation strikes the correct balance,” SEC Chairman Mary Schapiro said.

The SEC, in balancing the different interests at stake, revised its proposal in several ways. The key changes to make it more attractive for informants to report tips through corporate processes include:

- Allowing whistleblowers to obtain credit for reporting original information to their employers, even if the whistleblower never contacts the SEC. The whistleblower is entitled to a reward if the employer passes the tip along to the SEC, in addition to any other information it has collected in its internal review of the situation, and the information leads to a successful enforcement action or actions in which the SEC obtains monetary sanctions of more than \$1 million.

- The final rules expressly state that the SEC, when determining how much to award, will consider how much the whistleblower contributed to, or interfered with, internal compliance procedures.

- The final rules extend the time—from 90 days to 120 days—that the whistleblower can wait after reporting problems internally before approaching the SEC.

In addition, the final rules also revised the proposal by making it easier on whistleblowers and by broadening the scope of who can be a whistleblower. The revisions include:

- streamlining the whistleblowing process by allowing the informants to submit information through a single form;

- making clear that the anti-retaliation provisions are available to anyone who provides information, even if the information concerns a possible securities law violation, and even if it does not lead to a successful enforcement action; and

- narrowing and clarifying the exclusions pertaining to attorneys, auditors, and internal compliance personnel, and carving out exceptions in which such indi-

viduals can come forward with information and be eligible for an award.

Staff Recommendation. In recommending the final rules to the commission, SEC Enforcement Director Robert Khuzami noted that staff, after “much study,” ultimately concluded that requiring whistleblowers to first report problems to their employers would be detrimental to the whistleblower program, and inconsistent with Dodd-Frank. In the first place, he said, the SEC was not presented with empirical data to show that whistleblowers would always bypass internal processes. Second, companies that take compliance seriously would strive to have effective compliance procedures that in turn more likely would be used by whistleblowers.

In addition, he said, nothing in the Dodd-Frank whistleblower provision requires that wrongdoing first be reported to employers. In situations where the wrongdoing is carried out by senior management, the requirement that informants first approach their employers could add an additional burden that likely would discourage them from coming forward at all, he said.

However, Khuzami added, staff also recognized the significant value of internal processes, and “refined and revised” the proposal so that whistleblowers are incentivized to use corporate reporting procedures where appropriate. He cited, for example, the amendment to allow informants who report problems only to the company to be eligible for an award if the company passes the tip—and any other subsequently discovered information—to the SEC.

Under that change, the whistleblower potentially could get a larger award because of the information added on by the company, and whistleblowers who might otherwise not be eligible—because their information was too unspecific—could now qualify. Moreover, Khuzami said, this change could encourage companies to build robust compliance programs.

120-Day Period. Moving on to the 120-day grace period during which whistleblowers, after reporting to their employers, must report to the SEC, Khuzami warned that this does not affect the division’s expectation that companies will continue to self-report problems in a timely basis.

On another contentious issue regarding the ability of culpable whistleblowers to collect rewards, staff said the final rules are substantially similar to the proposed rules. Under the proposed and final rules, whistleblowers would not be able to collect rewards that are calculated based on their own monetary sanctions or on sanctions paid by others whose liability is substantially based on conduct that the whistleblower directed or planned. Individuals who are criminally convicted already are barred under Dodd-Frank from being eligible for an award.

Sean McKessy, the head of the Enforcement Division’s new Whistleblower Office, told the commissioners that staff has made significant progress in getting the office “up and running.” Among other developments, the office has created an updated whistleblower page that is launching May 25, McKessy said. He added that in the weeks ahead, the office also will develop comprehensive policies and procedures for the bounty program.

Objections. In objecting to the final rules, Casey said they were deficient in “two overarching ways.” The rules significantly underestimate their impact on internal processes, and overestimate the capacity of the commission to triage and manage all the tips, complaints, and referrals that will come pouring in, she said.

Despite the changes made in the final program to encourage internal reporting, the prospect of monetary gain will provide enough incentive for whistleblowers to bypass internal processes, Casey said. By diverting tips to the commission that otherwise would have been investigated by companies, the SEC risks having violations last longer and becoming more serious.

Casey also said staff “was not being adequately circumspect” in telling the commission that they can cope with the tips that come in. “The better course would have been to adopt” a program that requires some form of contemporaneous reporting to both the SEC and through internal compliance procedures, she said. “Such an approach would have been more incremental” in its effects, and would have allowed the SEC better to evaluate the impact of the new bounty program.

Casey further found fault with the final rules for allowing attorneys to participate in the bounty program if they believe that disclosure is necessary to protect investors. Such an approach, she warned, could undermine the attorney-client privilege.

Moreover, Casey reiterated concerns previously voiced in other Dodd-Frank rulemaking undertaken by the commission that the whistleblower rules were not accompanied by an adequate cost-benefit analysis. These rules significantly underestimate the cost of the whistleblower program, she contended, saying the staff failed to calculate the defense costs that companies might have to bear in the new enforcement environment.

Evaluation of Program. Casey asked staff members to explain how they plan to evaluate the program’s effectiveness. Khuzami responded that staff will continue to monitor and collect data on the tips and complaints that the SEC receives, such as the volume of the data, and whether the matter was reported internally to employers. He noted that so far, although the SEC has seen an uptick in the number of high-quality tips, it has not received an “unmanageable” flood that corporate commenters had anticipated.

McKessy added that once the bounty program is effective, the Whistleblower Office will be better able to identify and track the complaints that come through the program.

Stephen Cohen, associate director of the Enforcement Division, also told the commissioners that since enactment of Dodd-Frank, the SEC has seen an increase in the quality of tips. In addition, staff has received whistleblower complaints that cover the spectrum of the federal securities laws, and heard of matters that “we might not otherwise” have uncovered.

For example, he noted that staff recently spent two days with a whistleblower regarding an alleged wide-ranging fraud spanning several states and countries. Those two days saved staff about six to 12 months of investigative time, Cohen said.

In response to Casey’s question as to how staff will measure the impact of the program on internal corporate procedures, Khuzami said the corporate commu-

nity will inform the commission if there is a drop-off in internal reporting. "Primarily, we'll hear from companies as to how they view the impact." He also noted that the bounty program may not result in "wholesale changes" to the enforcement program, given that in many instances, the division will stick to its traditional practice of referring complaints to the companies themselves for investigation.

'Missed Opportunity.' For his part, Paredes said the commission missed the opportunity to craft an effective bounty program that would not encourage frivolous tips. Similarly, he voiced concerns that the final rules do not do enough to preserve the role of compliance programs. The SEC could have found ways to do this short of requiring mandatory reporting to employers, he said.

He also warned that the SEC could be inundated by allegations, many of which could prove to be "specious." The final rules do not adequately discourage the submission of low-quality tips, he said.

Paredes further criticized the final program for not being "more user friendly," which he said could deter whistleblowers from approaching the SEC. The commission "could, and should have, calibrated" the final rules differently, he said.

As to the commissioners who supported the final rules, Elisse Walter said she "wrestled" with the issues raised by commenters, and ultimately agreed with staff that reporting to internal compliance programs should not be mandatory. She also observed that the SEC's work on this issue "is not done." "This is just the beginning," she said, telling staff to continue to monitor the program with a "view to improving it."

In his remarks, Commissioner Luis Aguilar commended the final rules for being "faithful" to Dodd-Frank and for striking "the right balance." The majority of employees already choose to report problems internally, and it is important for whistleblowers to be able to come directly to the commission, he said.

BY YIN WILCZEK

Text of the final rule may be accessed at <http://op.bna.com/dlrcases.nsf/r?Open=vros-8h7vw6>.

Whistleblowers

Employee Advocates Applaud SEC Rule, But Management Lawyers Warn of Problems

Lawyers representing employees May 25 called the Securities and Exchange Commission's final rule implementing the Dodd-Frank Act whistleblower protections an appropriate balance of competing interests, but management representatives decried the SEC's decision not to require employees to complain internally before contacting the SEC about suspected securities law violations.

By a 3-2 vote on May 25, the SEC adopted a final rule to establish a whistleblower bounty program mandated under the financial reform legislation (see related article in this issue). Section 922 of the act provides that the SEC shall pay monetary awards to eligible whistleblowers who voluntarily provide the SEC with "original information" leading to a successful enforcement action yielding monetary sanctions of more than \$1 million. The bounties will range from 10 percent to 30 per-

cent of the total monetary sanctions collected by the SEC or in any related action.

The act expressly prohibits retaliation by employers against whistleblowers, providing a private cause of action if they are discharged or discriminated against for protected activity.

Business groups commenting on the SEC's proposed rule had urged the agency to require whistleblowers first to use their employers' internal complaint procedures. Although the SEC final rule gives whistleblowers some incentives to do so, it does not require employees to inform their companies before contacting the SEC about suspected violations.

Boon for Trial Lawyers? The U.S. Chamber of Commerce said that by approving the final rule, the SEC placed trial lawyer profits above effective corporate governance. "This rule will make it harder and slower to detect and stop corporate fraud—by undermining the strong compliance systems set up under [the] Sarbanes-Oxley [Act] to ensure companies take whistleblowers seriously," David Hirschmann, president of the chamber's Center for Capital Markets Competitiveness, and Lisa Rickard, president of the chamber's Institute for Legal Reform, said in a joint statement May 25.

The chamber warned that given "new large financial incentives" to bypass their companies' internal complaint mechanisms, potential whistleblowers will go directly to the SEC and "keep companies in the dark" about suspected financial wrongdoing. "This leaves expensive, robust compliance programs collecting dust, while violations continue to fester, eroding shareholder value," Hirschmann and Rickard said.

The chamber said that while it agrees the SEC should have access to the information needed to "detect and deter fraud," the final rule "prevents quick action to investigate and solve problems" by not requiring "simultaneous reporting" of whistleblower complaints to the affected company and the SEC.

The chamber warned that trial lawyers already are posting advertisements and running training sessions on how to profit from the Dodd-Frank Act bounty provisions. "As adopted, the SEC's flawed rule will lead to trial lawyers urging whistleblowers to keep the company in the dark as long as possible so as to maximize any available bounty," Hirschmann and Rickard said. "This is bad news for the shareholders and workers of any company victimized by a fraudulent actor."

Acknowledging Congress intended an SEC rule that takes whistleblower complaints seriously, the chamber said "the right approach" is not to keep companies in the dark about potential securities law violations. "The most effective approach is to ensure both companies and the SEC have access to information about ongoing frauds so they can be stopped as soon as possible and without needlessly increasing litigation," Hirschmann and Rickard said.

Plaintiffs' Lawyers Applaud 'Balance.' Meanwhile, two lawyers with Phillips & Cohen LLP, which represents whistleblowers, applauded the SEC final rule as protective of employees who suspect corporate wrongdoing.

The SEC withstood "intense pressure" from business groups "to weaken the rules in a way that would have discouraged most whistleblowers from coming forward," Erika A. Kelton, an attorney in Phillips & Cohen's Washington, D.C., office, said in a written state-

ment May 25. “By establishing incentives for people to report fraud concerns internally before going to the SEC—but not making such reporting mandatory—the SEC has struck a balance that still will encourage whistleblowers to come forward.”

Eric A. Havian, an attorney in Phillips & Cohen’s San Francisco office, hailed the SEC’s decision to extend anti-retaliation protection to workers who blow the whistle even if they do not qualify for a Dodd-Frank Act bounty.

“The fear of losing a job and being blackballed from working in an industry is a very realistic one and prevents many people from stepping forward,” Havian said in a written statement. “It is also a positive step that the rules allow audit and compliance personnel to go directly to the SEC if companies fail to act on their recommendations.”

Cyrus Mehri, a plaintiffs’ attorney in Washington, D.C., said the SEC had “taken a thoughtful approach” regarding whether whistleblowers must complain internally to their employers before contacting the federal enforcement agency. The final rule strikes an “appropriate balance” by giving employees some “positive incentives” to use their employer’s internal complaint procedure but not mandating that step, said Mehri, who is with the firm of Mehri & Skalet.

The changes to SEC’s proposed rule show that the agency took into account the voluminous comments it received on this point, Mehri told BNA May 25.

Changes Not Enough, Management Lawyer Says. However, Steven Pearlman, a management lawyer with Seyfarth Shaw in Chicago, said the SEC’s final rule does not solve the potential problems raised by allowing whistleblowers to report suspected violations to the SEC but to never inform their employers.

Although the SEC final rule does provide employees with some incentives to lodge internal complaints, Pearlman said that from the management perspective, the SEC rule “didn’t go far enough, really by a mile.”

The final rule includes a “grace period,” which provides that if an employee complains internally to the employer, the company has 120 days to investigate the alleged financial wrongdoing, Pearlman said. If the employer subsequently “self-reports” a suspected violation to the SEC following an internal investigation, then the employee still could receive the Dodd-Frank Act bounty, Pearlman said. The SEC final rule also provides that the agency “will consider” an employee’s use of a company’s internal complaint mechanism in determining the bounty amount, Pearlman said.

But those provisions are “not even close to enough” to assuage management’s concern about employees bypassing internal complaint procedures because of the strong financial incentives to go directly to the SEC, Pearlman told BNA May 25. “I think management is disappointed with that,” he said.

On the plus side for employers, Pearlman said the SEC final rule does require that whistleblowers must have a “reasonable belief” that a securities law violation has occurred, which makes the rule more similar to existing Sarbanes-Oxley Act requirements.

But Pearlman expressed concern that while the Dodd-Frank Act provides that auditors and other employees whose jobs involve preventing financial irregularities are ineligible for whistleblower bounties, the SEC final rule would recognize such individuals as whistleblowers under certain circumstances. That SEC exception “almost swallows the rule,” Pearlman said.

The SEC final rule bars employees who are involved in the alleged wrongdoing from benefiting by “blowing the whistle” on themselves as well as others, Pearlman noted. But he said management representatives would have preferred a “categorical bar” against recovery of a bounty by any purported whistleblower who was involved “in any way” in the alleged securities law violations.

BY KEVIN P. MCGOWAN