WHAT YOU NEED TO KNOW ABOUT THE SEC'S WHISTLEBLOWER RULES:

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Dodd-Frank and the SEC's Whistleblower Regulations

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Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 922

- Dodd-Frank Act enacted July 21, 2010
- Section 922: Whistleblowers who voluntarily provide SEC with original information about violations of securities laws will be awarded a share of between 10% and 30% of monetary sanctions imposed by the Commission that exceed $1 million
  - Title 15, U.S.C. Section 78-u6
- SEC released final whistleblower rules on May 25, 2011, effective August 12, 2011
  - Title 17, C.F.R. Section 240.21F

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Goals of the Whistleblower Provisions

- Create incentives + protections to vastly increase the frequency that private corporate citizens report potential securities law violations to the SEC for enforcement
- Two Principal Mechanisms
  - “Bounty” provisions
  - “Anti-Retaliation” provisions

Definition of a Whistleblower (“Bounty”)

- Any individual, or 2 or more individuals acting jointly
- Who provide(s) to the Commission, *in a manner established, by rule or regulation*
- Information relating to a violation of the securities laws

  15 U.S.C. § 78u-6(a)(6)

Definition of a Whistleblower ("Anti- Retaliation")

- You possess a ***reasonable belief*** that the information you are providing relates to a ***possible*** securities law violation . . .
- You provide that information in a manner described in Section 21F(h)(1)(A) of the Exchange Act (15 U.S.C. 78u-6(h)(1)(A))
- The anti-retaliation protections apply whether or not you satisfy the requirements, procedures and conditions to qualify for an award

17 C.F.R. § 240.21F-2(b)(1)(i)-(iii).

Eligibility For An Award

There are four major elements. The whistleblower must

(1) [*v]oluntarily* provide the Commission

(2) [w]ith *original* information

(3) [t]hat *leads* to the successful enforcement by the Commission of a Federal court or administrative action

(4) [i]n which the Commission obtains monetary sanctions totaling more than $1,000,000."

17 C.F.R. § 240.21F-3(a)(1)-(4); 15 U.S.C. § 78u-6(b).

Definition of “Voluntary”

- Made *before* the whistleblower (or his or her representative) receives an SEC request, inquiry, or demand that relates to the subject matter
- NOT voluntary if person’s report is required by:
  1. a preexisting legal duty,
  2. a contractual duty that is owed to the SEC or one of the other authorities, or
  3. a duty that arises out of a judicial or administrative order

17 C.F.R. § 240.21F-4(a)(1)(i)-(iii).

“Original Information”

Original information is defined as information that is:

- derived from the ***independent knowledge or analysis*** of a whistleblower;
- not known to the SEC from any other source, unless the whistleblower is the original source of the information;
- not *exclusively* derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information

17 C.F.R. § 240.21F-4(b)(1)(i)-(iv); 15 U.S.C. § 78u-6(a)(3).

Independent Knowledge and Independent Analysis

- Facts *not* derived from publicly available sources
- Gained from experiences, communications, and observations in business or social interactions
- Whistleblower's own analysis, whether done alone or with others, i.e., the whistleblower's examination and evaluation of information ***that may be publicly available***, but which reveals information that is not generally known or available to the public
- *Information obtained in attorney-client privileged communications or legal representation generally excluded*

17 C.F.R. § 240.21F-4(b)(2); 17 C.F.R. § 240.21F-4(b)(3).

Individuals Ineligible for Bounties

- "officer, director, trustee, or partner of an entity where the information was learned from . . ." compliance processes for handling possible violations of law;
- compliance or internal audit employee or employee or contractor of a firm retained to perform audit functions;
- person employed with firm retained to conduct investigation into possible violations of law; or
- person employed with a public accounting firm, if information is obtained through an engagement required of a CPA under federal securities laws

17 C.F.R. § 240.21F-4(b)(4)(iii)(A)-(D).

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The Exceptions That Swallow The Ineligibility Rules

- ***reasonable basis to believe*** that disclosure . . . is necessary to prevent conduct ***likely to cause substantial injury*** to the entity or shareholders
- the individual has a ***reasonable basis to believe*** that the entity is ***impeding an investigation*** of the misconduct
- at least 120 days have elapsed since person gave information to his/her ***supervisor***, the audit committee, chief legal officer, chief compliance officer or their equivalents
- at least 120 days have elapsed since person received information if circumstances indicated that ***one or more of these individuals or committees was already aware***

17 C.F.R. § 240.21F-4(b)(4)(v)(A)-(C).

Factors To Be Considered In Setting Award

- In the Commission's discretion –
  - Significance of the information to the success of the covered action
  - Degree of assistance provided by the whistleblower – "ongoing, extensive, and timely cooperation and assistance"
  - Programmatic interest of the Commission in deterring violations of the securities laws
  - Participation in internal compliance systems

Factors That May *Decrease* An Award

- Personal culpability of the whistleblower
- Unreasonable reporting delay
- Interference with internal compliance and reporting

  17 C.F.R § 240.21F-6.

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Culpability Alone Does Not Cause Ineligibility

- The *minimum* award is 10% of amounts recovered by the SEC
- Even extreme culpability will not disqualify a whistleblower from eligibility. 17 C.F.R. § 240.21F-16.
- A whistleblower is *only* ineligible if convicted of a criminal offense relating to the activity that is the subject of the SEC's enforcement action
- "The Securities Whistleblower Incentives and Protection provisions do not provide amnesty to individuals who provide information to the Commission." 17 C.F.R. § 240.21F-15.

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Whistleblowers Not Required to First Report Internally

- Many companies and law firms representing management submitted comments to the SEC suggesting that it require internal reporting first before an employee could blow the whistle to the SEC
- To promote its timely access to information, the SEC rejected any internal-report first requirement
- Rather, the SEC provided three “incentives” to encourage whistleblowers to work through internal compliance policies when appropriate:

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Internal Reporting “Incentives”

1. Treat original information as delivered on date of report to company, as long as same report is made to SEC within 120 days

2. Increase the size of awards for whistleblowers who report internally first, and reduce awards for whistleblowers who impede internal investigations

3. SEC will credit whistleblower with information his/her *company* provides to the SEC based on the whistleblower’s *internal* report

   – “Credit” provision only applies when whistleblower reports to SEC within 120 days of internal report

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Retaliation Against Whistleblowers is Prohibited

Section 922 prohibits retaliation against “whistleblowers” who:

- Provide information or testimony to the SEC; or
- Make disclosures required or protected under
  - SOX
  - Securities Exchange Act of 1934
  - 18 U.S.C. § 1513(e)
  - Any other law, rule or regulation subject to the jurisdiction of the SEC (*e.g.*, FCPA)

SEC Anti-Retaliation Rules

- Reports are protected if employee “reasonably believes” that the information provided relates to a “possible” securities law violation or other violation under SOX
- Even if whistleblower does not qualify for bounty, still protected from retaliation under statute and SEC rules
- The anti-retaliation provisions “shall be enforceable in an action or proceeding brought by the Commission”
- Also enforceable in a private action by the whistleblower

Whistleblower Anonymity and Confidentiality

- The SEC may not disclose information that could reasonably be expected to reveal the identity of a whistleblower. There are enumerated exceptions, and then there are mistakes --
- On April 25, 2012, *The Wall Street Journal* reported that the SEC had inadvertently disclosed the identity of a whistleblower during an inquiry of his former employer --
  - SEC attorney showed copies of notes to corporate officer, who immediately recognized whistleblower's handwriting
- Whistleblowers may provide anonymous information, but only through an attorney, and in compliance with SEC procedures (17 C.F.R. § 240.21F-9).

Certain Confidentiality Restrictions Are Prohibited

- Employers are barred from taking “any action to impede an individual from communicating directly with the Commission staff about a potential securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement.”

Dodd-Frank Also Expanded SOX's Whistleblower Protections

- Time to file a complaint with OSHA extended from 90 to 180 days
- SOX plaintiffs are entitled to a jury trial
- Non-publicly traded *subsidiaries* of publicly traded companies are now covered by SOX
- Pre-dispute arbitration agreements no longer enforceable under SOX

The Early Returns . . .

- The SEC originally projected that they would receive 30,000 whistleblower tips each year, and half would meet initial eligibility requirements
- SEC received 334 eligible tips during the seven-week period covered in the most recent Annual Report. The most common categories were: (1) market manipulation, (2) corporate disclosures and financial statements, and (3) offering fraud. Fewer FCPA tips.
- Complaints received from 37 states and 11 foreign countries. Most foreign tips emanated from China and U.K.
- 170 Notices of Covered Actions posted for period July 21, 2010 to July 31, 2011; no awards processed as of end of 2011
- Office of the Whistleblower: staffed by seven attorneys

Egan v. TradingScreen, Inc., 2011 WL 1672066 (S.D.N.Y. May 4, 2011)

- First district court case to interpret the anti-retaliation provisions of section 922 of Dodd-Frank.
- Interpreted the anti-retaliation statute broadly

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Egan – Facts

- Egan was TradingScreen's former Head of U.S. Sales
- In early 2010, Egan informed TradingScreen's President that its CEO was diverting the company's corporate assets to another company that the CEO solely owned
- Latham & Watkins was retained to investigate
- Latham's investigation allegedly confirmed the allegations, but before the independent Directors of the Board could force the CEO to resign, the CEO gained control of the Board and fired Egan

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Egan – Motion to Dismiss

- Egan sued under the anti-retaliation provisions of Dodd-Frank. The defendants moved to dismiss the claim
- As Egan made his reports to TradingScreen, not to the SEC, the defendants argued he was not a "whistleblower" afforded protection under Dodd-Frank
- Section 922 of Dodd-Frank defines a "whistleblower" as "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws *to the Commission* …." 15 U.S.C. § 78u-6 (emphasis added)

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Egan – Motion to Dismiss

- Egan argued:
  - Reporting to the SEC is not required, because the Act specifically provides that it protects certain types of disclosures that do not require reporting to the SEC, i.e., reports "required or protected" under:
    - SOX
    - Securities Exchange Act
    - 18 U.S.C. § 1513(e)
    - Any other law, rule or regulation subject to the jurisdiction of the SEC
  - Even if reporting to the SEC is required, Egan "jointly provided" information to the SEC by providing information to Latham, which Latham then relayed to the SEC

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Egan – Court's Analysis:

- The Court determined the Act was internally contradictory
- On the one hand, Dodd-Frank defines "whistleblower" as one who reports to the SEC
- On the other hand, Dodd-Frank appears to intend to protect whistleblower reports that are not required to be made to the SEC

Egan: Court chooses broad interpretation

- Court held there is a narrow exception to definition of "whistleblower" for disclosures "required or protected" under:
  - the Sarbanes-Oxley Act;
  - the Securities Exchange Act;
  - 18 U.S.C. § 1513(e); or
  - other laws and regulations subject to the jurisdiction of the SEC.
- Such reports are also protected by the anti-retaliation provision even if not made to the SEC
- This is the same interpretation as the SEC Final Rule

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Egan - Arguments for coverage

- **First, Egan claimed his reports were covered by SOX.**
  - Court rejected this argument because TradingScreen is not a publicly traded company
- **Second, he claimed his reports were about violations of FINRA rules that are "subject to the jurisdiction of the Commission."**
  - Court rejected this argument because reports of violations of FINRA rules are not "required or protected" under any law, rule, or regulation of the Commission
- **Third, he claimed his reports were protected by 18 U.S.C. § 1513(e)**
  - Court rejected this argument because Egan did not claim he reported issues to federal law enforcement other than Latham's alleged report to the SEC, so coverage still hinged on whether this report constituted "jointly providing information" to the SEC

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Egan – Court Broadly Defines "Jointly Providing Information" to the SEC

- Egan's conduct in initiating the inquiry into the CEO's misconduct and providing information to Latham could constitute jointly "providing information" to the SEC, if Latham reported it to the SEC.
- Court made clear that this interpretation does not apply to provision defining eligibility for a bounty

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Egan – Implications

- Employers who investigate and report information to the SEC that they received from internal whistleblower may unwittingly create jurisdiction for a retaliation suit under Dodd-Frank if the whistleblower did not report to the SEC
- Under this reading of Dodd-Frank's anti-retaliation provision, employees in any SOX matter could arguably bring their whistleblower retaliation claims under Dodd-Frank instead of SOX, meaning:
  - Six to ten-year statute of limitations (as opposed to 180 days under SOX)
  - Double back pay damages
  - Direct right of action in federal court, with no need to exhaust remedies before OSHA
- This reading of the statute could make OSHA's role in SOX cases obsolete

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Sylvester v. Parexel International LLC
(ARB May 25, 2011)

- First major SOX case by Obama's Administrative Review Board
- Complainants: a Clinical Nurse and a Case Report Manager who recorded data for clinical drug trials and complained that certain time entries were falsified on patient charts
- When terminated, they filed claims with OSHA under SOX, alleging that their complaints constituted complaints of fraud on shareholders, mail, wire, and financial institution fraud

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Sylvester - ALJ Dismisses Case

- The ALJ dismissed the complaints, holding that the complainants failed to establish that their expressed concerns:
  - "definitively and specifically" related to a violation of any of the laws covered by SOX;
  - involved shareholder fraud, fraud generally, or were otherwise adverse to shareholders' interests; or
  - constituted reasonable concerns about SOX violations

Sylvester - ARB Reverses: ALJ's Dismissal Of Case Was Inappropriate

- "SOX claims are rarely suited for Rule 12 dismissals."
- The heightened pleading standards set forth by the U.S. Supreme Court in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal* do not apply to SOX claims before the Department of Labor
- Complainants do not need to demonstrate that their complaints "definitively and specifically" related to a SOX-enumerated violation, as this is "an inappropriate test and is often applied too strictly."

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ARB Re-evaluates Standards For Demonstrating “Protected Activity” Under SOX (cont’d)

- “It is clear that a complainant may be afforded protection for complaining about infractions that do not relate to shareholder fraud.”
- A complainant can engage in protected activity “even if the complainant fails to allege, prove, or approximate specific elements of fraud….”
- Reporting that may not seem SOX-related may now be protected

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Sharkey v. J.P. Morgan Chase & Co., 2011 WL 135026 (S.D.N.Y. Jan. 14, 2011)

- Plaintiff, a former VP in Private Wealth Management, claimed her employment was terminated following her report to management that her client was violating securities laws
- Defendants moved to dismiss because she did not allege a reasonable belief that her employer committed a violation
- Court held that "[t]he statute by its terms does not require that the fraudulent conduct or violation of federal securities law be committed directly by the employer that takes the retaliatory action."
- Case dismissed with leave to replead with more specificity

Next Steps For Employers

- Be prepared for increase in whistleblower complaints
- Review internal whistleblower procedures and policies to ensure that they encourage internal reporting and the maximum opportunity to address compliance concerns before employees go to the SEC in pursuit of generous bounties
- Communicate to employees that there are effective internal whistleblower and compliance programs to address their concerns
- Ensure robust procedures and well-trained personnel for conducting prompt internal investigations

Elements of Effective Compliance and Reporting

- Robust codes of conduct and compliance policies
- Whistleblower policies that preserve confidentiality and anonymity and prohibit retaliation
- Mandatory employee training on policies and procedures. Certifications?
- Internal audits and quality control
- Whistleblower reporting, hotlines, anonymous and 3rd party systems
- Procedures for responding to internal complaints and providing information to general counsel, compliance officers, board of directors
- Internal investigations -- retention of independent counsel?
- Self-reporting to regulators, including FINRA, SEC, CFTC, etc. Difficult “120-day decisions”?

Incentivize Internal Reporting First

Most whistleblowers file suit or report to regulators only *after* attempts at internal reporting failed – lessons from the False Claims Act

- 90% of qui tam plaintiffs initially reported their concerns first
- Qui tam plaintiffs overwhelmingly report that financial bounties were *not* principal motivating factor for their filing of the lawsuit

The clear lesson: employees who raise SOX, Dodd-Frank and FCPA concerns must be --

- taken seriously, treated with respect, and not perceive retaliation
- their concerns must be investigated promptly
- they must be convinced that the investigation is fair and not rigged
- they must receive feedback and some report on the conclusion of the investigation, within appropriate limits

Additional Information – Orrick.com

- Additional information and resources available at Orrick.com
- Practices –
  - » Employment Law
  - » Securities Litigation and Regulatory Enforcement

“And therefore never send to know for whom the whistle blows; it blows for thee.”

John Donne (1624)

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