INSIDE THE MINDS™

SEC COMPLIANCE BEST PRACTICES

LEADING LAWYERS ON MANAGING RISKS, BUILDING AND MAINTAINING COMPLIANCE PROGRAMS, AND UNDERSTANDING NEW LEGISLATION

2011 EDITION

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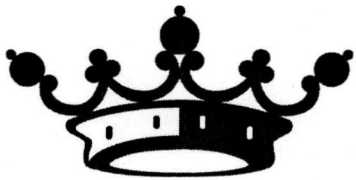

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Dodd-Frank Act Bounties for Whistleblowers

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The Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the Securities and Exchange Commission (SEC) to pay large monetary awards to individuals who voluntarily provide the SEC with original information about a possible violation of the securities laws. In November 2010, the SEC proposed new Regulation 21F (Securities Exchange Act Release 34-63237) under the Exchange Act to implement the whistleblower directive under Dodd-Frank. The new statute and the SEC's proposed rules also have prompted a flurry of activity by plaintiffs' firms seeking to cash in on the potential windfall of awards and by companies seeking to stem the tide of potential claims. This chapter discusses the new statute, the SEC's proposed rules, and the internal compliance changes companies may wish to consider to address this new framework.

Dodd-Frank Act Whistleblower Provisions

The Dodd-Frank Act contains significant new whistleblower protections, including the creation of SEC and Commodity Futures Trading Commission (CFTC) whistleblower programs, a dramatic expansion of current whistleblower protections under the Sarbanes-Oxley Act of 2002, and a new whistleblower cause of action for employees performing tasks related to consumer financial products or services.

The monetary incentives for whistleblowers to report securities and commodities law violations to the SEC and CFTC is the key feature of the new legislation. Whistleblowers who provide the respective commissions with original information about violations of securities or commodities laws are eligible to be awarded a share of between 10 and 30 percent of monetary sanctions ultimately imposed by the commissions that exceed $1 million.

The act provides strong protections to individuals who report under it. The act prohibits employer retaliation against whistleblowers who provide information to the SEC or CFTC, assist in any investigation or legal action of the SEC or CFTC related to such information, or engage in any other protected activity under the Sarbanes-Oxley Act. An employee claiming retaliation under Dodd-Frank may bring an action directly in federal district court (as opposed to the procedure under Sarbanes-Oxley, where a complainant is first required to file an administrative complaint with the Department of Labor).

In contrast to Sarbanes-Oxley's previous ninety-day statute of limitations, the statute of limitations for bringing a retaliation claim under these provisions of the Dodd-Frank Act has been dramatically expanded: for whistleblowers who engage in SEC-related whistleblower conduct or other Sarbanes-Oxley protected activity, an action must be filed either within six years after the date when the violation occurs or within three years after the date "facts material to the right of action are known or reasonably should have been known by the employee," but not more than ten years after the date of the violation.

This long limitations period not only expands employers' potential liability under the act, but it could create problems for employers who do not typically maintain employee records for ten years. Employers are advised to examine their document policies to ensure that employment retention records are maintained for a ten-year period.

Upon a finding of retaliation against a whistleblower who has reported a violation of securities laws or engaged in other Sarbanes-Oxley protected activity, the Dodd-Frank Act provides for the whistleblower's reinstatement, double back pay (as opposed to just back pay, as under Sarbanes-Oxley), attorneys' fees, and other costs. With respect to whistleblowers who report violations of the commodities laws, the act provides for reinstatement, back pay (as opposed to double back pay), and "special damages," including attorneys' fees and costs.

Sweeping Amendments to § 1514A of the Sarbanes-Oxley Act

The Dodd-Frank Act expands the scope of Sarbanes-Oxley's whistleblower protections in several key ways. The statute of limitations has been broadened from ninety to 180 days to file a complaint with the Department of Labor. Sarbanes-Oxley plaintiffs are now expressly entitled to a jury trial. Non-publicly traded subsidiaries of publicly traded companies are now covered by Sarbanes-Oxley, by amendment to the definition of "publicly traded company" to include any "subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company." Prior to this amendment, the Department of Labor took the position that employees of non-publicly traded subsidiaries were generally not covered by the act absent a showing of a substantial nexus between the

parent and subsidiary. "Nationally recognized statistical ratings organizations" are now covered by Sarbanes-Oxley, so employees of these organizations will have the benefit of Sarbanes-Oxley whistleblower protection.

Pre-dispute arbitration agreements will no longer be enforceable under Sarbanes-Oxley (except perhaps in the collective bargaining agreement context), nor will the rights and remedies under Sarbanes-Oxley be capable of waiver by agreement. This means employers will no longer be able to compel arbitration under Sarbanes-Oxley, nor will they be able to include a release of Sarbanes-Oxley claims in their general releases or settlement agreements with employees.

Key Elements of Proposed Regulation

On November 3, 2010, the SEC proposed Regulation 21F, pursuant to its obligations under the Dodd-Frank Act. Regulation 21F consists of sixteen separate rules that refine and amplify the key provisions of the statute. The proposed rules set forth procedures for submitting information, eligibility to receive awards, and circumstances under which payments would be made. The proposed regulation also contains provisions that would protect whistleblowers from retaliation for their actions regardless of whether they qualify for an award. Final rules must be adopted no later than April 2011.

Eligibility Standards

Whistleblower

Under Regulation 21F, a whistleblower would be any person who alone, or with others, provides information to the SEC relating to a potential violation of the securities laws. Only individuals, not corporations, could be whistleblowers. However, whistleblowers need not be employees of the subject company.

Ineligible Persons

The following individuals would not be eligible to receive awards:

- Persons who, at the time they acquired the information submitted to the SEC, were members, officers, or employees of the SEC or any other law enforcement organization, the Public Company Accounting Oversight Board, or a foreign government, foreign instrumentality, or foreign financial regulatory authority
- Persons convicted of a criminal violation related to an enforcement action for which the person otherwise would be eligible to receive an award
- Persons who obtained the information provided to the SEC through an audit of a company's financial statements where providing the information would be contrary to Section 10A of the Exchange Act
- Persons who acquired the information provided to the SEC from any of the ineligible individuals described above
- Any person who is a spouse, parent, child, or sibling of a member or employee of the SEC, or who resides in the same household as an SEC member or employee
- Persons who knowingly and willingly make false statements or representations in their whistleblower submission or other dealings with the SEC or other authorities

In addition to the foregoing, individuals, lawyers, auditors, compliance personnel, and certain other persons who have a duty to respond appropriately would be disqualified from consideration for an award, as explained below under "Voluntary Submission" and "Original Information."

Voluntary Submission

A submission by a whistleblower to the SEC would satisfy the requirement that it be made voluntarily only if:

- The whistleblower does not have a preexisting legal or contractual duty to report violations of the type at issue.
- The submission is made before the whistleblower (or any person representing the whistleblower) receives a formal or

> informal request, inquiry, or demand from the SEC, Congress, any other federal, state, or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, about a matter to which the information in the whistleblower's submission is relevant.

Requests, inquiries, or demands from the entities mentioned above to a whistleblower's employer for the documents or information submitted by the whistleblower would be considered directed to the whistleblower and therefore not voluntarily submitted. Thus, a pre-existing legal or contractual duty to report violations to the government would disqualify a submission unless the employer were to fail to provide the documents or information in the employee's possession in a timely manner.

Original Information

Applicable Standards

The whistleblower would have the burden of showing that he or she has submitted "original" information about a potential securities law violation to the SEC. Information about a potential violation not already known by the SEC would be considered "original" if it is derived from an individual's "independent" knowledge or analysis. Knowledge of a potential violation would be considered independent if it is not obtained from publicly available sources. For example, knowledge gained through personal experience or communications would be deemed independent, but knowledge gained through court filings would not. Analysis of a potential violation would be considered independent if the analysis involves an individual's examination and evaluation, either alone or with others, of information that generally may be publicly available, but reveals information not generally known or available to the public. For example, an analysis through academic or professional studies that identifies potential securities law violations by virtue of an understanding of complex schemes would be considered independent.

Exclusions

The proposed regulation enumerates seven situations in which information would be deemed not to be original, and therefore excluded, because it is obtained in the following ways:

- Through communications protected by the attorney-client privilege
- Through the legal representation of a client where the lawyer (or a person such as an accountant or other expert hired to assist counsel) seeks a personal benefit by making a whistleblower submission
- Through an audit or similar engagement required under the securities laws by an independent public accountant where the information relates to a violation by the engagement client or its directors, officers, or other employees
- Through the performance of legal, compliance, audit, supervisory, or governance responsibilities for an entity, where the information was communicated to the individual with the reasonable expectation that the individual would take steps to cause the entity to respond appropriately to the violation (unless the company fails to report the information to the SEC within a reasonable time or acts in bad faith)
- Otherwise from or through an entity's legal, compliance, audit, or other similar functions or processes for identifying, reporting, and addressing potential non-compliance with the law (unless the company fails to report the information to the SEC within a reasonable time or acts in bad faith)
- By a means that violates applicable federal or state criminal law
- From anyone who learned the information secondhand from any individual who first learned the information in one of the six ways enumerated above

Company Obligations to Report

The definition of original information makes it clear that the fourth and fifth exclusions noted above are dependent upon the company having

reported the information to the SEC within a "reasonable time" and not having "acted in bad faith" by, for example, having destroyed documents or other evidence or having conducted a sham internal investigation. Although the SEC did not define what is meant by "reasonable time," it did emphasize in the proposing release that this might mean immediately in the case of an ongoing fraud that poses substantial risk of harm to investors. Thus, companies would have to determine quickly whether the conduct is ongoing and presents a substantial risk to investors and, even where it does not, have procedures for determining if and when to report the information to the SEC. In the proposing release, the SEC further clarified that an individual who learns the information while being interviewed by company legal or compliance personnel in the course of an internal investigation will be deemed not to possess original information, unless the company did not provide the information to the SEC within a reasonable time or acted in bad faith in conducting the internal investigation.

Companies that receive whistleblower complaints under their existing Sarbanes-Oxley internal procedures are advised to act on them quickly, first by conducting a thorough internal investigation in accordance with well-documented and careful internal investigation guidelines.

Relates to Potential Violation of Securities Laws

Under the proposed regulation, an individual would be deemed a whistleblower if the information submitted by the individual to the SEC relates to a potential violation of the securities laws. The word "potential" is not in the statute, but the SEC proposes to include it in the regulation so the agency would be able to consider an individual a whistleblower at the time information is submitted to the SEC, rather than at some later date when the violation is proved. The SEC is required by statute not to disclose any information that could reveal the identity of a whistleblower. Accordingly, the SEC believes this approach is necessary to afford confidential treatment from the outset to any information that otherwise might reveal the whistleblower's identity.

Leads to Successful SEC Enforcement Proceedings

To receive a bounty under the proposed regulation, the whistleblower must supply original information that leads to a successful enforcement

proceeding with monetary sanctions exceeding $1 million. The proposed regulation indicates that the SEC would consider the following factors in deciding whether a whistleblower's information met this requirement:

- The information caused the SEC staff to commence an examination, open an investigation, reopen an investigation that had been closed, or inquire concerning new and different conduct as part of a current examination or investigation, and the information "significantly contributed" to the success of the SEC's enforcement action.
- The information related to conduct already under examination or investigation by the SEC, Congress, any other federal, state, or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, and the information otherwise would not have been obtained and was essential to the success of the action.

The calculation of the monetary sanctions on which an award would be based would include penalties, disgorgement, and interest, as well as any money deposited into a disgorgement fund.

Procedural Requirements

To obtain an award under the proposed whistleblower program, an individual initially would have to submit the information regarding the potential violation to the SEC online according to instructions on the SEC's website, or on proposed Form TCR by mail or fax. At the same time, the whistleblower would have to file proposed Form WB-DEC attesting to the original nature of the information submitted and the person's eligibility for an award. Finally, to complete the process, the person would need to file proposed Form WB-APP formally applying for an award. The SEC and the Department of Justice have made it clear that persons who intentionally submit false information to the SEC under the whistleblower program will be prosecuted.

Protections Against Retaliation

The proposed regulation incorporates by reference the provisions of Dodd-Frank (now included in Section 21F(h)(1) of the Exchange Act) that afford

protection to whistleblowers against retaliation by their employers. One of the effects of the regulation would be to extend to a maximum of ten years the statute of limitations for filing retaliation claims. Claims generally could be filed six years after the adverse action, or three years after actual or imputed notice of the action, but no more than ten years after the action.

Efforts to Foster Use of Existing Company Compliance Programs

In the proposing release, the SEC expressed a policy interest in fostering robust corporate whistleblower and related compliance programs designed to receive, handle, and respond to complaints about potential violations of law. Although it does not propose requiring a whistleblower to use such internal programs to be eligible for an award, the SEC has proposed two incentives for employees initially to report their information to their companies. The first proposed incentive is that, in determining the amount of an award, the SEC will consider, among other factors, increasing the award size where the information is reported initially under an existing corporate program. The SEC also indicated, however, that it still might give a whistleblower more than the minimum 10 percent of the monetary sanctions where the whistleblower eschews reporting to the company "for fear of retaliation or other legitimate reasons." The second proposed incentive would deem the date of reporting original information to the SEC to be the earlier date on which the whistleblower reported it to the company, so long as the employee files a claim form with the SEC within ninety days after the internal report. Whether these measures would provide sufficient incentives to foster a robust corporate compliance program is open to question, and substantial comment on this topic has been made by issuers and the securities bar.

Whistleblower Communications with the SEC

The proposed regulation would prohibit any action to impede a whistleblower's communications with the SEC. For example, a company could not seek to enforce a confidentiality agreement with an employee to prevent the employee from disclosing information relating to a potential securities law violation to the SEC, except to the extent the information is protected by the attorney-client privilege. The proposing release does not address the company's ability to prevent a whistleblower from