

SEC Offers Incentives to Whistleblowers: Potential Risks and Strategies for Public and Private Companies

On August 12, 2011, the Securities and Exchange Commission's Office of the Whistleblower opened its doors. The Office is in charge of administering the newly-enacted Whistleblower Program, which applies to all entities (including public and private companies) regulated by the SEC. It is widely anticipated that the financial incentives provided by the Program, together with the current economic climate and the recent uptick in publicized fraudulent financial activity, may lead to whistleblowers coming out of the woodwork to try to collect the statutory bounty. Covered entities are therefore likely to face significant monetary exposure, including legal costs, as well as potential damage to their reputation. We will generally highlight several key areas of the SEC Whistleblower Program and focus on proactive strategies companies can implement to reduce their exposure.

Part I: Highlights of the Whistleblower Program

On May 25, 2011, the SEC adopted rules to create a whistleblower program (the "Program") that rewards individuals who provide the agency with "high-quality" tips that lead to successful enforcement actions.¹ The Program was implemented under Section 922 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.² According to the SEC, the Program is "primarily intended to reward individuals who act early to expose violations and who provide significant evidence that helps the SEC bring successful cases."³

Definition of Whistleblower: A whistleblower is defined as someone who "alone or jointly with others . . . provide[s] the Commission with information pursuant to the procedures set forth in [the rules], and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur."⁴ A whistleblower can only be an individual, as the rules expressly state that a company or other entity is not eligible to be a whistleblower.⁵

The Bounty: In order for a whistleblower to obtain a monetary award, the Commission itself must first obtain monetary sanctions totaling more than \$1,000,000.⁶ In its discretion, the Commission can award a whistleblower "at least ten percent and no more than thirty percent of the monetary sanctions that the Commission and the other authorities are able to collect."⁷ Among the factors the Commission is instructed to consider when exercising its discretion are:

1. the significance of the information provided by the whistleblower;
2. assistance provided by the whistleblower;
3. law enforcement interest;
4. the whistleblower's participation in any internal compliance system (discussed further below);

5. the whistleblower's own culpability;
6. any unreasonable reporting delay; and
7. any interference with internal compliance and reporting systems.⁸

Providing Information Voluntarily: To be eligible for an award, a whistleblower must "voluntarily" submit his or her information to the commission.⁹ A submission is made "voluntarily" if it is provided "before a request, inquiry or demand that relates to the subject matter of [the whistleblower's] submission is made to [the whistleblower] or anyone representing [the whistleblower] (such as an attorney): (i) by the Commission; (ii) in connection with an investigation, inspection or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization, or (iii) in connection with an investigation by Congress, any other authority of the federal government, or a state Attorney General or securities regulatory authority."¹⁰

Providing Original Information: The bounty will be paid only based on "original information," meaning that it is "(i) derived from [the whistleblower's] independent knowledge or independent analysis; (ii) not already known to the Commission from any other source, unless [the whistleblower] is the original source of the information; (iii) not exclusively derived from an allegation made at 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; and (iv) provided to the Commission for the first time after July 1, 2010 (the date of enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act)."¹¹

"Lead To" a Successful SEC Action: The "lead to" criterion is satisfied if: (1) original information was given to the Commission that was "sufficiently specific, credible and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of the original information;" (2) original information was given that concerned conduct already under examination or investigation by the Commission, the Congress, federal or certain other state regulatory bodies, and the information significantly contributed to the success of the action; and (3) the whistleblower reports original information internally first to his or her company, and the company later reports the information to the Commission, or reports the results of an internal investigation that was prompted by the whistleblower's information, as long as the whistleblower also reports directly to the Commission within 120 days.¹²

Initial Internal Compliance Encouraged But Not Required: A hotly contested issue when the rules were being drafted was whether or not to require a whistleblower to have reported internally first in order to be entitled to a bounty. The Commission was not willing to go that far, but in an attempt at compromise, did build in several potential incentives for employees to do so. The rules provide, as noted above, that participation in internal reporting is a factor that may enhance the amount of any bounty in the SEC's discretion (although still only within the 10-30% window).¹³ In addition, if information is reported first to the company, the whistleblower will receive credit, in awarding the amount of the bounty, not only for his or her information but also for everything the company thereafter provides to the SEC, including whatever information company investigators may develop independently of the whistleblower's material. Finally, and importantly, whistleblowers do not lose their "place in line" (for purposes of having provided "original" information, as discussed above) if they report internally first, as long as they report to the SEC within 120 days thereafter: the

rules expressly provide for a 120-day “look-back” period such that the whistleblower receives credit as of the first date he or she provided the information internally.¹⁴

Anti-Retaliation Provision: Finally, the rules contain a broad anti-retaliation provision. An individual is deemed a whistleblower for anti-retaliation purposes if he or she possesses a reasonable belief that the information provided relates to a “possible” securities law violation that has occurred, is ongoing, or is about to occur, and the information is provided in accordance with the Rules.¹⁵ The whistleblower need not be deemed entitled to a bounty in order to receive anti-retaliation protection, which will attach whether or not the SEC investigated the allegation or took any action, even if the underlying conduct complained of was not a violation of the law in the first place. Liability for retaliation can include, among other things, reinstatement, double back pay with interest, and reimbursement of legal fees.¹⁶

Part II: Encouraging Internal Reporting

It is undoubtedly important for companies to implement their own policies to detect fraud and other wrongdoing, under the Sarbanes-Oxley Act and otherwise, and to ensure that those procedures are effective. This alert addresses primarily the changed landscape in view of the Whistleblower Program, and how companies can seek to minimize the chances that employees will go directly to the SEC, instead of first submitting their information for internal investigation by the company.

As noted above, the rules do provide some incentives to reward initial internal reporting, but those rules will be of questionable efficacy absent vigorous corporate efforts to publicize them, present them in a persuasive and positive light, and encourage employees to avail themselves of those benefits. The best way to do this will be to integrate the new rules into a company’s already existing procedures, but in a way that convinces employees that internal reporting is preferable, and will benefit both their personal interests and the ultimate redress of the situation.

The precise tone and content of any such communication should be tailored to each particular company, but needs to be conveyed persuasively. Possible strategies include:

- Emphasizing to potential whistleblowers that the problem is more likely to be resolved effectively if the company is permitted to investigate internally first, by demonstrating (among other things) that the company is committed to uncovering and eliminating fraud and wrongdoing; has a comprehensive procedure in place to do so; and (if possible) has a track record of successfully following through on whistleblower complaints.
- In that regard, companies should also consider pointing out, although not in a heavy-handed way, that the SEC, like most government agencies, is overworked and underfunded and that government cannot always be counted on to reach the most efficient result.
- The fact that a whistleblower who reports internally first will get credit for information subsequently developed by the company should be couched, accurately, as beneficial in two respects. First, it will help get to the bottom of any ultimate wrongdoing, because the SEC will get the benefit not just of the individual’s information, which may be sketchy, but also of a full investigation by the company with its greater resources. Second, it will also benefit the whistleblower’s own self-interest, because incomplete information may not lead to any penalty, and hence to no bounty at all, and also because this is a factor the SEC will consider in determining the whistleblower’s percentage.

- The “look-back” period should be explained so that employees clearly understand that an internal report will “stop the clock” if there is any sort of “race” to be first to provide “original information.” This is critical because if employees do not realize that, and believe they need to go to the SEC immediately or risk being beaten to the punch by someone else, and therefore losing out entirely on the chance of any bounty, they will likely not consider reporting internally first. This feature of the rules should be presented, again accurately, as both enhancing the likelihood of a successful investigation and completely protecting the whistleblower’s interest in a bounty.
- Employees must be made to understand that whistleblowers will be fully protected against retaliation and that confidentiality will be respected to the extent possible.

In addition, it is important to ensure that potential whistleblowers have received and are aware of all of the foregoing communications – even the best and most persuasive notifications are useless if not seen and absorbed by the intended audience. The manner in which presentation can be made pervasive again will be dictated by the particulars of the company, but certainly management should consider outlets such as bulletin boards in company cafeterias, internal intranet sites, and employee handbooks. It should not be assumed that one such communication will suffice and so the message should be repeated on a regular basis.

More broadly, the efficacy of a company’s efforts to persuade potential whistleblowers to report internally first will depend on the company’s credibility with its employees generally, and whether employees believe that internal complaints will be vigorously pursued and trust that they will be protected appropriately. That is beyond the scope of this alert, but of course is of paramount importance in enabling companies to effectively cope with the new whistleblower terrain.

Part III: The Future

The rules discussed in this client alert were approved by the SEC on a close 3-to-2 vote. However, of the three SEC commissioners who voted in favor, two were Republicans, and the term of one of the dissenters has now expired and she will presumably be replaced by a Democratic appointee. Thus the imminent lineup on the Commission will probably be 4 to 1 in favor of retaining the new rules. A bill known as the “Whistleblower Improvement Act” was recently introduced in the House of Representatives to, among other things, require in most instances that in order to be eligible for a bounty, an employee must report information to his or her employer first before going to the SEC. It is unlikely that this bill would be passed by the Senate and signed by President Obama even if it were to pass in the House. While the political environment could change considerably after the 2012 elections, corporate counsel would be safe to assume that the existing rules will remain in effect for the foreseeable future and should implement preventive measures to reduce their exposure.

If you have questions regarding this Alert, please contact the authors, **Steven R. Popofsky** at 212.554.7857/spopofsky@mosessinger.com or **Jason Canales** at 212.554.7875/jcanales@mosessinger.com.

¹ Press Release, United States Securities & Exchange Commission, “SEC Adopts Rules To Establish Whistleblower Program, May 25, 2011 (“SEC May 25th Press Release”).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, §922, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”). Dodd-Frank §922(a) amends the Securities & Exchange Act of 1934, 15 U.S.C. §78a et. seq. (“Exchange Act”), by

adding a new §21F, titled “Securities Whistleblower Incentives and Protections.” Exchange Act §21F is hereinafter referred to as “SEC Rule.”

³ SEC May 25th Press Release.

⁴ SEC Rule 21F-2(a).

⁵ Id.

⁶ See SEC Rule 21F-3 (a)(4). For purposes of calculating the \$1 million monetary threshold, two or more administrative or judicial proceedings brought by the Commission will be treated as a single action if the proceedings arise out of the same nucleus of operative facts. See SEC 21F-4 (d) (1).

⁷ SEC Rule 21F-5.

⁸ SEC Rule 21F-6.

⁹ SEC Rule 21F-3 (a)(1).

¹⁰ SEC Rule 21F-4(a).

¹¹ See SEC Rules 21F-3 (a)(2) & 21F-4(b).

¹² SEC Rule 21F-4(c).

¹³ SEC Rule 21F-6(a)(4).

¹⁴ See SEC May 25th Press Release.

¹⁵ SEC Rule 21F-2(b).

¹⁶ Dodd-Frank §922(h).

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The Chrysler Building
405 Lexington Avenue
New York, NY 10174-1299
Tel: 212.554.7800 Fax: 212.554.7700

2200 Fletcher Avenue
Fort Lee, NJ 07024
Tel: 201.363.1210 Fax: 201.363.9210
Abraham Y. Skoff, Esq.
Managing Attorney for New Jersey



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