

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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Part of an ongoing series

SEC Adopts Final Rules Establishing Whistleblower Program

July 2011

On May 25, 2011, the Securities and Exchange Commission (SEC) adopted final rules to implement a whistleblower program as established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”). The whistleblower program requires the SEC to pay awards to eligible whistleblowers who voluntarily provide the agency with original information about a violation of the federal securities laws that leads to a successful enforcement action in which the SEC obtains monetary sanctions totaling more than \$1 million.

This *A Closer Look* describes the final rule and its impact. As we discuss below, the goal of the new whistleblower program—“getting high-quality, original information about securities violations directly into the hands of Commission staff”—is likely to be achieved, though with significant foreseeable impact on companies’ existing compliance programs. In our view, companies should take steps now to assure that they have strong compliance programs in place to prevent possible violations, as well as processes to review whistleblower allegations in a timely and effective manner.

Background

Section 922 of Dodd-Frank amended the Securities Exchange Act of 1934 (“the Exchange Act”) to add a new section called “Securities Whistleblower Incentives and Protection” (Section 21F of the Exchange Act). Section 21F directs the SEC to pay awards, subject to certain limitations and conditions, to whistleblowers who voluntarily provide the SEC with original information that leads to a successful action in which the SEC obtains more than \$1 million in monetary sanctions.

On May 25, in a 3–2 vote, the SEC adopted final rules to implement the whistleblower program. Chairman Mary Schapiro said that the new rules “build upon our efforts over the past two years and our experience with the Sarbanes-Oxley Act—an Act that made great strides in creating whistleblower protections and requiring internal reporting systems at public companies. From that experience, we learned that despite Sarbanes-Oxley, too many people remain silent in the face of fraud. Today’s rules are intended to break the silence of those who see a wrong.” Commissioners Kathleen Casey and Troy Paredes declined to support the rules, citing concerns that they would undermine companies’ internal compliance programs. Commissioner Casey also stated that the rules overestimate “the ability of the Division of Enforcement to triage and manage incoming tips and complaints,” and that such a process will be challenging and strain existing resources. In addition, Commissioner Paredes expressed his view that the process for providing tips to the SEC and obtaining awards will be burdensome and may chill individuals’ efforts to report information.

In its press release, the SEC highlighted its newly created Office of the Whistleblower, mandated by the Dodd-Frank Act. The office, led by Sean McKessy, has been staffed and the Investor Protection Fund has been fully funded.

The rules will become effective on August 12, 2011, and are available at <http://www.gpo.gov/fdsys/pkg/FR-2011-06-13/pdf/2011-13382.pdf>.

Summary of final rules

The final rules:

- Do not require that whistleblowers report potential violations internally to companies’ compliance programs, as many commenters had suggested. The final rules contain measures that are meant to incentivize whistleblowers to utilize their companies’ internal compliance and reporting systems where appropriate.
- Exclude certain categories of persons and information from eligibility for an award, including officials (e.g., senior leaders and managers, lawyers, compliance personnel, auditors) who learn information about misconduct in connection with the company’s processes for identifying, reporting, and addressing possible violations of law. There are, however, broad exceptions that would make these individuals eligible to be whistleblowers.
- Protect whistleblowers from retaliation by employers for reporting information.
- Set forth procedures for submitting information and claims to the SEC, and establish factors to be considered in determining the amount of awards.

Key provisions

Who is a whistleblower?

The final rules define a whistleblower as an individual¹ who provides the SEC with information that 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. To be eligible for protection against retaliation, the whistleblower must have a “reasonable belief” that the information he/she is providing relates to a possible securities law violation.²

The whistleblower program will cover “possible” violations of the federal securities laws (the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940). Thus, the scope of the program will cover a wide range of possible violations, including those relating to: the registration, offer, and sale of securities; securities trading; and the activities of both unregistered and registered securities market participants. A whistleblower may report a violation that has occurred or is ongoing, or that has not yet occurred.

To be eligible for an award, a whistleblower must voluntarily provide the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action or related action in which the SEC obtains monetary sanctions totaling more than \$1 million. Each element is described below.

Voluntarily-submitted information

Whistleblowers are eligible for awards only when they *voluntarily* provide original information about securities violations. A submission is considered voluntary if a whistleblower provides the information to the SEC *before* receiving any request, inquiry, or demand related to the subject matter of the submission from the SEC, the Public Company Accounting Oversight Board (PCAOB), any self-regulatory organization, Congress or any other authority of the federal government, or any state attorney general or securities regulatory authority (“regulatory authorities”). The request, inquiry, or demand could be made in the context of an investigation or, with respect to the SEC, PCAOB, and self-regulatory organizations, as part of an investigation or examination.

A submission will *not* be considered voluntary within the meaning of the rules if the SEC or a regulatory authority directed a request to the whistleblower or his/her representative (lawyer) first.

A submission will also not be considered voluntary if the whistleblower is required to report his/her original information to the SEC as a result of a pre-existing legal duty, a contractual duty owed to the SEC or a regulatory authority, or a duty that arises out of a judicial or administrative order. This includes persons such as independent monitors or consultants

¹ The final rule applies only to individuals. A company or other entity is not eligible to be a whistleblower.

² The “reasonable belief” standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation *and* that this belief is one that a similarly situated employee might reasonably possess. Whistleblower submissions must be made under penalty of perjury.

who may be appointed or retained as a result of SEC or other proceedings with a requirement that they report their findings, conclusions, or other information to the SEC.

A whistleblower's submission will be considered voluntary even if he waits to make the report until after the SEC or another regulator has contacted his/her firm as part of an investigation or examination. For example, an examination request directed to a broker-dealer or investment adviser would not automatically foreclose an employee from submitting a whistleblower form related to the subject matter of the exam. The SEC states that it will carefully scrutinize such submissions when determining whether they "significantly contributed" to a successful enforcement action in view of the fact that regulators had already made a request for information to the employer on the same or related subject matter. If examiners or enforcement investigators interview or request information from a firm employee, for example, the employee could not later make a "voluntary" submission related to the subject matter of the interview.

A whistleblower may also make a "voluntary" report after being contacted for information as part of an internal investigation, or by a regulator not covered by the rules (e.g., foreign securities regulators, state accountancy boards).

What is "original information"?

For a whistleblower's submission to be considered "original information," it must be:

- Derived from his/her independent knowledge or independent analysis
- Not already known to the SEC from any other source, unless the whistleblower is the original source of information
- Not exclusively derived from an allegation made in a judicial or administrative hearing; in a governmental report, hearing, audit, or investigation; or in the news media, unless the whistleblower is the original source of the information
- Provided to the SEC for the first time after July 21, 2010

While a whistleblower cannot rely exclusively on allegations already made in the media or in another public source, and while he or she must apply additional evaluation, assessment or insight, it is not necessary that he/she have direct, first-hand knowledge of the possible violation. Rather, the rules contemplate that some whistleblowers will not themselves be involved in the conduct at issue, but will learn about it through their observations, relationships, or personal due diligence. This category of individuals would include outside analysts and those who analyze information about companies and derive conclusions about possible misconduct.

Information that leads to successful enforcement

To qualify for an award, a whistleblower's information must lead to the successful enforcement by the SEC of a federal court or administrative action in which the agency obtains monetary sanctions totaling more than \$1 million.

A whistleblower's information may be deemed to have led to the successful enforcement if:

1. The information was sufficiently specific, credible, and timely to cause staff to commence an examination, open an investigation, reopen an investigation, or open a new line of inquiry in an existing examination or investigation.
2. The conduct was already under examination or investigation by a regulatory authority and the information contributed significantly to the success of the action.
3. The whistleblower reported original information through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time he/she reported them to the Commission; the entity later provided the whistleblower's information to the SEC; and the information the entity provided satisfies requirements 1 and 2 above.

Internal compliance programs

Notably, to qualify for an award, the final rules *do not* require a whistleblower to first report information internally to an entity's compliance program before reporting it to the SEC. The SEC states in the adopting release that its "primary goal . . . is to encourage the submission of high-quality information to facilitate the effectiveness and efficiency of the Commission's enforcement program," and "[f]or this reason we are not requiring that a whistleblower utilize an available internal compliance program prior to submission to the Commission."

To address industry concerns that internal corporate compliance programs would only survive with a mandatory reporting requirement, the SEC included several provisions in the final rules that it believes will incentivize whistleblowers to first report internally. The SEC stated "compliance with the federal securities laws is promoted when companies have effective programs for identifying, correcting, and self-reporting unlawful conduct by company officers or employees. The objective of this provision is to support, not undermine, the effective functioning of company compliance and related systems by allowing employees to take their concerns about possible violations to appropriate company officials first while still preserving their rights under the Commission's whistleblower program."

The provisions are:

- *Lookback period.* The final rules provide that a whistleblower who reports a possible violation internally may report it to the SEC within 120 days and still be treated as if he/she reported to the SEC at the earlier reporting date.
- *Credit for cooperating with compliance.* In determining the amount of an award to a whistleblower, the final rules provide that the SEC may consider a whistleblower's voluntary participation in a company's internal compliance as a factor in increasing the amount of an award. On the other hand, a whistleblower's interference with a company's compliance program may decrease the amount of an award.
- *Bundling with company report.* A whistleblower who first reports information to his/her company's internal compliance program may be eligible for an award if the company then reports the information to the SEC and the information leads to a successful action. Under this provision, all information submitted by the company will be attributed to the whistleblower even if he/she did not report it to the SEC.

It is quite clear that the SEC's primary goal is to encourage the submission of whistleblower tips to the SEC to facilitate its enforcement efforts, though the SEC also states its intention to provide incentives for whistleblowers to report possible violations internally to company compliance programs in order to "promote the continued development and maintenance of robust compliance programs." It remains to be seen whether in advancing its primary goal to draw whistleblower complaints, these rules will undercut those already functioning and effective internal compliance programs by leaving them in the dark about possible violations, and thus unable to identify the root cause of the violation, take prompt remedial action, implement changes to assure against reoccurrence, and report to senior managers, auditors, investors, and others.

The SEC states its expectation that the SEC staff will, in "appropriate cases," inform the company of the nature of the whistleblower's allegations and give the company an opportunity to investigate the matter and report back to the SEC. Among the factors the SEC will consider in deciding whether to do so are "information [the SEC has] concerning the nature of the alleged conduct, the level at which the conduct allegedly occurred, and the company's existing culture related to corporate governance." The SEC "may also consider information [it has] about the company's internal compliance programs, including what role, if any, internal compliance had in bringing the information to management's or the Commission's attention."

Having a robust compliance program coupled with a strong "tone at the top," effective supervision and ongoing training of employees is still the best way to prevent violations. Companies should take stock of their existing compliance programs and codes of conduct and implement improvements where warranted. Companies will want to focus on internal hotlines and other internal reporting mechanisms to ensure such mechanisms are known by employees, that they are easy to access, and that they may be used without fear of retaliation. Companies that lack a functioning and effective compliance program may face an increase in SEC inquiries arising from whistleblower complaints, as well as increased regulatory scrutiny of their internal compliance efforts.

Companies should take steps now to ensure that they have procedures in place and resources available to make a timely assessment of all whistleblower complaints (both those received directly from a whistleblower and those received via the SEC's whistleblower program) so that they can take quick action to initiate an investigation if warranted. This can include having policies and procedures for the assessment of complaints, having an investigative plan to investigate them in a timely manner, including by using qualified internal audit or external personnel, and having a prepared list of external contacts when the need for an independent third-party investigation arises.

Eligibility for an award: exclusions and exceptions to exclusions

In its final rules, the SEC made substantial changes to the categories of persons and the types of information that are eligible for a whistleblower award. The following "exclusions" apply to narrow categories of individuals whose knowledge does not, in the SEC's view, constitute having the "independent knowledge or analysis" of a whistleblower:

- *Attorneys.* Attorneys are not permitted to use information obtained through confidential attorney-client privilege to make whistleblower claims (unless disclosure of the information is permitted under SEC rules or state bar rules). This exclusion also applies to in-house counsel, who may be eligible for an award only to the extent that their disclosures are in accordance with their ethical obligations and SEC rules. The exclusion for privilege information also extends to non-attorneys who learn information through a confidential attorney-client communication.
- *Senior leaders, managers in the reporting chain.* Whistleblower awards cannot be claimed by officers,³ directors, trustees, or partners of an entity who are informed by another person 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. Examples include learning about a violation because an employee reports misconduct to the designated person, being informed of an allegation of misconduct that was made via the company's hotline, or learning of a report from the company's auditors regarding a potential illegal act. The final rules, however, do not preclude officers and other designated persons from obtaining an award for a whistleblower submission in all circumstances. For example, a company officer would be eligible for a whistleblower award if the officer discovers information indicating that other members of senior management are engaged in securities law violation.
- *Compliance or audit personnel.* Employees whose principal duties involve compliance or internal audit responsibilities are excluded, as are employees of outside firms that are retained to perform compliance or internal audit work for an entity. For example, a compliance officer is subject to the exclusion whether he/she learns about possible violations in the course of a compliance review or another employee reports the information to the compliance officer.
- *Outside firms retained to conduct internal investigations.* Individuals employed by or associated with a firm retained to conduct an internal investigation or inquiry into possible violations of law are excluded.
- *Public accounting firms.* Whistleblower awards cannot be claimed by employees and other persons associated with a public accounting firm working on an engagement required under the federal securities laws, if the information relates to a violation by the engagement client or the client's directors, officers, or other employees. The adopting release states that the rules do not limit an individual from making a specific and credible submission alleging that a public accounting firm violated the federal securities laws or professional standards.
- *Information obtained in violation of criminal law.* Individuals are excluded from claiming whistleblower award if the information they provide has been obtained by means or in a manner that is determined by a US court to violate federal or state criminal law.
- *Foreign government officials.*

³ An officer is defined in the Exchange Act as "a president, vice president, secretary, treasurer, or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated."

- *Information from an excluded person.* Individuals who obtain information from a person who is excluded (as described above) are also excluded unless the information is not excluded from that person's use (i.e., if the person from whom the information was obtained is free to use the information in a submission pursuant to one of the exceptions discussed below) or they provide the SEC with information about possible violations involving that person.

Exceptions

The rules include exceptions that would, in certain instances, render compliance, internal audit personnel, public accountants, and other "excluded" persons (as described above) eligible for whistleblower status:

- *Imminent substantial injury.* A person who would be excluded as described above may make a whistleblower submission if he/she has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors. The adopting release states that in most cases the whistleblower will need to demonstrate that responsible management or governance personnel at the entity were aware of the imminent violation and were not taking steps to prevent it. The SEC also states that "[i]n such cases, we believe it is in the public interest to accept whistleblower submissions and to reward whistleblowers – whether they are officers, directors, auditors, or similar responsible personnel – who give us information that allows us to take enforcement action to prevent substantial injury to the entity or to investors."
- *Conduct that would impede an investigation.* A person who would be excluded as described above may make a whistleblower submission if he/she has a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct. Thus, an officer or individual who is generally excluded will not be subject to exclusion if he/she has a reasonable basis to believe that the entity is destroying documents, improperly influencing witnesses, or engaging in other improper conduct that may hinder an investigation.
- *Four months later.* A person who would be excluded as described above may make a whistleblower submission if at least 120 days have passed since the whistleblower provided the information internally to the relevant entity's audit committee, chief legal officer, or chief compliance officer. Similarly, an excluded person can become a whistleblower after at least 120 days have passed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people were already aware of the information.

The exceptions to the exclusions may in practice be broad, particularly if the alleged violation is ongoing. When a company receives an internal complaint or tip, it should not wait 120 days to initiate an investigation of the allegations. Timing is of the essence. It is in the company's interest to immediately investigate the potential violation so that it can demonstrate to the SEC that it followed its internal reporting policies and addressed the whistleblower's concerns.

Award payment and criteria

If the whistleblower meets the conditions set forth in the final rules, he or she is entitled to an award of between 10% and 30% of the monetary sanctions that the SEC and other authorities are able to collect. The rules make clear that the determination of the amount of an award is solely within the SEC's discretion.

The SEC will consider the following factors in relation to the facts and circumstances of each case, and may increase or decrease the award percentage based on its analysis of these factors. The following criteria may increase a whistleblower's award percentage:

- Significance of information provided by the whistleblower.
- Assistance provided by the whistleblower.
- The SEC's law enforcement interest in deterring securities violations.
- Participation in internal compliance systems.

In determining whether to decrease the amount of an award, the SEC will consider the following factors:

- Culpability or involvement of the whistleblower in matters associated with the SEC's action or related actions.
- Whether the whistleblower unreasonably delayed reporting the securities violations.
- Whether the whistleblower interfered with his/her company's internal compliance and/or reporting systems.

Relationship with the CFTC whistleblower program. The final rules state that the SEC will not make an award to a whistleblower for a related action if he/she has already been granted an award by the Commodity Futures Trading Commission (CFTC) for that same action pursuant to the CFTC's whistleblower award program under the Commodity Exchange Act.

Treatment of related actions. The SEC also will pay an award based on amounts collected in certain "related" actions. A related action is defined as a judicial or administrative action that is brought by the US attorney general, an appropriate regulatory authority, a self-regulatory organization, or a state attorney general in a criminal case, and is based on the same original information that the whistleblower voluntarily provided to the SEC, and that led the SEC to obtain monetary sanctions totaling more than \$1 million.

Aggregation of actions. For purposes of making an award, the SEC will treat two or more administrative or judicial proceedings brought by the SEC as one SEC action if these proceedings arise out of the same nucleus of operative facts. In addition, for purposes of making payments on an action in which the SEC has already made an award, the SEC will treat as part of that same action any subsequent SEC proceeding that, individually, results in a monetary sanction of \$1 million or less, and arises out of the same nucleus of operative facts.

Treatment of culpable whistleblowers

The final rules do not provide amnesty to individuals who provide information to the SEC. Individuals who are convicted of a criminal violation that is related to the SEC action or to a related action may not obtain an award.

In determining whether the required \$1 million threshold has been satisfied for purposes of making an award, the SEC will not take into account any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.

Similarly, if the SEC determines that a whistleblower is eligible for an award, any amounts that the whistleblower or such an entity pays in sanctions as a result of the action or related actions will not be included within the calculation of the amounts collected for purposes of making payments.

Anti-retaliation protections

Under the final 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 he/she is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur.
- Provides the information as described by the Exchange Act.

According to the SEC, as noted above, the “reasonable belief standard” requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation and that this belief is one that a similarly situated employee might reasonably possess. The SEC believes its requirement of a reasonable belief on the part of the whistleblower strikes the appropriate balance between encouraging individuals to provide the SEC with high-quality tips without fear of retaliation, while not encouraging bad faith or frivolous reports or permitting abuse of the anti-retaliation protections.

The retaliation protections apply to a whistleblower regardless of whether or not he/she ultimately meets the requirements, procedures, and conditions to qualify for an award. The rules expressly state that the SEC may enforce the anti-retaliation provisions in an action or proceeding.

Communications

The rules provide that no person may take any action to impede a whistleblower from communicating directly with the SEC staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement. Further, the rules specifically authorize SEC staff to communicate directly with a director, officer, member, agent, or employee without seeking the consent of an entity’s counsel if the director, officer, member, agent, or employee has first initiated communication with the SEC as a whistleblower.

Confidentiality of submissions

The rules adopt the statutory requirement that the SEC may not disclose information that could reasonably be expected to reveal the identity of a whistleblower, except in the following circumstances:

- *In litigation.* Disclosure may be provided when required to a defendant or respondent in connection with a federal court or administrative action that the SEC files or in another public action or proceeding that is filed by an authority to which it provides the information.
- *To other regulators.* When the SEC determines that it is necessary to accomplish the purposes of the Exchange Act and to protect investors, it may provide information to the Department of Justice, an appropriate regulatory authority, a self-regulatory organization, a state attorney general in connection with a criminal investigation, any appropriate state regulatory authority, the PCAOB, or foreign securities and law enforcement authorities. The SEC will determine what assurances of confidentiality it deems appropriate in providing such information to foreign securities and law enforcement authorities.
- *Other uses.* The SEC may make disclosures in accordance with the Privacy Act of 1974.

Anonymous submissions

Whistleblowers may remain anonymous when submitting information to the SEC, as long as the whistleblower is represented by an attorney during the submission of information and claim for an award, and the attorney's contact information is provided to the SEC. But, before the SEC will pay any award, a whistleblower must disclose his/her identity to the SEC.

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