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SEC Whistleblower Rules Encourage Internal Investigations

A highly controversial provision of the Dodd-Frank Act,¹ prompted by the SEC's alleged mishandling of the Madoff investigation, directs the SEC to reward whistleblowers with a portion of funds collected in successful actions stemming from whistleblower tips.² On May 25, 2011, the SEC finally adopted controversial rules implementing its whistleblower program, effective July 24, 2011.³ Until now, only information resulting in successful insider-trading enforcement actions was eligible for SEC bounties. Tipping the SEC off to a Ponzi scheme, as Harry Markopolos tried—and failed—with respect to Madoff, or to any other violative activity not related to trading on material non-public information, did not, in the past, promise any cash to the tipper. That has changed, and with its new Office of the Whistleblower, the SEC may be better able to identify high-quality tips and act on them quickly. One can hope that the SEC will be more transparent about its sources and processes for tracking tips than in the past.⁴

Corporate America had been holding its breath as the SEC staff went through a prolonged, laborious rulemaking process to effect the statutory whistleblowing provision, Section 21F of the Securities Exchange Act of 1934, as amended. Section 21F sets forth a basic framework: (1) a whistleblower, (2) who voluntarily provides the SEC, (3) with original information, (4) that leads to a successful enforcement by the SEC that results in monetary sanctions of more than \$1M, (5) may be awarded 10% to 30% of any amounts recovered by the SEC. Congress left to the SEC the task of developing and issuing rules to implement the statute.

Unpopular Proposed Rules

Proposed rules published for comment in November 2010⁵ were unpopular with both affected camps: companies and whistleblowers. Business interests, basically unhappy with Section 21F and looking to the SEC to restrict its application, predicted

¹ “Securities Whistleblower Incentives and Protection,” Section 922, Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010.

² The CFTC has also put out rules for comment which still are not final. Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act, 76 Fed. Reg. 4569 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pt. 165).

³ Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (May 25, 2011) (“Adopting Release”).

⁴ See Kaja Whitehouse, *SEC Whistleblower Call Draws Few Tipsters*, N.Y. POST (Feb. 23, 2011, 01:20 EST), (The SEC received 168 complaints in first six months (July 22, 2010 through Feb. 2, 2011); 1,500 to 2,000 complaints to National Whistleblowers Center annually; 100 tips in same time period to Stuart Meissner, attorney with whistleblower practice; DOJ fraud line (cited as analogous agency) received 700 complaints in 2010, 565 complaints in 2009); Melanie Waddell, *SEC's Mary Schapiro Talks About Whistleblower Office, 12b-1: Exclusive Interview*, ADVISORONE (Apr. 26, 2011) (“Since creating the whistleblower office, the SEC has seen a ‘significant increase in high-quality tips,’ according to SEC spokesman John Nester.”).

⁵ Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities and Exchange Act of 1934, Release No. 34-63237 (“Proposing Release”).

For further information about this Client Alert, please contact:

Wayne M. Aaron
212-530-5284
waaron@milbank.com

Dorothy Heyl
212-530-5088
dhey@milbank.com

David Schwartz
212-530-5260
dschwartz@milbank.com

The authors gratefully acknowledge the assistance of Nicole Nielson, Summer Associate, in preparing this Client Alert.

You may also contact any member of Milbank's Litigation Group. Contact information can be found at the end of this Client Alert or in the Practice Areas section at www.milbank.com.

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a deluge of frivolous SEC complaints by employees lured by the prospect of hefty bounties. On the other side, lawyers representing potential whistleblowers criticized the proposed rules as unfriendly to whistleblowers. Both constituencies were vocal in their disagreement with the proposed rules.

One issue in particular divided both sides: whether current employees should be required to report issues internally, using whistleblower hotlines and procedures required by Sarbanes-Oxley or otherwise in place, in order to qualify for an award.⁶ Such a requirement for internal reporting (either prior to or simultaneously with reporting to the SEC) was not a feature of the proposed rules, although the SEC asked for comment on how internal reporting might be encouraged. Business interests protested that internal compliance systems would be rendered ineffective unless awards were contingent on prior internal reporting. Supporting this line of argument was the Chamber of Commerce, which strenuously advocated for an internal reporting requirement. In its view, “[n]ot informing the company of a potential fraud and waiting for the SEC to act is the equivalent of not calling the firefighters down the street to put out a raging fire and instead calling the lawyers from the next town to sue over the fire instead.” On the other side of the aisle, the whistleblower lobby argued just as strenuously that a requirement for internal reporting would gut the statute.

In the final rule, the SEC declined to make awards contingent on internal reporting. The two Republicans, Commissioners Kathleen Casey and Troy Paredes, dissented, and the rule passed on a politically polarized vote of 3 to 2. The SEC, however, did take make a number of amendments in the final rules designed to encourage internal reporting, while not making it mandatory.

It remains to be seen whether the final whistleblower rules will be challenged in court, or, more dramatically, whether Section 21F will be modified through legislative action.⁷

Key Elements of the Whistleblower Rules

These are the essential elements of the statute, as now implemented and clarified in the whistleblower rules:

- “**Whistleblowers**” are defined as individuals (not corporations, but simply natural persons) who provide the SEC with information relating to possible violations of the securities laws that either have occurred, are ongoing, or are about to occur. Certain types of individuals, such as government officials, are not eligible for awards.
- Information provided to the SEC must be “**original information**,” meaning information derived from the whistleblower’s “independent knowledge” or “independent analysis,” both of which are defined in the whistleblower rules.
- Recoveries (including penalties, disgorgement, and pre- and post-judgment interest) stemming from actions based on the information must **exceed \$1 million**.
- If a whistleblower does report internally to the company, there is a “lookback period” of **120 days**, essentially a tolling period during which the internal reporter maintains priority status for the purpose of deciding eligibility for an award. In other words, if a whistleblower reports to the SEC within 120 days of having reported internally, the SEC uses the internal reporting date (not the later reporting date to the SEC) to determine his or her priority over another prospective whistleblower who reports the same information directly to the SEC (but not internally) during the intervening period.⁸

This provision is intended to encourage employees to report internally and motivate employers to investigate complaints quickly and then make responsible self-reporting decisions.

- The factors for determining the percentage amount of the award (from 10% to 30%) include whether or not the whistleblower utilized any internal reporting systems prior to reporting to the SEC, and whether the whistleblower assisted any internal inquiry or, conversely, interfered with compliance and reporting systems. This was a change added to the final SEC rule, further designed to encourage internal reporting.

⁶ Like many who volunteer information to the SEC, Markopolos was not an employee of the company on which he reported. In fact, one of the SEC’s best source for tips, complaints, and referrals has traditionally been former, not current, employees.

⁷ Congressman Michael Grimm (R-NY) of Staten Island held a hearing and drafted a bill to amend Section 21F that would require internal reporting subject to limited exceptions, would eliminate the minimum 10% award, would exclude culpable whistleblowers from receipt of award, would prohibit contingency fees for attorneys, and would require the SEC to notify entities of the whistleblower’s information prior to an enforcement action. A press release is available on his website (last visited May 31, 2011).

⁸ This means that even if, in the interim, another whistleblower makes a submission that causes the staff to begin an investigation into the same matter, the whistleblower who had first reported internally will be considered the first whistleblower who came to the Commission with “original information,” assuming that the information would have been sufficiently specific and credible to have caused the staff to begin an investigation.

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- An officer, director, auditor or other designated persons can, in some circumstances, become a “whistleblower” after at least 120 days have elapsed since receipt of information of a possible violation of the securities laws by the company’s audit committee (or equivalent gatekeeper).⁹
- If a whistleblower reports first internally, and the company later self-reports (or the whistleblower reports to the SEC simultaneously with reporting internally and the company provides the SEC with results of an audit or investigation initiated in whole or in part in response to the whistleblower’s information), the whistleblower could possibly receive a substantially higher recovery than if the whistleblower reported only to the SEC. In other words, this is another approach by the SEC to incentivize whistleblowers to first report issues internally by giving the whistleblowers “credit” for the “original information” that is disclosed to the SEC.¹⁰

Company Reporting Policies and the Whistleblower Rules

Under the whistleblower rules, companies will benefit from policies and procedures that encourage employees to report possible securities law violations internally, either anonymously or not. Now is the time for companies to ascertain whether their mechanisms for internal reporting are user-friendly and to evaluate the method for following up on such internal complaints.

The SEC has made clear that proper documentation of compliance procedures is an important feature of a robust internal compliance system. If a complaint is frivolous, the subject company wants to have a thorough, objective report supporting that conclusion in hand should the employee subsequently report to the SEC. Conversely, if the complaint turns out to have some merit, and an internal inquiry turns up evidence of fraud or other materially significant conduct, the company benefits from self-reporting to the SEC, in terms of now-standard rewards for cooperation.¹¹ (And since it is unlikely that a complaining employee would not report a viable complaint to the SEC, an SEC investigation is likely inevitable). Either way, the company that acts diligently to investigate internally reported claims will be well-prepared to address any further regulatory inquiries in an efficient and cost-effective manner.

Companies need to be very aware of the new 120-day “deadline,” which could pose a problem for an internal inquiry that involves analyzing complex or extensive facts. A whistleblower who internally reports will necessarily report to the SEC within 120 days to preserve his or her priority. In some cases, the whistleblower has no incentive to advise the company on his or her ongoing intentions and some whistleblowers could elect to report to the SEC before the end of the 120-day period. Thus, if the company’s internal investigation is not completed well in advance of 120 days, the company will not be in a strong position to self-report any violations to the SEC, and the whistleblower may well report to the SEC ahead of the company, undermining any “self-reporting” or cooperation credit of which the company might otherwise avail itself. The SEC’s solution to this problem is that the company self-report *before* the investigation is completed. This is, at best, an unattractive option, but one that companies will need to consider seriously if they want to get full credit for cooperation and limit their exposure from a whistleblower, who could potentially be shaping the SEC’s view of the facts.

Feedback was not a requirement under Sarbanes-Oxley whistleblowing procedures, but is extremely important now. Companies have an incentive to keep potential whistleblowers in the loop, if for no other reason than to reassure employees that complaints are being taken seriously. Corporate procedures should adequately provide for reasonable feedback to those lodging complaints internally, consistent with the need for discretion while conducting an internal investigation. For example, if a company determines that the matter complained about does not rise to the level of a securities law violation, but takes necessary corrective steps, it clearly is in the company’s interest to advise the complaining employee that the complaint does not meet the standards for recovery under the whistleblower rules. (Of course, the prospective whistleblower may not be convinced and report to the SEC anyway).

⁹ 17 C.F.R. § 240.21F(4)(b)(4)(iii) (2011).

¹⁰ 17 C.F.R. § 240.21F(4)(c)(3).

¹¹ SEC Cooperation Initiative, described at <http://www.sec.gov/spotlight/enfcoopinitiative.shtml>.

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SEC Enforcement of Anti-Retaliation Protections

One interesting aspect of the whistleblower rules is that the SEC has declared itself the enforcer of Section 21F's anti-retaliation prohibition,¹² a point not dealt with in the earlier proposed rules or the statute. Rule 21F-2(b)(2) makes clear that the whistleblower provisions of Dodd-Frank "including any rules promulgated thereunder, shall be enforceable in an action or proceeding brought by the Commission." The Adopting Release clarifies that this provision applies to the anti-retaliation provisions (among others), stating unequivocally that: "we have enforcement authority for violations of Section 21F(h)(1) by employers who retaliate against employees for making reports in accordance with Section 21F."¹³

Here is the scenario to be concerned about: an employee reports a possible securities law violation to the SEC, but does not inform the employer. If the employee's responsibilities are later reduced or changed in any way, the employee could further allege that those actions were in retaliation for the whistleblowing. Further, the definition of "whistleblower" - solely as it applies to the anti-retaliation protections - is much more favorable to the prospective whistleblower. All that need be shown is whether the employee had "a reasonable belief" that the information provided to the SEC related to a possible securities law violation that either had occurred, was occurring, *or even was about to occur*. To determine whistleblower status for anti-retaliation protections, it does not matter whether the SEC actually investigated the underlying complaint, let alone brought an enforcement action resulting in an award to the employee. But companies have a more basic concern: not only must they address and respond to the underlying allegations (whether identified by the whistleblower or the SEC), but they also may find themselves having to bear the expense and distraction of a separate SEC investigation for alleged violations of the anti-retaliation provisions. One would hope that with the SEC's lack of resources and funding this new kind of investigation would be reserved for the extreme case (and further hope that the facts here -- where the company neither knew of the whistleblowing claim nor retaliated against the employee -- do not present that case).

Another key take-away from this provision is the following: while whistleblowers cannot be the subject of any adverse employment actions that are taken because of any lawful act by the whistleblower to provide information to the SEC, adverse employment actions taken for any other reasons are *not* covered by these new SEC rules. In other words, companies need to document each and every step with an employee to have a clear record to justify a termination for reasons not remotely related to "retaliation" but rather simply related to poor performance. In addition, counsel should be consulted before taking adverse actions against any employee who could conceivably qualify as a "whistleblower."

Conclusion

It remains to be seen whether the whistleblower statute and rules actually will result in more SEC complaints or better utilization of such tips by the SEC. The whistleblower rules will provide challenges both for the SEC and companies that must vet and respond to the complaints alleged. While the SEC rules aim to encourage internally reporting first, whistleblower bounties certainly provide an attractive incentive for tips, complaints, and referrals regarding possible securities laws violations such that companies must be prepared to commit the resources to investigate allegations and respond to them appropriately. It is simply too early to tell whether whistleblowers will opt for internal reporting first or simply seek a bounty from the SEC. Finally, the anti-retaliation provisions of the whistleblower rules—and the SEC's separate authority to conduct investigations of suspected violations of them—will require additional corporate resources, both in the form of procedures to prevent retaliation and resources to respond to SEC investigations of possible retaliation, although it is too early to know how much the SEC will use this newly authorized kind of investigation.

¹² 17 C.F.R. § 240.21F(2)(b)(2).

¹³ Adopting release at 18.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any member of our Litigation and Arbitration Group listed below.

New York

Wayne M. Aaron	212-530-5284	waaron@milbank.com
Thomas A. Arena	212-530-5328	tarena@milbank.com
Sander Bak	212-530-5125	sbak@milbank.com
James N. Benedict, <i>Chair</i>	212-530-5696	jbenedict@milbank.com
James G. Cavoli	212-530-5172	jcavoli@milbank.com
Christopher E. Chalsen	212-530-5380	cchalsen@milbank.com
Scott A. Edelman	212-530-5149	sedelman@milbank.com
Christopher J. Gaspar	212-530-5019	cgaspar@milbank.com
David R. Gelfand	212-530-5520	dgelfand@milbank.com
John M. Griem, Jr.	212-530-5429	jpgriem@milbank.com
Douglas W. Henkin	212-530-5393	dhenkin@milbank.com
Michael L. Hirschfeld	212-530-5832	mhirschfeld@milbank.com
Lawrence T. Kass	212-530-5178	lkass@milbank.com
Sean M. Murphy	212-530-5688	smurphy@milbank.com
Daniel Perry	212-530-5083	dperry@milbank.com
Stacey J. Rappaport	212-530-5347	srappaport@milbank.com
Richard Sharp	212-530-5209	rsharp@milbank.com
Alan J. Stone, <i>Practice Group Leader</i>	212-530-5285	astone@milbank.com
Errol B. Taylor	212-530-5545	etaylor@milbank.com
Andrew E. Tomback	212-530-5971	atomback@milbank.com
Fredrick M. Zullo	212-530-5533	fzullo@milbank.com

Washington, DC

David S. Cohen	202-835-7517	dcohen2@milbank.com
Robert J. Koch	202-835-7520	rkoch@milbank.com
Andrew M. Leblanc	202-835-7574	aleblanc@milbank.com
Michael D. Nolan	202-835-7524	mnolan@milbank.com

Los Angeles

Linda Dakin-Grimm	213-892-4404	ldakin-grimm@milbank.com
Robert J. Liubicic	213-892-4525	rliubicic@milbank.com
Jerry L. Marks	213-892-4550	jmarks@milbank.com
Mark Scarsi	213-892-4580	mscarsi@milbank.com

London

Tom Canning	44-20-7615-3047	tcanning@milbank.com
Julian Stait	44-20-7615-3005	jstait@milbank.com