

# SEC whistleblowers will protect investors and earn their awards

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The U.S. Securities and Exchange Commission recently issued final rules that will govern its new whistleblower-reward program when the rules go into effect on Aug. 12. Established by the Dodd-Frank Act's amendments to the Securities Exchange Act of 1934, the program provides much needed incentives that will help employees with inside information overcome their fears of retaliation and report securities violations to management and to the SEC.

Corporate interests have denounced the SEC whistleblower initiative as a "bounty-hunter" program for disgruntled employees and their lawyers who want to "cash in" on corporate employers' mistakes. But the program serves an important public interest. It gives the SEC a powerful new enforcement tool for ferreting out and prosecuting the Madoffs and the Stanfords before they have the chance to ruin the finances of millions of people. Providing cash incentives to whistleblowers not only will encourage compliance with corporate-finance laws, but also will help restore the public's confidence that government regulators can protect them against ruin when they invest in the financial markets. This is critically important in a time when investment-based retirement plans have effectively replaced the defined-benefit pensions that corporations once provided to their employees.

For good reason, corporate employees tend to be unwilling to put their jobs on the line to expose even the very serious types of fraud that have damaged the U.S. economy during the past decade. This fear has grown during the current recession, when good jobs can be very hard to find. The SEC whistleblower program cannot eliminate the fear of losing a job for speaking out, but its financial incentives — awards of 10% to 30% of any amount the SEC collects through enforcement actions that collect above \$1 million — will surely help motivate many whistleblowers who would otherwise be too intimidated by the threat of retaliation to come forward with their information. The law also encourages participation by prohibiting retaliation and by strengthening the anti-retaliation provisions of the Sarbanes-Oxley Act, 18 U.S.C. 1514A.

Even in advance of the Aug. 12 effective date of the final rules, the SEC has been accepting information from whistleblowers since the program went into effect on July 22, 2010, and has begun responding quickly and effectively to high-quality tips. Lawyers representing whistleblowers should be prepared to quickly assess a whistleblower's situation and to advise him or her on the best way to proceed, using the final rules the SEC has issued as a guide. If researched thoroughly and prepared correctly, a whistleblower submission under the new program can help the SEC prosecute violations and also earn

the whistleblower a substantial financial reward. Done incorrectly or without sufficient foundation, a whistleblower submission can fail to result in an enforcement action and thus expose a whistleblower client to the risk of retaliation with no chance of reward. Fortunately for lawyers who represent whistleblowers, the SEC's new rules, along with extensive staff commentary, provide practitioners with what amounts to a 305-page manual for practice before the SEC Office of the Whistleblower.

## **WHO CAN QUALIFY**

The essentials of the program are set forth in the Securities Exchange Act and in the final rules. A whistleblower can qualify for an award under § 21F(b)(1) of the act only by "voluntarily providing" the SEC with information concerning a securities violation, which means that the whistleblower has to provide information to the SEC before it is requested of him by the SEC or certain other authorities. Rule 21F-4(a)(1), (2). Attorneys whose clients have reason to anticipate such a request should submit their information as soon as practicable, bearing in mind the limitations described below.

Only whistleblowers with "original information" about violations of securities laws or the Foreign Corrupt Practices Act qualify for the whistleblower-reward program and anti-retaliation provisions. To qualify as "original information" supporting a claim for an award, the information must be derived from the individual's "independent knowledge" or "independent analysis"; not already known to the SEC from any other source, unless the whistleblower was the original source of the information to that other source (e.g., another agency); and not "exclusively derived" from certain public sources (e.g., government reports, hearings, audits or the news media), unless the whistleblower is a source of the information contained therein. Rule 21F-4(b)(1).

The rules define "independent analysis" fairly broadly to include a whistleblower's "examination and evaluation," conducted alone or with others, of information that might be publicly available, if the analysis reveals information that is not "generally known or available to the public." Rule 21F-4(b)(3). This may include analysis of data by an expert retained by the whistleblower, if such analysis significantly advances an investigation. Adopting Release at 51. A corporate insider may be able to give meaning to figures and data in public documents, such as financial reports, that by themselves would not provide evidence of securities violations. When some of a whistleblower's information is from public sources, the attorney crafting a submission should be sure to include any important "independent analysis" and explain what that analysis adds to an investigation.

## **PRESUMPTIVELY INELIGIBLE**

To promote enforcement of securities laws while also encouraging companies to build effective internal compliance programs, the SEC in its final rules has made certain persons presumptively ineligible for participation in the reward program. An attorney representing a would-be whistleblower should thus review the client's position in or relationship to the company, her job responsibilities and functions, and how she came into possession of her information in order to determine whether she is presumptively ineligible.

Such a review will often be needed because those persons who are presumptively excluded will tend to be the same people who have relevant information about securities violations: officers, directors, trustees or partners who learned the information in connection with the entity's processes for identifying and addressing unlawful conduct, Rule 21F-4(b)(4)(iii)(A); employees and contractors whose principal duties are in compliance or internal audit, Rule 21F-4(b)(4)(iii)(B); those employed by a firm retained to investigate possible violations of the law, Rule 21F-4(b)(4)(iii)(C); and those employed by a public accounting firm performing an engagement required by federal securities laws, who learn of a potential violation by the engagement client through the engagement. Rule 21F-4(b)(4)(iii)(D). Also presumptively excluded are individuals who obtain information through a communication subject to attorney-client privilege, unless disclosure would be permitted due to waiver or by a rule of the SEC or state rules governing attorneys, as well as those who obtain information in connection with their own or their firm's legal representation of a client, unless disclosure would be permitted as described above. Rule 21F-4(b)(4)(i), (ii).

For the nonattorneys described above, it may still be possible to file a submission with the SEC under certain circumstances. A presumptively excluded whistleblower may be exempt from exclusion because she reported her concerns internally and has waited 120 days before filing with the SEC, Rule 21F-4(b)(4)(v)(C); or because she has reason to believe that investors may suffer imminent "substantial injury," Rule 21F-4(b)(4)(v)(A); or because she reasonably believes the company is taking action likely to impede an investigation, Rule 21F-4(b)(4)(v)(B). A whistleblower can also avoid the exclusion categories if she has obtained her information outside her role in legal, compliance or audit functions. Attorneys who are advising compliance officers or auditors, or who are advising high-level employees who learn of violations in connection with internal-compliance mechanisms, will need to pay close attention to these rules in order to determine whether, and if so when, their clients can submit tips to the SEC and qualify for awards.

Regardless of any other considerations in practicing before the SEC Office of the Whistleblower, practitioners should take special care not to include any attorney-client privileged communications in any submission to the SEC. The commission will not consider or give credit for privileged information. In fact, consistent with the longer-established practices of the Department of Justice in its investigations of qui tam allegations and of the Internal Revenue Service in handling tips under that agency's whistleblower-reward program, the SEC's receipt of such information may, in itself, delay an investigation or even discourage the SEC from considering the submission at all.

## **INTERNAL COMPLIANCE PROGRAMS**

During the rulemaking process that ended with issuance of the final rules for the program, the corporate interests that commented were unanimous in calling on the SEC to require employees to report their concerns internally before reporting them to the SEC. Whistleblower advocates disagreed, arguing that such a requirement would undermine the program altogether, sort of like the farmer requiring his chickens to speak with the fox before telling the farmer about the theft of hens from the henhouse. The chickens would just keep going missing, and the farmer's investment would always be at risk.

The SEC made the right decision by not requiring whistleblowers to report their concerns internally before speaking with the SEC. The commission pointed out that, although internal compliance programs could play an important role, the main goal of the new program was to assist the SEC in the enforcement of securities laws. Adopting Release at 104. Accordingly, the SEC struck a balance by issuing rules that encourage companies to create (and employees to use) strong internal compliance systems, while at the same time allowing whistleblowers to report directly to the SEC.

The decision whether to go first to an internal compliance program or straight to the SEC is usually a careful balancing act, especially if the whistleblower is still employed: Internal reporting often subjects a whistleblower to retaliation, but it may ultimately entitle her to a larger award. The SEC will consider internal reporting as a factor in determining the size of the award, and the whistleblower can also benefit from all information the company self-reports to the SEC as a result of her internal reporting. Rule 21F-6(a)(4), -4(c)(3). The SEC will afford whistleblower status to individuals as of the date they report information internally, as long as they also provide the same information to the SEC within 120 days. Rule 21F-4(b)(7). The flexibility these rules grant is key in allowing the whistleblower — who can best assess the likelihood of retaliation and who may know about the effectiveness or ineffectiveness of any internal compliance system — to determine how and when to report violations. See Adopting Release at 103.

There are other factors that whistleblower lawyers need to weigh in when advising a client whether to report internally first. In addition to participation in an internal compliance system, factors that might increase an award include the significance of information provided, the degree of assistance the whistleblower provides and the SEC's programmatic interest in the particular securities violations at issue. Key to the SEC's response will be, among other things, whether the conduct at issue involves an industrywide practice, Rule 21F-6(a)(3)(iii); the type, severity and duration of the violations, *id.*; the danger to investors "and others," Rule 21F-6(a)(3)(iv); and the number of entities and individuals who have suffered harm. *Id.* If a whistleblower has particularly good information about a particularly grievous harm, it may not be worth the risk of retaliation to report internally first.

The SEC and its staff have designed a workable program that can have a very positive effect both on corporate governance and on the functioning of U.S. financial markets. The new whistleblower program also provides plaintiffs' employment lawyers with an exciting new opportunity to help their clients do well by doing the right thing. If practitioners choose their cases carefully and pay close attention to the rules, they will assist their clients in protecting investors while also earning awards for their good deeds.

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