Doing Well by Doing the Right Thing

A Whistleblower's Guide to the SEC Whistleblower Program and the New Rules that Can Lead to Rewards for Reporting Securities Violations

by

David J. Marshall[1]

Katz, Marshall & Banks, LLP
1718 Connecticut Ave., N.W.
Sixth Floor
Washington, DC 20009
(202) 299-1140
marshall@kmblegal.com
www.kmblegal.com

(Revised February 15, 2013)

for presentation at

Georgia's New 2012 False Claims Act, and
Updates on Qui Tam, SEC and IRS Whistleblower Claims

a program of the
Institute of Continuing Legal Education in Georgia
March 20, 2013
Atlanta, Georgia

---

[1] David J. Marshall is a partner with Katz, Marshall & Banks, LLP, a whistleblower and employment-law firm based in Washington, D.C. He specializes in the representation of whistleblowers in tips submitted to the Securities and Exchange Commission through the SEC Office of the Whistleblower. Mr. Marshall also represents whistleblowers in the Internal Revenue Service's whistleblower program, in *qui tam* lawsuits under the False Claims Act, and in whistleblower-retaliation cases filed under the Sarbanes-Oxley Act, the Dodd-Frank Act and other federal and state laws. Alison Asarnow, an associate with Katz, Marshall & Banks, LLP, also specializes in the representation of whistleblowers in such cases, and contributed to this article.

TABLE OF CONTENTS

On May 25, 2011, after nearly a year of intense debate between whistleblower advocates and business interests, the Securities and Exchange Commission ("SEC") issued final rules that will govern the commission's newly created whistleblower program. Congress directed the SEC to establish the program as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Under the new law, individuals who provide the SEC with original information leading to enforcement actions that result in over $1 million in monetary sanctions will be eligible to receive awards of 10% to 30% of the amount collected.

In the one and one-half years that have passed since the SEC issued the final rules for the program and opened an Office of the Whistleblower, the new initiative has added significantly to the SEC's ability to enforce the nation's securities laws. SEC Chairman Mary Schaprio stated in a press release on August 21, 2012, that since the issuance of the final rules, "We're seeing high-quality tips that are saving our investigators substantial time and resources."[2] The SEC has recently made its first whistleblower award, and the whistleblower protections enacted by the Dodd-Frank Act are helping to ensure that insiders can approach the SEC with information without fear of reprisal.

I. <u>Background</u>

The Dodd-Frank Act is the latest in a series of significant financial reforms that began with passage of the Sarbanes-Oxley Act ("SOX") in 2002. Popular outrage over the greed and corruption exhibited by Enron, MCI and other companies prompted the near-unanimous passage of the earlier law, which provided a detailed, comprehensive set of rules and regulations designed to prevent accounting fraud by publicly traded companies. SOX also contained a whistleblower provision to protect employees from retaliation by their employers for reporting fraud. *See* 18 U.S.C. § 1514A ("SOX 806").

Another wave of financial overhaul and enhanced corporate whistleblower protections accompanied the extraordinary infusion of government funds into the private sector that addressed the sharp downturn of the housing and financial markets in 2008. That crisis was still unfolding when the Bernard Madoff "Ponzi"scandal hit the news and educated large numbers of Americans on the shortcomings in their government's ability to detect and prevent large-scale fraud on investors in the financial markets. The "bailout" legislation that followed included protections for whistleblowers who reported fraud, gross mismanagement, or waste of bailout funds, and in 2009 Congress amended the U.S. False Claims Act as well, making it easier for whistleblowing "relators" to bring *qui tam* actions to assist the U.S. government in recovering monies lost to fraud.

The Dodd-Frank Act of 2010 initiated a massive financial regulatory overhaul that lawmakers hope will restore confidence (and some would say sanity) in U.S. financial markets through a wide range of regulatory measures. The SEC whistleblower program contributes to this effort by incentivizing insiders to come forward with information about securities fraud, giving the SEC a powerful enforcement tool to prevent future Enrons, MCI's and Madoffs from harming the investing public. The new program is now up and running, and the SEC has now

[2] The SEC's press release is available at http://www.sec.gov/news/press/2012/2012-162.htm.

begun paying monetary awards to individuals who report securities violations or unlawful foreign bribes to the commission (discussed *infra*).[3] In an August 21, 2012, press release announcing the first such award, Sean McKessy, head of the SEC Office of the Whistleblower, , stated that the whistleblower office is now receiving "about eight tips" per day.

The SEC whistleblower program has received an enthusiastic welcome from employee-rights advocates and "good-government" groups, but has generated a great deal of concern among large corporations and their law firms. After asking for public comment on its proposed rules for the program in November 2010, the SEC received some 240 comment letters and 1,300 form letters from a broad array of stakeholders. Consumer advocates and the whistleblower community have argued that the program is necessary to prevent the sort of frauds that have damaged the economy in the last decade, largely at the expense of the nation's working people. The whistleblower community notes that corporate employees are in the best position to identify corporate misconduct, but that many are afraid to come forward because the very real risk of derailing their careers far outweighs the rewards, which would be few in the absence of significant financial incentives.

The corporate defense bar and their clients, on the other hand, claim that the SEC whistleblower program, which they call a "bounty-hunter program," serves only to create a perverse incentive for employees to hunt for information about potential corporate fraud or illegalities, disclose nothing to the employer, and then report the information to the government only when the violations have grown to a size that would warrant payment of a large enough "bounty" to justify the risk to their careers. Corporations claim that they have gone to great lengths to create internal reporting mechanisms, as the Sarbanes-Oxley Act required of public companies, only to face a radical new program that they say gives would-be whistleblowers little or no reason to use internal channels that can help management correct minor problems before they become major liabilities.

The final rules that the SEC adopted by a 3-2 vote on May 25, 2011, reflect the commission's effort to address these competing concerns. The business lobby and defense bar remain dissatisfied, as is evident in a number of statements issued by the U.S. Chamber of Commerce and others in response to issuance of the final rules. As a lawyer who represents of whistleblowers in the SEC whistleblower program, this writer believes that the Commission and its staff have designed what can become a workable and very effective program – both in rewarding whistleblowers and in giving corporations incentives to strengthen their compliance programs. This is certainly the view of key personnel who are leading the SEC Office of the Whistleblower. As Whistleblower Office Chief Sean McKessy explained in a speech at Georgetown University on August 11, 2011, the day before the final rules officially took effect, the new program is designed to "bolster, not hamper, the internal compliance systems at companies across the country."[4]

[3] The Dodd-Frank Act established a nearly identical whistleblower program for commodities trading, administered by the Commodities Futures Exchange Commission ("CFTC"). This article focuses on the SEC program, which addresses a wider range of financial activity and has generated more public debate to date.

[4] The Office of the Whistleblower's website (http://www.sec.gov/whistleblower) contains a

Those who are interested in the ongoing policy discussion surrounding the SEC whistleblower program will find a comprehensive summary of the issues and their resolution in the Adopting Release that the SEC issued with the new rules and has made available on its website.[5] The remainder of this article will provide practitioners with an overview of the key laws and rules governing the SEC whistleblower program, with a focus on how to prepare and advance high-quality tips that can help the SEC combat securities violations and at the same time earn rewards for whistleblowers.

II. The SEC Whistleblower Program

Under the new program, the SEC is required to pay awards to eligible whistleblowers who voluntarily provide the commission with original information that leads to a successful enforcement action in which the SEC recovers monetary sanctions in an amount over $1,000,000, which can include disgorgement, penalties, fines and interest. If the whistleblower meets these and other criteria described below, he or she is entitled to an award of 10% to 30% of the amount recovered by the SEC or by certain other authorities in "related actions." These awards are potentially quite substantial, as SEC sanctions against companies have run into the tens and even hundreds of millions of dollars in recent years. The SEC has set aside some $450 million to fund payments to whistleblowers.

On August 21, 2012, the SEC handed out its first award under the new "bounty" program. *See* Press Release, SEC Issues First Whistleblower Program Award (Aug. 21, 2012), *available at* http://www.sec.gov/news/press/2012/2012-162.htm. The unidentified whistleblower received nearly $50,000, which represented 30% of the amount collected at the time in the SEC enforcement action, and the maximum percentage payout under the law. *Id.* The whistleblower's disclosures resulted in the court ordering more than $1 million in sanctions, of which some $150,000 had been collected at the time of the press release. *Id.* The release noted that any increase in the sanctions collected, or any increase in the sanctions ordered as a result of the court issuing a final judgment against other defendants, would increase the whistleblower's award. *Id.* The SEC rejected the claim of a second individual seeking an award in this same matter "because the information provided did not lead to or significantly contribute to the SEC's enforcement action." *Id.*

---

wealth of information about the Commission's whistleblower program and enforcement practices. A transcript of Mr. McKessy's speech at Georgetown University is available on the SEC's website at http://www.sec.gov/news/speech/2011/spch081111sxm.htm.

[5] The Adopting Release and the final rules, a combined 305 pages, are available on the SEC's website at http://www.sec.gov/rules/final/2011/34-64545.pdf. The text of the rules themselves begins on page 241. The rules are codified at 17 C.F.R. pt. 240 and 249 (2012), but this article, like most written on the subject, uses instead the numbering system used in the rules as issued by the Adopting Release that explains them.

A. Whistleblower Status

The Dodd-Frank Act defines a "whistleblower" as an "individual … or two or more individuals acting jointly." Section 21F(a)(6). The final rules make it clear that a corporation or other such entity is not eligible for whistleblower status. Rule 21-F2(a).

1. "Voluntarily Provide"

In order to qualify for a reward under Section 21F(b)(1) of the Act, [6] a whistleblower must "voluntarily provide" the SEC with information concerning a securities violation. The SEC will view such information as provided voluntarily only if the whistleblower provides it to the Commission before he has received a request, inquiry or demand for the same from: 1) the SEC, or 2) connection with an investigation, inspection or examination by the Public Company Accounting Oversight Board or a self-regulatory organization, or 3) related to an investigation by Congress, another federal agency or authority, or a state attorney general or securities regulator. Rule 21F-4(a)(1), (2).

The final rules address a concern among whistleblower advocates who pointed out that the proposed rules had suggested a whistleblower might lose eligibility because the SEC or another of the agencies listed above had directed an inquiry or request to his employer and not to him individually. Given that such requests or demands are often drafted so as to arguably apply to a large number of employees (and to broad categories of information), this reading of "voluntary" would have barred many corporate employees from participation in the program. The final rules make it clear that a whistleblower will be deemed to have submitted information "voluntarily" as long as an official inquiry is not directed to him as an individual. *Id.*

If the whistleblower is obligated to report his information to the SEC as a result of a pre-existing duty to the commission or to one of the other entities described above, whether by contract or by court or administrative order, his information will not be considered voluntary and he will not be entitled to an award. Rule 21F-4(a)(3). This disqualification is not triggered by an employee's contractual obligation to his employer or another third party, Adopting Release at 36-37, or by the employee's receipt of a request for the same or related information from his employer as part of an internal investigation. *Id.* at 35. This means that an employer cannot remove the incentives that are key to the whistleblower program's effectiveness by simply requiring all employees to sign agreements requiring them to report any perceived securities violations to the SEC.

2. "Original Information"

In order to qualify as "original information" that will support a claim for an award, the whistleblower's tip must consist of information that is 1) derived from the individual's "independent knowledge" or "independent analysis," 2) not already known to the SEC from any other source (unless the whistleblower is the original source of the information, such as where

[6] Section 922 of the Dodd-Frank Act amended the Securities Exchange Act of 1934 to add Section 21F, which establishes the whistleblower award program. Citations to the "Act" herein are to the Exchange Act.

she had reported the information first to the Department of Justice, which passed the information to the SEC), and 3) not “exclusively derived” from certain public sources, including government reports, hearings, audits or investigation, or the news media, unless the whistleblower is a source of the information contained therein. Rule 21F-4(b)(1).

Independent Knowledge and Independent Analysis

Rule 21F-4(b)(2) defines “independent knowledge” simply as “factual information … this is not derived from publicly available sources.” The whistleblower may have observed the facts first-hand, but may also some into possession of the knowledge through her “experiences” or communications. This suggests that the whistleblower can have “independent knowledge” of facts despite having learned them from someone else such as a co-worker, customer or client, as long as that third person is a company attorney, compliance officer or other representative who would be ineligible for a reward under Rule 21F-4(b)(4), discussed below

In declining to heed the warning of business-side commentators that allowing tips based on third-party information would encourage frivolous claims, the SEC noted that excluding such information could deprive the Commission of highly probative information that could aid significantly in an enforcement action. Adopting Release at 47. The SEC noted that Congress had recently amended the False Claims Act to remove a similar requirement that a *qui tam* relator posses “direct” (or first-hand) knowledge of the facts. *Id.* n. 104.

“Independent analysis” refers to a whistleblower’s “examination and evaluation,” conducted by herself 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 might include, for example, expert analysis of data that could significantly advance an investigation. Adopting Release at 51.

Exclusions from Independent Knowledge and Analysis

Consistent with its goal of promoting enforcement of securities laws while also recognizing a company’s efforts to build and maintain an effective internal compliance program, the SEC has designated information in the possession of certain categories of employees and other individuals as not being derived from independent knowledge or analysis, making these individuals presumptively ineligible for participation in the whistleblower-reward program. Two of the exclusions that are carved out apply specifically to attorneys, both in-house and retained, and to non-attorneys who possess privileged information. The rules exclude:

- Information obtained 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, Rule 21F-4(b)(4)(i); and

- Information obtained in connection with the whistleblower’s (or her firm’s) legal representation of a client, unless disclosure would be permitted as described above, Rule 21F-4(b)(4)(ii).

In addition, the rules make certain individuals ineligible to receive awards in most circumstances because of their roles, formal or otherwise, in the internal compliance functions that the SEC believes are critical to the overall goal of increased adherence to securities laws. The SEC deems information to lack "independent knowledge or analysis" where the person obtained the information because she was:

- An officer, director, trustee or partner who learned the information in connection with the entity's processes for identifying and addressing unlawful conduct, Rule 21F-4(b)(4)(iii)(A);

- An employee or contractor whose principal duties are in compliance or internal audit, Rule 21F-4(b)(4)(iii)(B);

- Employed by a firm retained to investigate possible violations of the law, Rule 21F-4(b)(4)(iii)(C); or

- Employed by a public accounting firm performing an engagement required by federal securities laws, who, through the engagement, obtained information about a violation by the engagement client, Rule 21F-4(b)(4)(iii)(D).

In addition, other individuals who learn information from these categories of persons will not be considered to be providing "original information" if they turn around and report the information to the SEC. Rule 21F-4(b)(4)(vi). Persons who obtain information for a tip using methods that violate criminal laws are also excluded. Rule 21F-4(b)(4)(iv).

The four non-attorney exclusions described above – those for upper-level management, compliance personnel and auditors set forth in Rule 21F-4(b)(4)(iii) – do not apply in all circumstances. The wording of the rules suggests that these persons might have "independent knowledge" as long as they obtain their information outside their roles in compliance, investigation or audit. In addition, the rules provide that these exclusions do not apply, and the person can be eligible for an award, where at least one of the following conditions is present:

- The would-be whistleblower "reasonably believes" that disclosure to the SEC is needed to prevent "substantial injury" to the entity or investors, Rule 21F-4(b)(4)(v)(A);

- The would-be whistleblower "reasonably believes" that the entity is acting in a way that would impede an investigation of the violations, Rule 21F-4(b)(4)(v)(B); or

- At least 120 days have passed since the whistleblower reported her information internally to the audit committee, chief legal officer of other appropriate official of the entity, or since she obtained the information under circumstance indicating that those officials were already aware of the information, Rule 21F-4(b)(4)(v)(C).

In the opinion of the writer, these exceptions strike a reasonable balance between the SEC's need for enforcement and the interests of corporations in maintaining effective legal, compliance and audit functions. While excluding attorneys, compliance personnel and auditors in most circumstances will mean that the SEC and the investing public will never hear from some would-be whistleblowers who have credible knowledge of securities violations, the rules ensure that even these individuals can report their information to the SEC and become eligible for award in certain situations.[7] Where the wrongful conduct is seriously endangering investors, where the entity is destroying evidence, or where upper management have known about the problem for four months or more, the SEC will accept the whistleblower's original information despite her role. Corporations thus face the risk that even those employees they have entrusted with the most damning knowledge of securities violations can earn awards under the SEC whistleblower program. The only way a corporation can mitigate that risk is to make sure it maintains effective and efficient mechanisms for responding promptly to suspected securities violations.

In deciding where to draw the line between those who can earn an award for blowing the whistle on securities violations and those who cannot, the SEC rejected proposals that would have excluded many more, perhaps even most, of those individuals who are most likely able to provide the commission with high-quality tips. As originally proposed, the rules excluded from "independent knowledge" and "independent analysis" any information obtained not just by officers, directors, trustees and partners, but also by anyone with "supervisory" or "governance" responsibilities who was given the information with the expectation that they would do something about it. *See* Adopting Release at 64. The proposed rules also required such persons to wait a "reasonable time" (as opposed to 120 days) before reporting to the SEC.

These proposed rules drew intense criticism from whistleblower advocates, who pointed out correctly that excluding all "supervisory" personnel would effectively undermine the program. The whistleblower bar also criticized the rule as being so vague as to ensure that few supervisors would risk their positions to report to the SEC. At the same time, the proposed rule's exclusion of supervisors and employees with governance responsibilities emboldened big-business interests to call for extending the ban to all variety of positions in operations, finance, technology, credit, risk, product management, and on and on. In the end, the SEC struck a fair balance, [8] adopting narrow exclusions for core, compliance-related personnel and processes while rejecting pressure to deny eligibility to far more employees than Congress could possibly have intended or anticipated.

---

[7] Whistleblower Office Chief Sean McKessy's speech at Georgetown University explains in greater detail the exclusions, and exceptions to the exclusions, that apply to certain categories of individuals, and also sheds light on the policy considerations that frame the exclusions. See http://www.sec.gov/news/speech/2011/spch081111sxm.htm.

[8] *See* Adopting Release at 90 – 92 for the SEC's most comprehensive explanation of these competing interests and how the Commission weighed them in developing the final rules.

B. <u>Rules Designed to Support Internal Compliance Programs</u>

The SEC repeatedly makes it clear that the main purpose of the whistleblower program is to encourage individuals to provide high-quality tips to the Commission. The SEC notes in the Adopting Release at 105 that:

> …the broad objective of the whistleblower program is to enhance the Commission's law enforcement operations by increasing the financial incentives for reporting and lowering the costs and barriers to potential whistleblowers, so that they are more inclined to provide the Commission with timely, useful information that the Commission might not otherwise have received.

With this purpose in mind, the SEC rejected the business lobby's near-unanimous insistence that it require whistleblowers submit their complaints internally before filing them with the SEC. *Id.* at 103. "[W]hile internal compliance programs are valuable," the Commission observed, "they not substitutes for strong law enforcement. I*d.* at 104. The Adopting Release recognizes that whistleblowers might reasonably fear retaliation for raising their concerns, and also notes that law enforcement interests are sometimes better served when the Commission can launch an investigation before the alleged wrongdoers learn about it ans are able to destroy evidence or tamper with potential witnesses. *Id.* For these and related reasons, the SEC leaves it to each whistleblower to decide whether to report first internally or to the SEC. *Id.* at 91 – 92.[9]

At the same time, the Commission has included several provisions in the new rules that are expressly designed to encourage whistleblowers to utilize internal compliance programs. These include:

- Affording whistleblower status to the individual as of the date he reports the information internally, as long as the he provides the same information to the SEC within 120 days. This allows an employee to report internally while preserving his "place in line" for an award from the SEC for 120 days, even if another whistleblower provides the same or related information to the Commisison in the interim. Rule 21F-4(b)(7).

[9] In the view of the author, who has represented financial whistleblowers under the Sarbanes-Oxley Act since 2002, the business community's fears of a rush to report improprieties to regulators is unfounded. In fact, 2012 survey by the Ethics Resource Center confirms that the great majority of whistleblowers report their concerns internally as a first step in attempting to correct perceived illegalities. The survey of several thousand Fortune 500 employees reveals that 45% have witnessed wrongdoing in the workplace, but that only one percent reported the matters first to an external authority. See "National Business Ethics Survey of Fortune 500 Employees: An Investigation into the State of Ethics at America's Most Powerful Companies," Ethics Resource Center 2012, available at http://www.ethics.org/nbes/files/F500FinalWeb.pdf , at 13 – 15.

- Giving a whistleblower full credit for information provided by his employer to the SEC where the employee reports the information internally and the employer investigates and "self-reports" that information (and even additional information that the whistleblower may not have had) to the SEC, and the information supplied by the employer "leads" to a successful enforcement action. Rule 21F-4(c)(3). Whistleblower Office Chief Sean McKessy explained the benefit to the whistleblower in his recent Georgetown speech: "[T]he percentage of the award to the employee could be increased based on the enhanced quality and value of the information uncovered by the company's internal investigation. So the same employee that reported the 'tip of the iceberg' – something is wrong – gets the benefit of the full iceberg – everything that the internal investigation uncovered."[10]

- Treating a whistleblower's participation in an internal compliance and reporting system as a positive factor in determining the amount of the award. Rule 21 F-6(a)(4). Conversely, a whistleblower's interference with internal compliance and reporting may decrease the amount of the award. Rule 21 F-6(b)(3).

These rules provide the whistleblower, who the SEC believes is the best position to determine the effectiveness, or ineffectiveness, of the internal compliance system, flexibility in choosing how to report violations. *See* Adopting Release at 103. The rules enhance the SEC's law enforcement operations by encouraging people who may otherwise be deterred to report violations. This group includes those who will be persuaded to use the internal compliance programs because of new financial incentives who may not have done so otherwise, as well as those who will report directly to the SEC who may not have reported any violations at all if required to go to the company first. *Id.*

The SEC also points out that the rules' incentives to employees to report internally are likely to encourage companies to create and maintain effective internal compliance programs, as whistleblowers are more likely to participate in such a program. *Id.* at 104. Maintaining an effective program is in the best interests of a company because, as the SEC has in past enforcement actions, the Commission will often, upon receiving reports of a violation, notify the company and give it an opportunity to investigate the issue. In deciding whether to give a company that opportunity, the SEC will consider the company's "existing culture related to corporate governance," and, in particular, the effectiveness of the company's internal compliance programs. *Id.* at 92 n. 197.

C. Information that Leads to Successful Enforcement

The final rules clarify the standard for determining when a whistleblower's information has led to a successful investigation, entitling her to an award if the action results in monetary sanctions exceeding $1,000,000. When information concerns conduct not already under investigation or examination by the SEC, it will be considered to have led to successful enforcement if:

[10] See http://www.sec.gov/news/speech/2011/spch081111sxm.htm

- It is “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, Rule 21 F-4(c)(1); and

- The Commission brings a successful judicial or administrative action based in whole or in part on the conduct identified in the original information. Rule 21 F-4(c)(1).

The standard is somewhat higher for information concerning conduct already under investigation or examination. Information will be deemed to have led to successful enforcement if it “significantly contributed” to the success of the action. Rule F-4(c)(2). In determining whether information “significantly contributed” to the success of an investigation, the Commission will consider whether the information allowed the SEC to bring a successful action in significantly less time or with significantly fewer resources, bring additional successful claims, or take action against additional parties. *See* Adopting Release at 100.

As discussed above, information reported by a whistleblower internally can also be credited to the whistleblower and deemed to have led to a successful investigation if it conforms to the criteria in Rule 21F-4(c)(1) or (2). Rule 21 F-4(c)(3).

D. <u>Monetary Sanctions Totaling More than $1 million</u>

Under the final rule, in determining whether recovery in an enforcement action exceeds the $1,000,000 threshold, the word “action” generally means a single judicial or administrative proceeding. Rule 21 F-4(d). However, in certain circumstances actions can be aggregated. The SEC adopted this broad interpretation of the term “action” in accordance with congressional intent to increase the incentives for employees to report violations. Actions may include cases from two or more administrative or judicial proceedings that arise out of a common nucleus of operative facts, and any follow-on proceedings arising out of the same nucleus of operative facts may be aggregated as well. Rule 21 F-4(d)(1). Factors that may be taken into account when determining whether two or more proceedings arise from the same nucleus of operative facts include parties, factual allegations, alleged violations of federal securities laws, or transactions and occurrences. *See* Adopting Release at 110.

Where the SEC has brought a successful enforcement action, the SEC will also issue awards based on amounts collected in “related actions” brought by the Attorney General of the U.S., certain regulatory authorities and self-regulatory organizations, and state attorneys general under certain circumstances. Rule 21F-3. The rule regarding related actions is discussed in detail in the Adopting Release at 20 – 24.

E. <u>Determining the Amount of an Award</u>

The final rules reiterate that the amount of a whistleblower’s award is within the sole discretion of the Commission as long as the award within the 10% to 30% range that Congress established in the Dodd-Frank Act. Rule 21 F-5. The total award cannot exceed 30% limit even where the Commission makes awards to more than one whistleblower. *Id.*

The final rules set forth a number of factors that the SEC may consider when calculating the final award. Factors that might increase an award include participation by the whistleblower in an internal compliance system, the significance of information provided by the whistleblower, the degree of assistance provided by the whistleblower, and the SEC's programmatic interest in the particular securities violations at issue.[11] Rule 21 F-6(a)(1)-(4). Factors that might decrease an award include the culpability of the whistleblower, unreasonable reporting delay, or interference with internal compliance and reporting systems. Rule 21 F-6(b)(1)-(3). In short, the rules enable a whistleblower to maximize his or her award by report violations timely and effectively, to use internal channels where practical, and to assist the SEC as needed.

The rules also balance concerns about culpable whistleblowers receiving awards with the understanding that, at times, those with the best access to information may have participated in wrongdoing at some level. In order to incentivize such whistleblowers to come forward with securities violations, the rules do not exclude culpable whistleblowers from awards altogether, but they do prevent them from recovering from their own misconduct. In determining whether the whistleblower has met the $1,000,000 threshold and in calculating an award, the SEC will exclude any monetary sanctions that the whistleblower is ordered to pay individually or that an entity is ordered to pay based substantially on the conduct of the whistleblower. Rule 21F-16. The rule thus allows culpable whistleblowers, who may be uniquely situated to provide information regarding securities violations, to come forward while not creating incentives that would be encourage them to engage in securities violations.

The first award, which the SEC announced on August 21, 2012,[12] was in the amount of only $50,000, but that represented a full 30% of the amount the SEC had recovered at the time of the award, with additional installments to be made in the event of further recovery. Although the SEC did not make its exact calculus plain, the SEC's press release suggested that the SEC considered the effect of the whistleblower's assistance in leading to an "accelerated pace" of investigation and that this fast pace allowed the SEC to "prevent the fraud from ensnaring additional victims."

From the whistleblower perspective, the SEC's first whistleblower award was an encouraging sign that the Office of the Whistleblower intends to honor its commitment to individuals who come forward with information about securities violations, sometimes at great risk to their careers. The Commission set the award at the top of the allowable range, it paid the whistleblower a first installment long before it had collected the full $1 million that triggered the

---

[11] The SEC's description of its law-enforcement interests provides some guidance to practitioners who are assessing the Commission's likely response to a given "tip." Key to the SEC's response will be, *inter alia*, whether the conduct at issue involves an industry-wide practice, Rule 21F-6(a)(3)(iii); the type, severity, duration and isolated or ongoing nature 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.*

[12] See the SEC's press release announcing the award at http://www.sec.gov/news/press/2012/2012-162.htm.

individual's entitlement to an award, and went to great lengths to keep protect the whistleblower's identity from public disclosure. [13]

III. Anti-Retaliation Provisions

The Dodd-Frank Act significantly expands whistleblower protections for employees who face retaliation for raising concerns about fraud, securities violations and related wrongdoing by their employers. The Act amends the employee-protection provisions of the Sarbanes-Oxley Act ("SOX"), 18 U.S.C. § 1514A, to make them more favorable to employees; creates a new cause of action that a whistleblowing employee can bring in federal court; and, as implemented by the SEC's final rules for the whistleblower program, allows the Commission to use its enforcement powers to hold employers accountable for retaliation. Practitioners who represent employee-whistleblowers before the SEC will want to familiarize themselves with these and other anti-retaliation laws, as their clients may face retaliation, including loss of their jobs, for reporting their employers' securities violations.

A. Amendments to SOX

Section 806 of SOX protects employees of publicly traded companies from retaliation by their employers for reporting certain types of fraud, including fraud on shareholders, and other securities violations. The amendments to SOX Section 806 are in Section 21F(c) of the Dodd-Frank Act, which increases the SOX statute of limitations from 90 days to 180 days, provides for jury trials in SOX cases brought in federal court, and invalidates pre-dispute arbitration agreements to the extent they purport to apply to SOX retaliation claims.

Section 929A of the Dodd-Frank Act also expands SOX 806's coverage to include subsidiary entities of publicly-traded corporations. 18 U.S.C. § 1514A(a). The ARB has issued several opinions post-Dodd Frank finding that this § 929A standard applies to cases filed pre-Dodd Frank or where the adverse action took place pre-Dodd Frank. Generally, these cases have held that § 929A was a clarification of Section 806's existing law. *See Johnson v. Siemens Bldg. Techs., Inc.*, ARB No. 08-032, ALJ No. 2005-SOX-015 (Mar. 31, 2011); *Merton v. Berkshire Hathaway, Inc.*, ARB No. 09-025, ALJ No. 2008-SOX-40 (ARB June 16, 2011) (ARB vacated decision and remanded to ALJ to determine liability consistent with *Johnson*); *Mara v. Sempra Energy Trading, LLC*, ARB No. 10-051, ALJ No. 2009-SOX-18 (June 28, 2011).

The Southern District of New York has held in two cases that § 929A applies even in cases where the employee plaintiff was retaliated against or filed suit prior to the Dodd Frank Act's enactment in 2010. *See Leshinksy v. Telvent GIT, S.A., et al.*, --- F. Supp.2d ---, 2012 WL 2686111 (S.D.N.Y., July 9, 2012) (order denying defendants' motion to dismiss); *Ashmore v. CGI Group Inc. and CGI Federal Inc.*, No. 1:11-cv-08611, 2012 WL 2148899 (S.D.N.Y. June 12, 2012).

[13] For additional commentary on the first SEC whistleblower award, see "SEC's First Whistleblower Award an Encouraging Sign for Whistleblowers," SEC Whistleblower Blog (Aug. 23, 2012) http://www.secwhistleblowerblog.com/sec%e2%80%99s-first-whistleblower-award-an-encouraging-sign-for-whistleblowers/.

Courts have reached differing conclusions on the question of whether the provision voiding pre-dispute arbitration agreements applies retroactively. In *Pezza v. Investors Capital Corp.*, 767 F. Supp. 2d 225 (D. Mass. 2011), the court held that this pre-dispute arbitration provision of the Dodd-Frank Act did apply retroactively, holding that Congress's intent was unclear on this point and that the presumption against retroactivity did not prohibit the statute from being applied retroactively because the arbitration ban was in essence a jurisdictional statute. *Id.* at 223. But other courts have held that this provision is not retroactive. *See Taylor v. Fannie Mae*, 839 F. Supp.2d 259, 263-64 (D.D.C. 2012); *Holmes v. Air Liquide USA LLC*, Civ. Action No. H-11-2580, 2012 WL 267194 (S.D. Tex. Jan. 30, 2012); *Henderson v. Masco Framing Corp.*, No. 3:11-CV-00088, 2011 WL 3022535, at *3-4 (D. Nev. July 22, 2011).

B. New Cause of Action

The new cause of action created by the Dodd-Frank Act is set forth in Section 21F(h)(1)(A), which allows "whistleblowers" to sue in federal court if their employers retaliated against them because they:

i. provide information about their employer to the SEC in accordance with the above-described whistleblower bounty program;

ii. initiate, testify or assist in any investigation related to the program; or

iii. make disclosures "required or protected" under the Sarbanes-Oxley Act, the Securities Exchange Act of 1934, or any other law, rule, or regulation under the jurisdiction of the SEC.

A Dodd-Frank retaliation claim may be filed directly in federal court within three years "after the date when facts material to the right of action are known or reasonably should have been known to the employee" (but subject to a maximum of six years). Section 21F(h)(1)(B)(iii). A whistleblower's remedies include reinstatement, double back pay with interest, attorneys' fees, and the reimbursement of other related litigation expenses. Section 21F(h)(1)(C).

Even though the statute by its terms provides the new cause of action only to "whistleblowers," which Section 21F(a)(6) of the Act defines as individuals who provide information to the SEC, a few courts have held that the third category of the anti-retaliation section extends to individuals whose disclosures are "required or protected" by certain laws within the SEC's jurisdiction, and who have reported internally but not reported their information to the SEC. *See, e.g.*, *Nollner v. Southern Baptist Convention, Inc.*, 852 F. Supp. 2d 986, 992-95 (M.D. Tenn 2012); *Kramer v. Trans-Lux Corp.*, No. 3:11-cv-1424, 2012 WL 4444820, at *3-5 (D. Conn. Sept. 25, 2012); *Egan v. TradingScreen, Inc.* (*Egan I*), No. 10 Civ. 8202, 2011 WL 1672066, at *5 (S.D.N.Y. May 4, 2011). These courts have explained that while the first two categories of protected activity under the anti-retaliation provision, by their own terms, protect only whistleblowers who work with the SEC directly, the third category is silent as to whom the disclosure must be made and that it would be rendered meaningless by a construction requiring contact with the SEC. *See Nollner*, 852 F. Supp. 2d 986 at 993; *Kramer*, 2012 WL 4444820, at *3-5; *Egan I*, 2011 WL 1672066, at *5.

These three decisions are consistent with the SEC's June 13, 2011, interpretive guidance provided in its comments to the final rule. The SEC advises, "[T]he statutory anti-retaliation protections apply to three different categories of whistleblowers, and the third category includes individuals who report to persons or governmental authorities other than the [SEC]." Securities and Exchange Commission, Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300-01 (June 13, 2011) (codified at 17 C.F.R. pts. 240-49).

At least one federal district court has also held that an employee who provides information to someone who then passes it on to the SEC can be considered a "whistleblower" under the statute. *Egan I*, 2011 WL 1672066, at *8-9. Because Egan did not engage in activity protected within the third category of the anti-retaliation provisions, the court evaluated whether he was protected on this alternative ground. *Id.* On a motion to dismiss the plaintiff's amended complaint which asserted the factual basis for this theory, the court held that the plaintiff had failed to provide specific allegations that his reports had been passed on to the SEC by internal investigators at the company, and thus the plaintiff was not a "whistleblower" and had not engaged in protected activity under the statute. *See Egan v. TradingScreen Inc.* (*Egan II*), No. 10-cv-08282, 2011 WL 4344067, at *2-4 (S.D.N.Y. Sept. 12, 2011).

The holdings of these cases are potentially far-reaching as they would allow plaintiffs who have engaged in protected activity under Section 806 of SOX to circumvent the administrative scheme outlined in SOX and take their claims directly to federal court, and to do so with the benefit of a longer statute of limitations (three years for claims filed in court under the Dodd-Frank Act, Section 21F(h)(1)(B)(iii)(bb), versus 180 days under SOX). The question whether other courts will adopt this reasoning will be answered over the next few years.

The court in *Asadi v. G.E. Energy (USA), LLC*, declined to address the question of whether a plaintiff who disclosed to a party other than the SEC qualified as a whistleblower, holding instead that plaintiff's claim failed, *inter alia*, because the Dodd-Frank anti-retaliation provision did not apply extra-territorially. No. 4:12-345, 2012 WL 2522599, at *3-4 (S.D. Tex. June 28, 2012). The court first noted that the provision was silent as to whether it applied extraterritorially, triggering a presumption that it did not apply outside the United States. *Id.* at *4. In contrast, Section 929(P) of Dodd-Frank explicitly granted district courts extraterritorial jurisdiction over certain actions brought by the SEC or the United States government, but by its plain language, did not apply to private actions. *See id.*

C. Enforcement by the SEC

The SEC's final rules allow the Commission to prosecuted violations of the Dodd-Frank anti-retaliation provisions through the Commission's own enforcement actions. Rule 21F-2(b)(2)). Exactly how this will work in connection with enforcement actions the SEC brings based on a whistleblower's "tip" remains to be seen. For those whistleblowers who claim protected activity through participation in the bounty program, the final SEC rules provide that the anti-retaliation provision applies "whether or not [the whistleblower]" meets the "requirements, procedures and conditions to qualify for an award." Rule 21F-2(b)(iii).

The final rules incentivize employees with knowledge of violations to come forward by prohibiting retaliation against whistleblowing employees who have a "reasonable belief" that the information they provide reveals possible securities law violations and have provided the information in a manner consistent with the rules. Rule 21F-2(b). The term "possible violation" was included as an attempt to deter frivolous claims while still protecting those with information regarding a plausible violation. *See* Adopting Release at 12-13. The final rules make it clear that the anti-retaliation protections apply regardless of whether a whistleblower qualifies for an award. *See* Adopting Release at 18.

D. Effect on Confidentiality Agreements

Another important protection for whistleblowers provided by the final rules is found in Rule 240.21F-17(a), which provides:

> No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications.

This groundbreaking rule applies to nearly all confidentiality and non-disclosure agreements that employers require of current employees. It also applies to separation, severance or settlement agreements, which generally include confidentiality provisions. SEC representatives have made clear in discussions with lawyers who represent both whistleblowers and corporations that they intend to enforce this provision stringently. There is no parallel rule in the regulations that govern similar whistleblower programs such as the Internal Revenue Service's whistleblower program or the anti-retaliation provisions of the False Claims Act, although courts have refused to enforce confidentiality agreements in the context of the False Claims Act. *See Head v. The Kane Co.*, 668 F. Supp.2d 146, 152 (D.D.C. 2009).

IV. <u>Things to Think About Before You Tip</u>

Although the SEC whistleblower program went into effect over a year ago with passage of the Dodd-Frank Act, the final rules that established the SEC's Office of the Whistleblower and will guide its handling of whistleblowers' tips were adopted by the SEC only on May 25, 2011, and formally took effect of August 12, 2011. The SEC reports that it has seen a significant increase in the number and quality of tips it has received since the program went into effect, although nothing like the "deluge" that some detractors predicted during the rule-making process. The number of tips can only grow as more insiders who have information about securities violations learn about the program, and as the SEC begins to distribute awards from the $451 million fund it has set up for that purpose.

This author and other lawyers representing whistleblowers before the SEC are finding that the Whistleblower Office is responding promptly to the more high-quality tips it receives. Whistleblowers who prepare strong submissions focusing on violations that fit within the SEC's law-enforcement priorities, and especially those who follow up by contacting the Office of the Whistleblower after filing, can expect an opportunity to meet with SEC staff early on in the process. The following is a partial list of do's and don'ts for practitioners who seek to help their clients make a compelling case for enforcement action by the SEC. These considerations are based on the final rules discussed above (citations omitted here) and on first-hand experience with the SEC whistleblower program to date:

- Determine whether the client has original information about violations of securities laws or the Foreign Corrupt Practices Act. Assess the seriousness of the alleged violations by reviewing past SEC regulatory and enforcement actions, and, where needed, with the help of an expert in such fields as securities regulation, public accounting or financial reporting.

- Review the client's position, job duties, and how he came into possession of his information to determine whether he falls within one of the groups of individuals who are presumptively excluded from the program. This would include attorneys, compliance personnel, and officers or directors who received the information in connection with corporate-governance responsibilities.

- If the client falls into one of the excluded categories, see if the client may be exempt from the exclusion because he reported his concerns internally and has waited 120 days, or because he has reason to believe investors may suffer imminent harm or the company is taking action that is likely to impede an investigation.

- Give careful consideration to whether to advise the client to report internally, keeping in mind that doing so might subject the client to retaliation but might also entitle the client to a larger award, both because he can benefit from additional, related information the company "self-reports" to the SEC and because SEC staff will consider his internal reporting as a factor in determining the size of an award.

- Remember that your client, through you, may file his tip anonymously as long as you follow the procedures set forth in the rules for anonymous submissions.

- Use the SEC-supplied forms and carefully follow the rules that apply to them, as a whistleblower is eligible for a reward only if he follows the prescribed procedures.[14]

- Prepare the client's submission to the SEC with an emphasis on facts about which the client has "independent knowledge" as defined in the final rules above.

- Include any "independent analysis" that you, your client or an expert you retain can apply to other facts, even publicly available ones, in a way that will assist SEC lawyers in an investigation. Keep in mind that your submission cannot be "exclusively derived" from certain public sources, but that SEC investigators will accept and appreciate your analysis of publicly available information if it reveals information that is not publicly available or generally known.

---

[14] This article does not discuss the forms and procedures, but they are spelled out clearly in the final rules, including Rules 21F-1, 21F-2 and 21F-10, and in the sample forms and directions for Form TCR ("Tip, Complaint or Referral") and Form WB-APP ("Application for Award of Original Information") that are appended to the final rules at 278 – 305.

- Take care not to include attorney-client privileged communications in your client's submission to the SEC. The Commission will not consider the information, and its receipt of such communications may in itself delay or even discourage the SEC's consideration of the submission as a whole.

- If you are uncertain about how best to present your client's submission, consult website of the Office of the Whistleblower,[15] which has a great deal of useful information about how to submit a tip and claim an award. That office's staff also answer telephone inquiries about the program and how it works. In addition, the SEC website (www.sec.gov) provides comprehensive, searchable information about securities laws, comment letters to issuers of securities, and past and ongoing Commission enforcement actions that can be very helpful in preparing your tip. You may also want to consult with other attorneys who are representing whistleblowers before the SEC, and who have first-hand experience with the SEC's handling of tips under the new program.

[15] http://www.sec.gov/whistleblower