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## SEC Adopts Dodd-Frank Whistleblower Rules

May 26, 2011

Yesterday, after extended contentious debate in the legal and compliance community, the Securities and Exchange Commission voted 3-2 to adopt rules providing for the payment of awards to whistleblowers. Specifically, the rules provide for a bounty of 10% to 30% of the aggregate monetary recovery from government enforcement actions for persons who voluntarily provide the SEC with original information about potential violations of the federal securities laws that leads to a successful enforcement action, resulting in sanctions of \$1 million or more. The final rulemaking release, SEC Release No. 34-64545 is available at <http://www.sec.gov/rules/final/2011/34-64545.pdf> and will become effective 60 days after publication in the Federal Register.

The most notable changes to the originally proposed rules demonstrate some acknowledgement by the SEC that the new whistleblower program has the potential to undermine the effectiveness of internal compliance programs. The final rules give whistleblowers certain incentives to report information internally before reporting to the SEC, but they do not require such internal reporting in contrast to the expressed preferences of numerous commentators from the business community. The final rules—while not requiring internal reporting—allow whistleblowers who first report internally to receive an award even if the employer is then the first to report the same information to the SEC. The final rules also allow the SEC to consider a whistleblower's participation in or interference with the internal compliance process in determining the amount of the award.

The Dodd-Frank Act has already had an impact on whistleblower activity. Since the Act passed, the SEC has seen an increase in both the volume and quality of whistleblower tips. Our expectation is that this trend will continue as the program generates publicity and, particularly, once the SEC begins paying awards. The changes to the rules make it more important than ever that companies study their internal compliance programs to ensure that they are comprehensive, facilitate internal reporting on a wide range of issues, and are designed to respond to whistleblower complaints rapidly and efficiently.

### WHO CAN BE A WHISTLEBLOWER?

Under the new rules, a whistleblower is any individual who provides information to the SEC regarding a possible violation of the securities laws that has occurred, is ongoing or that is about to occur. An eligible whistleblower may be an employee, agent or someone else outside the company who provides relevant information. The rules also allow anonymous reporting, provided that the anonymous reporting is done through counsel.

### WHAT CONSTITUTES VOLUNTARY DISCLOSURE?

An eligible whistleblower must provide information to the SEC voluntarily, that is, not in response to a government agency request to the whistleblower for information that relates to the subject matter of the whistleblower's submission. Contrary to the proposed rules, the final rules enable an employee to become an eligible whistleblower even if the SEC has already requested similar information from the whistleblower's employer. Accordingly, controlling information flow in the course of responding to a government inquiry will become particularly important to ensure that employees do not misuse information that they may learn through rumors that often flow under these circumstances. Information submitted by individuals pursuant to a pre-existing legal or contractual duty to report violations to the SEC or certain other federal authorities specified in the rules will not be considered "voluntary."

**"For an agency with limited resources like the SEC, I believe it is critical to be able to leverage the resources of people who may have first-hand information about potential violations."**  
— SEC Chairman Mary Schapiro, May 25, 2011

## WHAT IS ORIGINAL INFORMATION?

A whistleblower must provide original information to be eligible for an award. Information is original if it is derived from either the whistleblower's "independent knowledge" or "independent analysis" and is not already known to the SEC from any other source. First-hand knowledge is not required; original information can be derived from the observations and experiences of others. Importantly, however, the new rules exclude from the definition of original information that which is obtained by individuals, such as officers and directors, lawyers and auditors, who learn the information in the course of satisfying their obligation to conduct internal investigations or otherwise identify wrongdoing. Nevertheless, these individuals are eligible to provide original information if they have:

- a reasonable basis to believe that disclosure of the information is necessary to prevent substantial injury to the financial interest or property of the company or investors;
- a reasonable basis to believe that the company is engaged in conduct that will impede an investigation of the misconduct; or
- 120 days have elapsed since such individuals either reported the violation to the appropriate company personnel or received such information under circumstances indicating that the appropriate company personnel were already aware of it.

However, consistent with long-standing policy in the Division of Enforcement, the rules state explicitly that they are not designed to undermine the protections of the attorney-client privilege. Accordingly, to protect the internal investigative process, information protected by the attorney-client privilege—such as information learned by an employee in an investigative interview—will not qualify as original information.

## IN WHAT CIRCUMSTANCES WILL ORIGINAL INFORMATION BE CONSIDERED TO “LEAD TO A SUCCESSFUL ENFORCEMENT ACTION”?

To be eligible for a whistleblower award, the information provided must:

- be sufficiently specific, credible and timely to cause the staff to commence a new investigation, reopen a closed investigation or pursue an inquiry along a new channel of an ongoing investigation;
- “significantly contribute” to the success of an enforcement action concerning conduct already under investigation; or
- be provided to an employer concurrently or before the submission of such information to the SEC and subsequently cause the company to conduct an investigation and disclose information directly to the SEC such that it satisfies one of the first two prongs.

This final scenario represents a significant, new feature of the final rules which should both enhance the incentives for whistleblowers to report internally while highlighting the importance of having an open, well-functioning compliance program that encourages such whistleblower reports.

## WHAT PROTECTIONS DO WHISTLEBLOWERS HAVE?

In order to encourage whistleblowers to come forward with valuable information, the new rules prohibit retaliation by employers and provide whistleblowers a private cause of action in the event that they are discharged or discriminated against by their employers. These measures enhance similar provisions found in the Sarbanes-Oxley Act by increasing the possible recovery by the whistleblower to twice back pay and expanding application of the protection to all whistleblowers rather than only those whose information leads to a successful enforcement action. The rules also state that the SEC may enforce the anti-retaliation provisions provided under the Dodd-Frank Act. However, in order to take advantage of the anti-retaliation protections, a whistleblower must possess a “reasonable belief” that the information provided relates to a possible securities law violation.

## HOW WILL AWARDS BE DETERMINED?

The amount of a whistleblower award will be subject to highly individualized assessments made by the Claims Review Staff at the SEC's new Office of the Whistleblower. The rules provide that the award must be between 10% and 30% of the aggregate monetary recovery by the SEC and/or a “related action” initiated by another government agency, with various factors increasing or decreasing the award percentage. Notably, one factor that weighs in favor of a higher award is whether the whistleblower used internal compliance processes,

while a factor that cuts the other way is whether the whistleblower interfered with such processes. To further encourage the use of internal compliance processes, the rules allow for an employee to report information internally while preserving his or her “place in line” for a possible award from the SEC if the employee decides to disclose the same information to the SEC within 120 days of such internal report, a departure from the proposed rules which only provided a 90-day window.

#### **WHAT HAPPENS NEXT?**

The new rules will take effect 60 days after their publication in the Federal Register. In anticipation of today’s SEC vote, Representative Michael Grimm (R., N.Y.) circulated draft legislation on May 11, 2011, that would amend the Dodd-Frank Act to require a whistleblower to first report fraud through an internal compliance program before being eligible to receive an award under the program. Regardless of the outcome of this legislation, companies should assess whether there are deficiencies in their internal compliance controls and procedures; any internal reporting requirement that may result from this legislation will only increase the burden on organizations that will be required to respond to a likely increase in the number of whistleblower allegations.

#### **WHAT SHOULD MY COMPANY DO NOW?**

The new rules provide significant financial incentives for whistleblowers to report a wide range of misconduct to the SEC. In light of the greatly expanded whistleblower regime, companies should carefully reassess the state of their internal compliance programs to ensure that potential whistleblowers have an effective way to communicate their concerns and that such concerns are handled and addressed in a meaningful way. Companies should also take this time to re-evaluate their internal investigation policies and practices so that any issues, whether raised by a whistleblower or the SEC, can be negotiated and resolved quickly and thoroughly. These steps will ensure that self-reporting remains a meaningful option, even in a new, potentially more hostile, whistleblowing environment.

*This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances may vary. We make no undertaking to advise recipients of any legal changes or developments.*

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