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KIRKLAND ALERT

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SEC Adopts Final Whistleblower Rules

The SEC has now announced its final rules for implementing Dodd-Frank's whistleblower program, and companies must deal with the reality that their employees have strong incentives to bypass internal compliance and report potential securities law violations directly to the SEC.

One of the more controversial aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] was its creation of a whistleblower program. Section 922 of Dodd-Frank established both a "bounty" program for whistleblowers who provide information to the SEC related to securities violations and protections for whistlelowers against retaliation by their employers. It also created large financial incentives for whistleblowers, requiring the SEC to pay qualifying whistleblowers between 10 and 30 percent of any related recovery over $1 million.

As SEC Commissioner Troy Paredes noted, in the SEC's rulemaking process related to Section 922, "singular attention has centered on the extent to which the whistleblower program, depending on how it is structured, could unduly erode the value of internal compliance programs." Since Dodd-Frank's enactment, both industry groups and many commentators have urged the SEC to adopt rules that would require a whistleblower to first report potential wrongdoing internally. Without such a requirement, they argued, the new program would undermine the enormous efforts and resources expended by companies to create strong internal compliance programs following enactment of the last large-scale financial overhaul, Sarbanes-Oxley.

In November 2010, the SEC announced its proposed rules for the whistleblower program, but did not include an internal reporting requirement. In response to its proposed rules, the SEC received approximately 1,500 comments, many of them focused on the program's potential effect on internal compliance programs. On May 25, 2011, the SEC issued its final rules.[2] A 3-2 vote by the Commissioners approving the rules reflected the closely divided viewpoints related to the program.

The final rules still do not require internal reporting, but do attempt to address the internal compliance concerns. The SEC made three relevant modifications to its original proposal. ***First***, when determining the percentage of recovery to be awarded to the whistleblower, the SEC may increase the whistleblower's percentage if the whistleblower voluntarily participates in the internal compliance and reporting system, and, similarly, the SEC may decrease the whistleblower's percentage if the whistleblower interferes with the internal compliance and reporting system. ***Second***, the whistleblower is eligible for an award for providing original information to internal compliance where the company then discloses that information to the SEC. And ***third***, a whistleblower who reports a potential violation to internal compliance has 120 days to report the information to the SEC, and the SEC will treat the date of the internal report as the date of reporting to the SEC.

Even with this additional encouragement to first report to internal compliance, whistleblowers will face strong incentives to go directly to the SEC. The new program covers all actions brought by the SEC under the securities laws, from 10b-5 to Reg F-D to the FCPA, and the likelihood of whistleblower reports, both legitimate and unfounded, will continue to rise with the rising value of SEC settlements. Perhaps as the SEC establishes benchmarks for whistleblower awards, it will demonstrate that there are real financial benefits to the whistleblower for cooperating with internal compliance. But for now, the importance of being first in the door with information is likely to outweigh the undefined benefit of first reporting internally.

Even though the SEC has issued its final rules, this area of the law and practice is not settled. The performance

of the whistleblower program will be closely monitored not only by the companies and whistleblower advocates affected, but by Congress and the SEC. Congress has already held hearings on the potential adverse effects of the whistleblower program, including circulating draft legislation that would require the whistleblower to first report internally. Dodd-Frank also requires the SEC to produce a report about the whistleblower program to Congress by January 2012.

In the meantime, companies can take steps to maximize the likelihood that a whistleblower will first report internally. One of the most important steps a company can take is setting an ethical "tone at the top" by encouraging awareness of and compliance with all legal and regulatory obligations and reporting of misconduct. Company procedures should be in place to ensure that complaints are handled appropriately and whistleblowers are not mistreated. Companies may even consider providing their own financial incentives for first reporting potential wrongdoing internally. Moreover, in this environment, the existing compliance framework must respond expeditiously. With the 120-day reporting window for whistleblowers, companies will be faced with increased time pressure to conduct an internal investigation and added pressure to self-report violations to the SEC or other governmental agencies. We will continue to update our clients as this new program evolves

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1 More analysis of Dodd-Frank's provisions is available online in Kirkland publications at http://www.kirkland.com/sitecontent.cfm?contentID=221.

2 The Final Rule is available at http://sec.gov/rules/final/2011/34-64545.pdf, and the SEC press release that summarizes the final rules is available at http://sec.gov/news/press/2011/2011-116.htm.

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