

# Chapter 41

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## SEC and CFTC Whistleblower Rules and Anti-Retaliation Protections

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**§ 41:1 Introduction**

On May 25, 2011, in a 3–2 vote, the U.S. Securities and Exchange Commission (SEC) approved its final rules (the “SEC Whistleblower Rules”) to implement the whistleblower award program of section 21F of the Securities Exchange Act of 1934 (the “Exchange Act”), which was added by section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). On August 4, 2011, the Commodity Futures Trading Commission (CFTC), in a 4–1 vote, adopted its final rules implementing the commodity whistleblower incentives and protections of section 748 of the Dodd-Frank Act (the “CFTC Whistleblower Rules”). Section 748 amended the Commodity Exchange Act (CEA) by adding section 23. The SEC Rules and the CFTC Rules shall collectively be referred to as the “Whistleblower Rules.” The SEC and the CFTC shall collectively be referred to as the “Commissions.”

The Whistleblower Rules establish the standards and procedures the Commissions will apply in awarding whistleblowers monetary compensation for providing tips about possible federal securities and commodities law violations that lead to successful SEC and CFTC enforcement actions, and make definitions that set the contours for protection of whistleblowers under the Dodd-Frank Act’s anti-retaliation provisions.

The Dodd-Frank Act requires that the Commissions offer substantial financial incentives for individuals to provide information to the government regarding possible violations of the federal securities and commodities laws. Although the Commissions attempted to ameliorate concerns that their previously proposed rules would cause employees to bypass internal compliance systems, they did not require employees to report internally first before coming to the Commissions. As a result, there is little doubt that there will be an increase in external whistleblower activity. The SEC alone expects to

receive a significant number of tips each year<sup>1</sup> and plaintiffs' law firms have set up websites to attract whistleblower leads in the United States and abroad.

The CFTC Whistleblower Rules and the SEC Whistleblower Rules are identical in most respects. Indeed, the CFTC, which adopted its rules after the SEC, acknowledged that some companies may be subject to both whistleblower programs. For example, many financial firms are registered both as futures commission merchants with the CFTC and as broker-dealers with the SEC. Thus, the CFTC Whistleblower Rules reflect the CFTC's efforts to "ensure consistency and promote harmonization" with the SEC Whistleblower Rules.

The SEC's Whistleblower Rules became effective on August 12, 2011. The CFTC Whistleblower Rules became effective on October 24, 2011. However, the Whistleblower Rules will apply retroactively to all whistleblower tips made since July 21, 2010—the date the Dodd-Frank Act was enacted.<sup>2</sup>

### § 41:2 Affected Entities

The SEC and the CFTC Whistleblower Rules apply to all entities and individuals that are subject to the federal securities and commodities laws, respectively. Consequently, the Whistleblower Rules affect a broad range of entities, including public companies and their subsidiaries and affiliates, broker-dealers, investment advisers, investment companies, rating agencies, and hedge funds. Even private companies can be subject to whistleblower tips—for aiding and abetting a violation, for example.

### § 41:3 Essential Elements of Whistleblower Award Eligibility

Eligibility for an award under the Whistleblower Rules generally can be summarized as follows: (i) a whistleblower, (ii) who voluntarily provides the SEC or the CFTC, (iii) with original information, (iv) that leads to a successful enforcement action by the Commissions that results in an order requiring payment of more than \$1 million arising out of the same core facts, (v) is eligible for an award of 10% to 30% of any amounts recovered.

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1. SEC Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of Securities Exchange Act of 1934, SEC Release No. 34-63237, 75 Fed. Reg. 70,488, 70,512 (Nov. 3, 2010).
  2. 17 C.F.R. § 240.21F-4(b)(iv); *id.* § 165.2(k)(4).

### § 41:3.1 Definition of a Whistleblower

A whistleblower is defined as someone who, alone or jointly with others, provides the Commissions with information that relates to a possible violation of the federal securities or commodities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur.<sup>3</sup> The possible violation must be of federal securities or commodities laws or a rule or regulation promulgated by the Commissions; information relating to state securities or commodities laws or other laws do not qualify. In addition, the law violation need not have occurred yet; possible violations that are “about to occur” are sufficient.

The whistleblower must be an individual; a company or another entity is not eligible to be a whistleblower.<sup>4</sup> A whistleblower may remain anonymous when reporting possible violations to the SEC, but to do so, a whistleblower must report through an attorney.<sup>5</sup>

### § 41:3.2 Voluntary Submission of Original Information

Whistleblowers are eligible for awards only when they voluntarily provide original information about possible federal securities or commodities law violations to the Commissions.

#### [A] Voluntary

All information must be “voluntarily” provided to the Commissions.<sup>6</sup> Under the SEC Whistleblower Rules, information is voluntarily provided if it is provided before a request, inquiry, or demand was “directed” to the whistleblower personally or to his or her representative by the SEC, the Public Company Accounting Oversight Board or any self-regulatory organization, Congress, any other authority of the federal government, or a state attorney general or another securities regulatory authority.<sup>7</sup> The term “directed” was added to the final Whistleblower Rules by the SEC to “narrow[] the types of requests that . . . may preclude a later whistleblower submission from being treated as ‘voluntary.’”<sup>8</sup> Only a request that is specifically directed to

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3. 17 C.F.R. § 240.21F-2(a)(1); *id.* § 165.2(p); *see also* 15 U.S.C. § 78u-6(a)(6); 7 U.S.C. § 26(a)(7).
  4. 17 C.F.R. § 240.21F-2(a)(1); *id.* § 165.2(g), (p); *see also* 15 U.S.C. § 78u-6(a)(6); 7 U.S.C. § 26(a)(7).
  5. 17 C.F.R. § 240.21F-9(c); 15 U.S.C. § 78u-6(d)(2)(A).
  6. 17 C.F.R. § 240.21F-3(a)(1); *id.* § 165.1; 15 U.S.C. § 78u-6(b)(1); 7 U.S.C. § 26(b)(1).
  7. 17 C.F.R. § 240.21F-4(a).
  8. SEC Rules Implementing the Whistleblower Provisions of Section 21F of Securities Exchange Act of 1934, SEC Release No. 34-64545, 76 Fed. Reg. 34,300, 34,307 (May 25, 2011) [hereinafter SEC Adopting Release].

the individual involved (or to his or her representative) will preclude that individual from subsequently making a voluntary submission of the requested information or closely related information. This addition was a change from the proposed rules, wherein a whistleblower was precluded from an award because a governmental request for information was made to the office or function of the company where the whistleblower works or when the whistleblower possesses documents or information that fall within the scope of the request.<sup>9</sup>

The CFTC Whistleblower Rules, on the other hand, are more restrictive. Under the CFTC rules, a regulator's request to an employer will be imputed to the whistleblower when the requested documents or information from the whistleblower fall within the scope of the request received by the employer, unless after receiving the information from the whistleblower the employer fails to turn over the information to the requesting authority in a timely manner. In other words, in this situation the regulator's request directed to an employer is deemed to have been received by the whistleblower, thereby limiting the ability to qualify for an award.<sup>10</sup>

The Whistleblower Rules also provide that a submission will not be considered "voluntary" if the whistleblower is required to report the original information to the Commissions as a result of a preexisting legal duty, a contractual duty that is owed to the Commissions or one of the authorities noted above (such as a cooperation agreement with the Department of Justice), or a duty that arises out of a judicial or administrative order (such as an independent monitor appointed by the Commissions in an enforcement action).<sup>11</sup>

Finally, it should be noted that requests for information made by foreign regulatory authorities do not preclude a submission from being voluntary. In other words, a whistleblower remains eligible for an award even after he or she receives a request for information from a foreign regulatory authority.

### **[B] Original Information**

All information provided must be original.<sup>12</sup> To be original, the information must be based on the whistleblower's *independent knowledge* or *independent analysis*, and it must not already be known to the Commissions, nor derived exclusively from "an allegation made in a judicial or administrative hearing, in a governmental report,

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9. *Id.*

10. 17 C.F.R. § 165.2(o)(1).

11. *Id.* § 240.21F-4(a)(3); *id.* § 165.2(o)(2).

12. 17 C.F.R. § 240.21F-3(a)(2); *id.* § 165.1; 15 U.S.C. § 78u-6(b)(1); 7 U.S.C. § 26(b)(1).

hearing, audit, or investigation, or from the news media, unless [the whistleblower is] a source of the information.”<sup>13</sup>

*Independent knowledge* is defined as factual information in an individual’s possession that is not derived exclusively from publicly available sources. A whistleblower may gain independent knowledge from his or her own experience, communications and observations in his or her business or social interaction.<sup>14</sup> Thus, it appears that information learned through others can qualify as original information so long as the information is not in the public domain. Indeed, the SEC stated in its Adopting Release, “[W]e do not believe that ‘independent knowledge’ should be further limited to direct, first-hand knowledge. Such an approach could prevent the Commissions from receiving valuable information about possible violations from whistleblowers who are not themselves involved in the conduct at issue, but who learn about it through their observations, relationships, or personal diligence.”<sup>15</sup> Similarly, the CFTC recognized “that there are circumstances where individuals might review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to the Commission staff in understanding complex schemes and identifying potential violations of the CEA.”<sup>16</sup>

*Independent analysis* means an individual’s own “analysis, whether done alone or in combination with others.” “Analysis” is further defined as an individual’s “examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.”<sup>17</sup> The SEC explained that the independent analysis condition requires that the “whistleblower do more than merely point the staff to disparate publicly available information that the whistleblower has assembled, whether or not the staff was previously ‘aware of’ the information.”<sup>18</sup> An independent analysis requires some additional evaluation, insight, or assessment of the public information.

Original information includes only that information that is provided to the Commissions for the first time after July 21, 2010, the date of the enactment of the Dodd-Frank Act.<sup>19</sup>

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13. 17 C.F.R. § 240.21F-4(b)(1); *id.* § 165.2(k); *see also* 15 U.S.C. § 78u-6(a)(3); 7 U.S.C. § 26(a)(4).

14. 17 C.F.R. § 240.21-4(b)(2); *id.* § 165.2(g); *see also* 15 U.S.C. § 78u-6(a)(3); 7 U.S.C. § 26(a)(4).

15. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,312.

16. CFTC Whistleblower Incentives & Protection Final Rule, 76 Fed. Reg. 53,172, 53,174 (Aug. 4, 2011) [hereinafter CFTC Adopting Release].

17. 17 C.F.R. § 240.21F-4(b)(3); *id.* § 165.2(c).

18. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,312.

19. 17 C.F.R. § 240.21F-4(b)(1)(iv); *id.* § 165.2(k)(5).

### [C] 120-Day Look Back Provisions

To encourage employees to report possible violations to a company's internal compliance personnel in the first instance, the Whistleblower Rules provide a 120-day look back provision. Under this provision, if the whistleblower provides information to an internal compliance program, the whistleblower will have a 120-day time period during which he or she can alert the SEC or the CFTC of the same information and still be considered to have provided original information as of the date the information was provided to the internal compliance program.<sup>20</sup>

#### § 41:3.3 Successful Enforcement Action

To be eligible for an award, the information provided to the Commissions must lead to a successful enforcement action that results in monetary sanctions of more than \$1 million.<sup>21</sup>

A whistleblower provides original information that leads to a successful enforcement action in multiple situations. First, information may be considered to lead to a successful enforcement action if it was sufficiently specific, credible, and timely to cause the staff to commence an examination or open an investigation, reopen an investigation, or inquire about different conduct as part of a current examination or investigation, and the SEC or the CFTC brings a successful judicial or administrative action based in whole or in part on the conduct subject of the original information.<sup>22</sup> In determining whether this standard is met, the SEC may consider several factors including: (i) allegations that formed the basis for any of the SEC's claims in the judicial or administrative action; (ii) provisions of the securities laws that the SEC alleged as having been violated in the judicial or administrative action; (iii) culpable persons or entities (as well as offices, divisions, subsidiaries or other subparts of entities) that the SEC named as defendants, respondents or uncharged wrongdoers in the judicial or administrative action; or (iv) investors or a defined group of investors that the SEC named as victims or injured parties in the judicial or administrative action.<sup>23</sup>

Second, a whistleblower may also satisfy the "successful enforcement" requirement when he or she provides information about conduct already under examination or investigation that is considered

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20. 17 C.F.R. § 240.21F-4(b)(7); *id.* § 165.2(i)(3). The CFTC "look back" also extends to information originally provided to Congress, another federal or state authority, or a self-regulatory organization.

21. See 17 C.F.R. § 240.21F-3(a)(4); 15 U.S.C. § 78u-6(b)(1).

22. 17 C.F.R. § 240.21F-4(c)(1); *id.* § 165.2(i)(1).

23. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,324.



original and that significantly contributes to the success of the action or leads the investigation or examination in a new direction.<sup>24</sup> Under its rules, the SEC will look at factors such as whether the information allowed it to bring: (i) a successful action in significantly less time or with significantly fewer resources; (ii) additional successful claims; or (iii) successful claims against additional individuals or entities.<sup>25</sup> This expands the standard under the SEC's proposed rules, which required the information to be "essential" to the success of the action, and is intended to encourage more whistleblower tips.<sup>26</sup>

To encourage internal compliance programs, the SEC and the CFTC revised their proposed rules to provide that a whistleblower will be eligible for an award if he or she reports original information through a company's internal legal or compliance reporting procedures before or at the same time it is reported to the Commissions, and the company then reports the information to the Commissions.<sup>27</sup> In that event, the internal report may be the "original" source of the information. Further, the Commissions may attribute all the information provided by the company to the Commissions to the whistleblower, whether or not originally reported by the whistleblower.<sup>28</sup> As a result, a whistleblower may get credit—and potentially a larger award—for any additional information that is generated by the company in its investigation.<sup>29</sup> This change is intended to provide additional incentives for whistleblowers to report internally.<sup>30</sup>

### **[A] Calculating Amount Recovered**

The \$1 million threshold can be met by civil money penalties, disgorgement payments, and prejudgment interest totaling more than \$1 million in one or more related SEC and CFTC actions.<sup>31</sup> For purposes of calculating whether monetary sanctions exceed \$1 million, the Whistleblower Rules permit the aggregation of multiple cases that arise out of the same nucleus of operative facts. According to the SEC, the "same-nucleus-of-operative-facts test is a well-established legal standard that is satisfied where two proceedings, although brought

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24. 17 C.F.R. § 240.21F-4(c)(2); *id.* § 165.2(i)(2).

25. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,325.

26. *Id.* at 34,324–25.

27. 17 C.F.R. § 240.21F-4(c)(3); *id.* § 165.2(i)(3).

28. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,325; CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,178.

29. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,325–26; CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,178.

30. *Id.*

31. 17 C.F.R. § 240.21F-4(e); *id.* § 165.2(j).

separately, share such a close factual basis that the proceedings might logically have been brought together in one proceeding.”<sup>32</sup> This is a change from the proposed rules, under which only a single action would have been considered in determining whether the \$1 million threshold had been met.<sup>33</sup> Once the \$1 million threshold has been passed, the amount of the award may also be based on related actions brought by other government agencies such as criminal prosecutions by the Department of Justice.<sup>34</sup>

The SEC will not pay an award if an award already has been granted to the whistleblower by the CFTC for the same action.<sup>35</sup> However, the CFTC Whistleblower Rules do not have a similar restriction—the CFTC will grant an award even if the whistleblower has already received an award from the SEC.<sup>36</sup> Thus, a whistleblower could potentially recover twice if he or she receives the SEC award first.

## § 41:4 Exclusions from Award Eligibility

The Whistleblower Rules exclude several categories of individuals from award eligibility, subject to certain exceptions.

### § 41:4.1 Principals

An officer, director, trustee, or partner of a company who receives information about the alleged misconduct from a company employee or from the company’s internal compliance process is excluded from receiving an award.<sup>37</sup> In explaining the scope of this exclusion, the SEC in the Adopting Release stated that “including all supervisors at any level would create too sweeping an exclusion of persons who may be in a key position to learn about misconduct . . . .”<sup>38</sup>

### § 41:4.2 Attorneys

Attorneys are not permitted to use information obtained from client engagements or attorney-client privileged information to make

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32. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,327 (citing relevant case law).

33. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,301 (“In response to comments, we have provided in the final rules that, for the purposes of making an award, we will aggregate two or more smaller actions that arise from the same nucleus of operative facts. This will make whistleblower awards available in more cases.”).

34. 17 C.F.R. § 240.21F-4(d); *id.* § 240.21F-3(b); *id.* § 165.2(a), (m).

35. 17 C.F.R. § 240.21F-3(b)(3).

36. CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,179.

37. 17 C.F.R. § 240.21F-4(b)(4)(iii)(A); *id.* § 165.2(g)(4).

38. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,318.

whistleblower claims themselves.<sup>39</sup> The SEC has made it clear that this exclusion applies to in-house attorneys who may be eligible for an award only to the extent that their disclosures are consistent with their ethical obligations and SEC rules.<sup>40</sup> Furthermore, the exclusion for privileged information extends to non-attorneys who learn information through confidential attorney-client communications.<sup>41</sup> The CFTC explained that its rules “prevent the use of confidential information not only by attorneys, but by secretaries, paralegals, consultants and others who work under the direction of attorneys and who may have access to confidential client information.”<sup>42</sup>

However, and as noted in the SEC’s Adopting Release, the SEC Rule<sup>43</sup> “permits attorneys representing issuers of securities to reveal to the [SEC] ‘confidential information related to the representation to the extent the attorney reasonably believes necessary’ (1) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer, in a [SEC] investigation or administrative proceeding, from committing perjury, suborning perjury, or committing any act that is likely to perpetrate a fraud upon the Commission; or (3) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used.”<sup>44</sup>

Moreover, attorneys are eligible for an award if the disclosure to the Commissions does not violate applicable state bar rules; for example, the submission was based on the waiver of privilege or a crime-fraud exception.<sup>45</sup>

### § 41:4.3 Compliance Personnel

Employees whose principal duties include compliance or internal audit functions, or individuals retained by a company to perform compliance or audit functions, are not eligible for an award.<sup>46</sup> It

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39. 17 C.F.R. § 240.21F-4(b)(4)(i), (ii); *id.* § 165.2(g)(2).  
 40. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,315; *see also* CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,176.  
 41. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,315; *see also* CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,176.  
 42. CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,176.  
 43. 17 C.F.R. § 205.3(d)(2).  
 44. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,314 n.119.  
 45. 17 C.F.R. § 240.21F-4(b)(4)(i); *id.* § 165.2(g)(3); *see also* SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,314 n.120 (citing California Evidence Code § 956 (“There is no privilege under this article if the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit a crime or fraud.”)).  
 46. 17 C.F.R. § 240.21F-4(b)(4)(iii)(B); *id.* § 165.2(g)(5).

should be noted that the Whistleblower Rules *do not* clearly extend these exclusions to other company employees involved in control or accounting functions, unless the Commissions construe “compliance” to include accounting and financial reporting personnel.

#### **§ 41:4.4 Individuals Retained to Conduct Inquiry**

Individuals retained to conduct an inquiry or investigate possible law violations are not eligible for an award.<sup>47</sup>

#### **§ 41:4.5 Accountants**

Under the SEC Whistleblower Rules, employees and other persons associated with a public accounting firm who obtain information through an engagement required under the federal securities laws—such as a financial statement audit for a public company client, a broker-dealer annual audit, or an engagement for an investment advisor related to compliance with the custody rule—are not eligible for an award if that information relates to a violation by the engagement client or the client’s directors, officers, or other employees.<sup>48</sup> Also, public company auditors are ineligible for awards where the information was obtained through an audit of a company’s financial statements, and making a whistleblower submission would be contrary to the requirements for auditor reporting of potential illegal activity specified in section 10A of the Exchange Act.<sup>49</sup>

The CFTC Whistleblower Rules, however, do not provide a similar exclusion, and accountants are eligible for an award. The CFTC reasoned that outside auditors face an existing obligation to report violations to the SEC under section 10A of the Exchange Act, but no such requirement exists under the CEA.<sup>50</sup>

#### **§ 41:4.6 Other Exclusions**

Information that was obtained in a way that is determined by a U.S. court to have violated federal or state criminal law is also excluded.<sup>51</sup> The Whistleblower Rules further exclude foreign government officials, including employees of state-owned enterprises.<sup>52</sup> In order to prevent evasion of the rules, anyone who obtained his or her information from persons subject to the exclusions listed above is also excluded.<sup>53</sup>

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47. 17 C.F.R. § 240.21F-4(b)(4)(iii)(C).

48. *Id.* § 240.21F-4(b)(4)(iii)(D).

49. *Id.* § 240.21F-8(c)(4).

50. CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,177.

51. 17 C.F.R. § 240.21F-4(b)(4)(iv); *id.* § 165.2(g)(6).

52. 17 C.F.R. § 240.21F-8(c)(2); *id.* § 165.6(a)(7).

53. 17 C.F.R. § 240.21F-8(c)(6); *id.* § 165.6(a)(8).

### § 41:5 Exceptions to Exclusion from Award Eligibility

The Whistleblower Rules provide that an otherwise excluded whistleblower will be eligible for an award if:

- he or she has a reasonable basis to believe that disclosure is necessary to prevent the company from engaging in conduct that is likely to cause substantial financial injury to the company or investors;
- he or she has a reasonable basis to believe the company is engaging in conduct that will impede an investigation of the misconduct; or
- at least 120 days have elapsed since the whistleblower provided the information through the company's internal reporting system.<sup>54</sup>

The final Whistleblower Rules also clarified that the exceptions do not apply to attorneys; they apply only to principals, compliance or internal audit personnel, individuals employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law, and independent public accountants.<sup>55</sup>

### § 41:6 Factors Considered in Determining the Amount of an Award

If all the aforementioned requirements are satisfied, the Commissions are required to pay the whistleblower an award of 10% to 30% of the amount recovered as result of the tip. The Whistleblower Rules, however, give the Commissions wide discretion in determining the amount of the award within the 10% minimum and the 30% maximum provided in the Dodd-Frank Act.<sup>56</sup> To determine an award, the Commissions will use a methodology in which some factors increase and others decrease the percentage of the recovery awarded to the whistleblower. This approach is similar to those used by the Department of Justice and the Internal Revenue Service.<sup>57</sup>

The Commissions' methodology is intended to be flexible and applied on a case-by-case basis. Indeed, the SEC has stated: "[N]o attempt has been made to list the factors in order of importance . . . . Depending upon the facts and circumstances of each case, some factors may not be applicable or may deserve greater weight than others. Furthermore, the absence of any one of the positive factors does

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54. 17 C.F.R. § 240.21F-4(b)(4)(v); *id.* § 165.2(g)(7).

55. *Id.*

56. 17 C.F.R. § 240.21F-5; *see also* 15 U.S.C. § 78u-6(c)(1)(A).

57. *See* SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,331.

not mean that the award percentage will be lower than 30%, nor does the absence of negative factors mean the award percentage will be higher than 10%. . . . In the end, we anticipate that the determination of the appropriate percentage of a whistleblower award will involve a highly individualized review of the facts and circumstances surrounding each award[.]”<sup>58</sup>

### **§ 41:6.1 Factors That May Increase an Award**

#### **[A] Significance of Information**

The Commissions will assess the significance of the information provided by a whistleblower to the success of the action or related action.<sup>59</sup> In considering this factor, the Commissions can take into account, among other things: (i) the nature of the information provided, including the reliability and completeness of the information, and (ii) the degree to which the information provided by the whistleblower supported one or more successful claims brought in the action or related action.<sup>60</sup>

#### **[B] Degree of Assistance Provided**

The Commissions will assess the degree of assistance provided by the whistleblower.<sup>61</sup> Factors the Commissions may consider are:

- (i) whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance by, for example, helping to explain complex transactions, interpreting key evidence, or identifying new and productive lines of inquiry;
- (ii) the timeliness of the whistleblower’s initial report to the Commissions or to an internal compliance program of the business organizations committing, or impacted by, the securities violations, where appropriate;
- (iii) the resources conserved as a result of the whistleblower’s assistance;
- (iv) whether the whistleblower appropriately encouraged or authorized others to assist the Commissions;
- (v) the efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the

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58. *Id.*

59. 15 U.S.C. § 78u-6(c)(1)(B)(i)(I); 7 U.S.C. § 26(c)(1)(B)(i)(I).

60. 17 C.F.R. § 240.21F-6(a)(1); *id.* § 165.9(b)(1); *see also* 15 U.S.C. § 78u-6(c)(1)(B); 7 U.S.C. § 26(c)(1)(B).

61. 15 U.S.C. § 78u-6(c)(1)(B)(i)(II); 7 U.S.C. § 26(c)(1)(B)(i)(II).

authorities in the recovery of the fruits and instrumentalities of the violations; and

- (vi) any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting the Commissions.<sup>62</sup>

### **[C] Programmatic Interest of SEC or CFTC**

The Commissions will assess their programmatic interests in deterring violations of the federal securities and commodities laws.<sup>63</sup> In considering this factor, the Commissions may take into account, among other things:

- (i) the degree to which an award enhances the Commissions' ability to enforce the federal securities and commodities laws and protect investors;
- (ii) the degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submissions of significant information and assistance;
- (iii) whether the subject matter of the action is a priority of the Commissions;
- (iv) whether the reported misconduct involves regulated entities or fiduciaries;
- (v) whether the whistleblower exposed an industry-wide practice;
- (vi) the type and severity of the securities or commodities violations;
- (vii) the age and duration of misconduct;
- (viii) the number of violations and the isolated, repetitive, or ongoing nature of the violations; and
- (ix) the dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or threatened by the underlying violations, and the number of individuals or entities harmed.<sup>64</sup>

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62. 17 C.F.R. § 240.21F-6(a)(2); *id.* § 165.9(b)(2).

63. 15 U.S.C. § 78u-6(c)(1)(B)(i)(III).

64. 17 C.F.R. § 240.21F-6(a)(3); *id.* § 165.9(b)(3).

**[D] Participation in Internal Compliance Programs**

The Commissions will assess whether, and the extent to which, the whistleblower participated in internal compliance systems. In considering this factor, the Commissions may take into account, among other things: (i) whether, and the extent to which, a whistleblower reported the possible violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commissions; and (ii) whether, and the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities or commodities violations.<sup>65</sup>

**§ 41:6.2 Factors That May Decrease an Award****[A] Whistleblower Culpability**

The Commissions will assess the culpability or involvement of the whistleblower in the wrongdoing. In considering this factor, the Commissions may take into account, among other things:

- (i) the whistleblower's role in the securities or commodities violations;
- (ii) the whistleblower's education, training, experience, and position of responsibility at the time the violations occurred;
- (iii) whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations;
- (iv) whether the whistleblower financially benefitted from the violations;
- (v) whether the whistleblower is a recidivist;
- (vi) the egregiousness of the underlying fraud committed by the whistleblower; and
- (vii) whether the whistleblower knowingly interfered with the Commissions' investigation or related enforcement actions.<sup>66</sup>

**[B] Delay in Reporting Violation**

The Commissions will assess whether the whistleblower unreasonably delayed reporting the possible securities or commodities violations. Factors the Commissions will consider include:

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65. 17 C.F.R. § 240.21F-6(a)(4); *id.* § 165.9(b)(4).

66. 17 C.F.R. § 240.21F-6(b)(1); *id.* § 165.9(c)(1).



- (i) whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;
- (ii) whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and
- (iii) whether there was a legitimate reason for the whistleblower to delay reporting the violations.<sup>67</sup>

### **[C] Interference with Internal Compliance Programs**

In situations where the whistleblower interacted with the company's internal compliance program, the Commissions will evaluate whether the whistleblower undermined the integrity of the internal compliance system. Factors the Commissions will consider include whether the whistleblower *knowingly*:

- (i) interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities or commodities violation;
- (ii) made any material false, fictitious, or fraudulent statements or representations; and
- (iii) provided any false writing or document knowing the writing or document contained any false, fictitious, or fraudulent statements or entries.<sup>68</sup>

### **[D] Potential Adverse Incentives**

Unlike the SEC, the CFTC will also consider whether potential adverse incentives may result from oversized awards.<sup>69</sup>

## **§ 41:7 Treatment of Culpable Individuals**

The Whistleblower Rules do not grant amnesty to individuals who provide information to the SEC or the CFTC, and persons who are convicted of a criminal violation that is related to the action cannot receive an award.<sup>70</sup> Moreover, in determining whether the required \$1 million threshold has been satisfied for purposes of making the award, the SEC and the CFTC will exclude any monetary sanctions

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67. 17 C.F.R. § 240.21F-6(b)(2); *id.* § 165.9(c)(2).

68. 17 C.F.R. § 240.21F-6(b)(3); *id.* § 165.9(c)(3).

69. 17 C.F.R. § 165.9(a)(5).

70. *Id.* § 240.21F-15; *id.* § 240.21F-8(c)(3); 15 U.S.C. § 78u-6(c)(2)(B); 17 C.F.R. §§ 165.6(a)(2), 165.16; 7 U.S.C. § 26(c)(2)(B).

that the whistleblower is ordered to pay, or that are ordered against any company whose liability is based on conduct that the whistleblower directed, planned, or initiated.<sup>71</sup> In explaining this provision, the SEC stated in its Adopting Release that it is seeking to prevent wrongdoers from financially benefitting from essentially blowing the whistle on their own misconduct.<sup>72</sup> Further, in determining whether the amount of the award should be decreased, the SEC and the CFTC may assess the culpability of the whistleblower.<sup>73</sup> However, the Whistleblower Rules do not categorically exclude culpable whistleblowers from award eligibility.<sup>74</sup> Indeed, the rules expressly contemplate that a whistleblower may be a participant in a securities or commodities fraud scheme or otherwise engage in other culpable conduct and still receive an award, albeit potentially smaller due to his or her own misconduct.

### § 41:8 Whistleblower Confidentiality and Anonymity

The Whistleblower Rules permit whistleblowers to submit tips anonymously so long as they are represented by an attorney, who must certify that he or she has verified the whistleblower's identity.<sup>75</sup> Recognizing the importance of preserving anonymity to encourage whistleblowers to come forward, the Commissions have stated that they will not disclose information that could reasonably be expected to reveal the identity of the whistleblower, except under certain circumstances, such as when disclosure to a defendant is required in connection with a federal court or administrative action, or when the Commissions determine that it is necessary to disclose the identity to the Department of Justice or other regulatory agency in order to advance the purposes of the Exchange Act or to protect investors.<sup>76</sup>

### § 41:9 Whistleblower Protections: The Anti-Retaliation Provisions

The Dodd-Frank Act significantly increased the employment rights of purported whistleblowers beyond those adopted in the Sarbanes-Oxley Act of 2002 (SOX).<sup>77</sup>

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71. 17 C.F.R. § 240.21F-16; *id.* § 165.17.
  72. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,350.
  73. 17 C.F.R. § 240.21F-6(b)(1); *id.* § 165.9(c)(1).
  74. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,350; CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. 53,191.
  75. 17 C.F.R. § 240.21F-7(b); 15 U.S.C. § 78u-6(d)(2)(A); 17 C.F.R. § 165.7(c)(2); 7 U.S.C. § 26(d)(2).
  76. 17 C.F.R. § 240.21F-7; 15 U.S.C. § 78u-6(h)(2); 17 C.F.R. § 165.4; 7 U.S.C. § 26(h)(2).
  77. 18 U.S.C. § 1514A.

The Dodd-Frank Act expands SOX's whistleblower protection cause of action by extending the deadline to file a charge with the Department of Labor from 90 to 180 days and providing that parties to a SOX retaliation claim have a right to trial by jury.<sup>78</sup> It also extends whistleblower protection to employees of affiliates and subsidiaries of publicly traded companies, as well as employees of rating agencies.<sup>79</sup> The Dodd-Frank Act also creates three new federal causes of action for whistleblowers.

Two of these causes of action have received relatively little attention—they protect employees who report potential violations of the Commodity Exchange Act (CEA) to the CFTC,<sup>80</sup> and employees who report potential violations of federal banking laws to their employers, the newly created Bureau of Consumer Financial Protection, or other government authorities.<sup>81</sup>

The third whistleblower protection provision in the Dodd-Frank Act, which has received the most attention, provides that no employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act undertaken by the whistleblower in (i) providing information to the Commission in accordance with the Whistleblower Rules; (ii) initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or (iii) making disclosures that are protected under the Whistleblower Rules, SOX, or any other law, rule, or regulation subject to the jurisdiction of the Commission.<sup>82</sup> (For ease of reference, we will refer to this as the “core” Dodd-Frank Act anti-retaliation provision.)

The Whistleblower Rules provide that, with respect to the core Dodd-Frank anti-retaliation provision, an individual is a whistleblower if that individual possesses a reasonable belief that the information he or she is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur, and he or she reports that information in accordance with the procedures delineated in the rules.<sup>83</sup> The anti-retaliation protections apply irrespective of whether the whistleblower is ultimately entitled to an award.<sup>84</sup>

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78. *Id.* § 1514A(b).

79. *See id.* § 1514A(a).

80. *See* 7 U.S.C. § 26.

81. 12 U.S.C. § 5567. These provisions are beyond the scope of this chapter.

82. 15 U.S.C. § 78u-6(h)(1).

83. 17 C.F.R. § 240.21F-2(b)(1); *see also* 15 U.S.C. § 78u-6(a)(6).

84. 17 C.F.R. § 240.21F-(b)(1)(iii).

“The ‘reasonable belief’ standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess.”<sup>85</sup> According to the SEC Adopting Release, the “reasonable belief” requirement “strikes the appropriate balance between encouraging individuals to provide us with high-quality tips without fear of retaliation, on the one hand, while not encouraging bad faith or frivolous reports, or permitting abuse of the anti-retaliation protections, on the other.”<sup>86</sup>

### **§ 41:9.1 Relationship Between New Dodd-Frank and SOX Retaliation Claims**

As noted above, the core Dodd-Frank Act anti-retaliation provision protects, among other things, whistleblowers who make disclosures that are protected by SOX. This reference to SOX has already received attention from the courts, because SOX protects internal reporting, whereas the definition of “whistleblower” in the Dodd-Frank Act is limited to “any individual who provides . . . information relating to a violation of the securities laws to the Commission[.]”<sup>87</sup> Nonetheless, one federal district court recently held that under the Dodd-Frank Act, an employee does not need to provide information to the Commission to be protected from retaliation, although reporting to the Commission would still be a prerequisite to receipt of any whistleblower bounty.<sup>88</sup> If other courts follow this approach, Dodd-Frank Act retaliation claims could effectively subsume SOX retaliation claims.

That is significant because there are substantial benefits to bringing retaliation claims under the core Dodd-Frank provision rather than under SOX. First, a whistleblower must exhaust administrative remedies under SOX by filing a complaint with the Department of Labor’s Occupational Safety and Health Administration (OSHA), while Dodd-Frank allows immediate suit in federal court. Second, SOX requires that a whistleblower file his charge with OSHA within 180 days, whereas the limitations period to sue in court under Dodd-Frank is six years (or three years after the material facts were known or reasonably should have been known to the employee, but in no event longer than ten years). Third, Dodd-Frank allows employees to recover

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85. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,303 & n.33 (citing *Livingston v. Wyeth, Inc.*, 520 F.3d 344, 352 (4th Cir. 2008); *Clover v. Total Sys. Servs., Inc.*, 176 F.3d 1346, 1351 (11th Cir. 1999)).

86. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,303.

87. 15 U.S.C. § 78u-6(a)(6) (emphasis added).

88. *Egan v. TradingScreen, Inc.*, No. 10 Civ. 8202, 2011 U.S. Dist. LEXIS 47713 (S.D.N.Y. May 4, 2011).

double back pay, whereas only actual back pay is available under SOX.<sup>89</sup> Fourth, Dodd-Frank's final rules contain a provision that purports to prevent employers from enforcing confidentiality agreements to prevent whistleblower employees from cooperating with the SEC.<sup>90</sup>

### **§ 41:9.2 SEC Authority to Enforce Anti-Retaliation Provisions**

In addition, the SEC Adopting Release takes the position that, “[b]ecause the anti-retaliation provisions are codified within the Exchange Act,” the SEC has enforcement authority for violations by employers who retaliate against employees for making reports in accordance with section 21F.<sup>91</sup> This provision surprised observers, as the Department of Labor historically has not brought enforcement actions under SOX. (OSHA, however, recently announced plans to strengthen its Whistleblower Protection Program, by updating its procedures, instituting additional training, and creating a direct reporting relationship to the Assistant Secretary of Labor.<sup>92</sup> It remains to be seen whether OSHA plans to take a more proactive role in pursuing SOX retaliation claims.) The CFTC declined to exercise enforcement authority over retaliation claims, noting that the CFTC’s Dodd-Frank Act whistleblower provision states that only the whistleblower may bring a cause of action for alleged retaliation.<sup>93</sup>

### **§ 41:9.3 Non-Waivability of Anti-Retaliation Protections**

Employers cannot require their employees to waive the anti-retaliation protections as a condition of employment under the general terms of the Exchange Act: “Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void.”<sup>94</sup>

### **§ 41:9.4 Extraterritorial Application**

One issue that is already being litigated in administrative proceedings before the Department of Labor is whether the Dodd-Frank Act

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89. Compare 18 U.S.C. § 1514A, with 15 U.S.C. § 78u-6(h).

90. 17 C.F.R. § 240.21F-17(a).

91. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,304.

92. See News Release, OSHA, U.S. Dep’t of Labor’s OSHA Announces Measures to Improve Whistleblower Protection Program, available at [www.osha.gov/pls/oshaweb/owadisp.show\\_document?p\\_table=NEWS\\_RELEASES&p\\_id=20394](http://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=NEWS_RELEASES&p_id=20394) (Aug. 1, 2011).

93. CFTC Adopting Release, *supra* note 16, 76 Fed. Reg. at 53,182.

94. 15 U.S.C. § 78cc(a).

whistleblower retaliation provisions protect employees located outside the territorial United States. In the only appellate decision to date examining the question of extraterritorial application of the SOX anti-retaliation provision, the First Circuit applied the traditional presumption against the extraterritorial application of Congressional statutes.<sup>95</sup> There is a strong argument that the core Dodd-Frank anti-retaliation position should be treated the same way, as the statute nowhere states explicitly that whistleblower protections should apply outside the United States.<sup>96</sup>

### **§ 41:10 SEC Communications with Whistleblowers and Attorney-Client Privilege**

The Whistleblower Rules authorize SEC and CFTC staff to communicate directly with whistleblowers who are directors, officers, members, agents, or employees of a company who have counsel, without first seeking the consent of the company's counsel.<sup>97</sup> In response to commentators who expressed concern that the rules will undermine the attorney-client privilege, the SEC's Adopting Release "emphasize[s] that nothing about this rule authorizes the staff to depart from the Commission's existing procedures and practices when dealing with potential attorney-client privileged information."<sup>98</sup>

### **§ 41:11 Confidentiality Agreements**

Under the SEC Whistleblower Rules, any agreement that prevents employees or other individuals from disclosing information about possible securities laws violations is unenforceable under the Whistleblower Rules.<sup>99</sup> Specifically, SEC Whistleblower Rule 21F-17 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 (other than agreements dealing with information covered by [certain section of the rules]) with respect to such communications."<sup>100</sup>

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95. *Carnero v. Boston Scientific Corp.*, 433 F.3d 1 (1st Cir. 2006).

96. *See generally* Jason C. Schwartz, Thomas M. Johnson, Jr., & Amanda Penabad, *The Extraterritorial Application of the Dodd-Frank Whistleblower Provisions*, ALM'S L.J. NEWSLETTERS: EMPLOYMENT LAW STRATEGIST (Aug. 2011).

97. 17 C.F.R. § 240.21F-17(b); *id.* § 165.18.

98. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,352.

99. 17 C.F.R. § 240.21F-17(a).

100. *Id.* § 240.21F-17(a).

## § 41:12 Arbitration and Alternative Dispute Resolution

In light of the Supreme Court's recent decision in *AT&T Mobility, LLC v. Concepcion*,<sup>101</sup> which held that the Federal Arbitration Act preempts state rules that purport to classify class action waivers in consumer arbitration agreements as unconscionable, there is a renewed interest among many companies in arbitration and other alternative dispute resolution programs.

The Dodd-Frank Act, however, prohibits predispute agreements to arbitrate certain retaliation claims. It expressly prohibits predispute arbitration agreements governing claims under the CFTC, Bureau of Consumer Financial Protection, and SOX whistleblower provisions described in section 41:9 above. That is significant, as broker-dealers frequently require their employees to sign arbitration agreements as part of the standard Form U-4 that is used to register broker-dealer representatives with the SROs.

The Dodd-Frank Act, however, does not bar predispute agreements to arbitrate the "core" whistleblower cause of action.<sup>102</sup> This is also potentially significant, because retaliation claims can spawn expensive parallel litigation—such as shareholder class actions. If enforced by the courts, predispute arbitration agreements concerning Dodd-Frank's core anti-retaliation regime could minimize the publicity of retaliation claims and reduce potential exposure.

## § 41:13 Practical Considerations for Responding to the Whistleblower Rules

The Whistleblower Rules are designed and intended to have a significant effect on many aspects of a company's business and operations. Consequently, many commentators have suggested that companies regularly review their compliance programs and assess whether revisions should be made. In particular, companies should consider the following four critical components of an effective and robust compliance program: (i) a culture of compliance; (ii) internal reporting procedures; (iii) human resources procedures; and (iv) internal investigation practices.

### § 41:13.1 Culture of Compliance

As regulated enterprises, broker-dealers and investment advisers are required to have policies and procedures reasonably designed to prevent

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101. *AT&T Mobility, LLC v. Concepcion*, 563 U.S. \_\_\_\_ (2011).

102. *See* 15 U.S.C. § 78u-6.

and detect violations of law. For example, section 15(b)(6)(A)(i) of the Exchange Act authorizes the Commission to sanction a person associated with a broker or dealer who “has failed reasonably to supervise, with a view to preventing violations of [federal securities laws] another person who commits such a violation, if such other person is subject to his supervision.”<sup>103</sup> Section 203(e) of the Investment Advisers Act states that “if an investment adviser fails to reasonably supervise an employee or any other person subject to the adviser’s supervision, and that person violates the federal securities laws, then the SEC may take action against such investment adviser.” Pursuant to SEC regulations, each registered investment company and business development company is required to adopt and implement policies and procedures approved by its board of directors that are reasonably designed to prevent violations of federal securities laws and regulations, including policies and procedures that provide for the oversight of compliance by each investment adviser.<sup>104</sup> And, under NASD Rule 3012, FINRA member firms must establish, maintain, and enforce written supervisory control policies and procedures.<sup>105</sup> SEC and FINRA rules regarding compliance programs are discussed in chapter 34 of this treatise.

A culture of compliance is important to prevent wrongdoing and misconduct from occurring and encouraging employees to report possible violations internally when they do occur. Creating an atmosphere in which employees understand that they are to rigorously adhere to the law, follow company rules and procedures, and report potential misconduct when they first become aware of it will significantly alleviate many of the issues raised by the Whistleblower Rules. In the event of an enforcement investigation, the company’s compliance culture and the efficacy of its compliance programs are also important determinants in whether a firm will be sanctioned and the

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103. 15 U.S.C. § 78o(b)(4)(E).

104. 17 C.F.R. § 270.38a-1(a)(1)-(2). *See also id.* § 270.38a-1(a)(4) (requiring investment and business development companies to designate one individual as Chief Compliance Officer to be responsible for administering compliance policies and procedures); *id.* § 275.206(4)-7(a) (requiring that investment advisers adopt and implement written policies and procedures to prevent violations of the Investment Advisers Act).

105. FINRA Rule 3010 outlines the requirements for a reasonable supervisory system and each member must “establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Final responsibility for proper supervision shall rest with the member.”



nature of any sanction imposed.<sup>106</sup> There are several measures a company can take to foster a culture of compliance.

### **[A] Promote Compliance**

Self-Regulatory Organization (SRO) rules generally require training of employees on securities law compliance. In addition, companies should consider and evaluate whether they have an environment that encourages compliance and internal reporting. Corporate culture is set from the top of the organization by senior management and the board of directors. Such a commitment empowers employees to prevent wrongdoing and encourages employees to speak to their supervisors or use other internal reporting systems when they first become aware of any possible misconduct.

### **[B] Codes of Conduct and Training**

Broker-dealers and other regulated enterprises are required to have written policies and procedures governing compliance matters, supervision, and other aspects of their business, often referred to as "WSPs."<sup>107</sup> Companies should periodically review their codes of conduct and WSPs to see if any changes are appropriate, particularly with respect to encouraging communications between employees and compliance personnel, and the avenues provided for such communications. Companies should disseminate their codes of conduct to all employees and make them available online and in multiple languages, as appropriate. Employees should receive training on the code of conduct or WSPs when they are first hired, and periodically thereafter, so that they are aware of the company's compliance policies and procedures. In addition, companies should consider requiring employees to sign an annual certification stating they are familiar with the code of conduct and WSPs, and have received training on these topics. Annual training programs signal a high-level commitment to compliance issues, and requiring employees to sign an annual statement may impress upon them that they are personally responsible for

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106. The SEC has stated it will consider a company's internal compliance programs and efforts to promptly investigate and disclose possible violations as a factor in determining sanctions in its so-called "Seaboard report" and subsequent releases on non-prosecution and deferred prosecution agreements. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001).

107. *See supra* chapter 27.

seeing that compliance policies are followed. In addition, FINRA Rule 3010(a)(7) requires that each registered person and principal attend an annual compliance meeting at which relevant compliance matters are discussed. Member firms often use this forum as a vehicle for continuing compliance education.

### **[C] Mandatory Reporting of Potential Violations**

As part of a culture of compliance, companies should require employees to promptly report all possible violations of the code of conduct or firm policies and procedures and regularly remind employees of this requirement. As part of their annual certification that they have reviewed the code of conduct and firm WSPs, companies should also consider having employees acknowledge that they are not aware of any potential violations of the code of conduct and WSPs, including any federal securities and commodities laws that have not already been reported to the company.

#### **§ 41:13.2 Internal Reporting Procedures**

In response to concerns from the business community and others that the Whistleblower Rules would incentivize employees to bypass internal compliance procedures to be first in line to collect a whistleblower award, the Commissions revised the rules to provide greater incentives for employees to use internal compliance systems before going to the Commissions. However, the Whistleblower Rules do not require employees to report possible violations internally and, despite these additional incentives, employees may be tempted to bypass internal systems to maximize their chance of receiving an award. Consequently, companies should consider several measures, such as the following, to further promote and encourage internal reporting.

### **[A] Accessible Internal Reporting Systems**

Internal reporting should be made available to employees by providing several methods of reporting, such as toll-free hotlines, an office of the ombudsman, and an anonymous email system and websites that accept anonymous allegations, among other things. A company's reporting mechanisms should be available twenty-four hours a day and in multiple languages for companies operating internationally or with foreign employees. In this regard, foreign nationals are eligible to receive awards under the Whistleblower Rules and plaintiffs' firms have already set up websites soliciting whistleblower tips from foreign nationals. In countries where methods of anonymous reporting are restricted, companies may need to tailor their procedures to local requirements.

Companies should also consider benchmarking their internal reporting systems against those of similar companies in their industry. For example, companies should assess the number of reports they are receiving in comparison to other companies. If receiving appreciably fewer reports, companies should consider whether sufficient efforts are being made to inform employees of reporting procedures or whether there are other factors, such as fear of retaliation, that are causing fewer reports.

### **[B] Communicating Importance of Internal Reporting**

Companies should highlight the importance of compliance and internal reporting at all levels of the organization and continually communicate this message throughout the company. Creative ways to raise employee awareness of the importance of reporting compliance issues should be considered, such as recognition of employees that show exceptional commitment to compliance, including by reporting possible violations to the company.

### **§ 41:13.3 Human Resources**

Both compliance and human resources departments will undoubtedly play a key role in promoting the use of internal compliance procedures and responding to whistleblower complaints. Human Resources also plays an important role in protecting whistleblowers and seeing that employment decisions are made without regard to any protected activity. They can also address employees' personnel concerns before they spill over into whistleblowing activity.

### **[A] Screening New Employees**

Human resources and compliance personnel should screen prospective new hires to identify and properly vet any red flags, consistent with applicable federal and state laws.

### **[B] Employee Evaluations**

Companies should think of ways to incorporate adherence to the code of conduct, including the use of internal reporting procedures, into employee evaluations. This will provide positive incentives—as opposed to only disincentives—for employees to use compliance procedures. For example, companies should consider: (i) using an employee's commitment to fostering a culture of ethics and accountability among the criteria used to evaluate performance; and (ii) including the reporting of potential misconduct as a positive performance criterion. Employees that demonstrate leadership in compliance areas and actively and candidly participate in investigations of misconduct should be recognized.

**[C] Manager Training**

Human resources and compliance personnel should evaluate the training programs currently provided to managers and supervisors regarding how to react and respond to employee reports of possible violations and revise or add new training programs if necessary. Many employees are likely to (or may be required to) first approach a direct supervisor about potential misconduct. If these supervisors do not take these reports seriously and provide proper advice on how to handle and remediate the situation, as appropriate, employees are less likely to use internal compliance procedures. In addition, inattention by supervisors may increase a firm's exposure to regulatory liability for failure to supervise claims.

**[D] Documenting Whistleblower Employment Actions**

Many whistleblower cases arise out of working relationships in which an employee believes he or she is being treated unfairly by superiors. By promptly investigating and addressing these circumstances, human resources and compliance departments can reduce the likelihood that the employee will seek assistance outside of the company by making a whistleblower complaint.

**[E] Exit Forms and Separation Releases**

It is important to obtain confirmation from departing employees that they have disclosed to the company any misconduct of which they are aware so that it can be addressed and remedied appropriately. Companies may want to include questions seeking this information in exit interviews and to include representations by departing employees in separation agreements that they have made full and truthful disclosures about any misconduct of which they are aware. In addition, separation agreements should include acknowledgments of employee rights to file charges, provide truthful information, and otherwise assist governmental authorities so they are not misinterpreted as impeding these rights, while at the same time waiving individual relief to the maximum extent permitted.

**§ 41:13.4 Internal Investigations**

Broker-dealers and investment advisors should develop a system to quickly respond to allegations of impropriety. Even companies that have such systems in place should periodically review their procedures and assess whether changes should be made. Indeed, the Whistleblower Rules pose significant challenges to a company's internal investigation procedures. Upon receiving a tip, a company must act quickly as it has 120 days before an employee can report to the SEC or

the CFTC without losing his or her “first in line” status. At the same time, the Whistleblower Rules require that companies be cautious and deliberative in how they conduct their investigations. Indeed, under the rules, an anonymous whistleblower may report the results and progress of the investigation to the SEC or the CFTC. Moreover, all employees involved in the investigation can potentially become whistleblowers in certain situations. With this in mind, companies must be careful and take various precautions when conducting an investigation in the post-Whistleblower Rules era.

### **[A] Investigative Plans**

Companies should consider a review of their current investigation procedures and create a plan in advance to respond to allegations of possible violations. The scope and nature of the investigation will depend on the type of allegations being made. Some allegations are more serious than others and will demand greater attention and resources. Companies should decide which employees will be involved in different types of investigations and develop basic protocols that will be used in whistleblower investigations. In some cases, it may be important that the investigation be conducted by someone with an independent perspective, such as when there are allegations involving senior management, so as to give external confidence to the results of the investigation. Companies should consider identifying in advance the types of allegations they intend to use outside counsel to investigate, so the investigation can commence promptly. Public companies should also review the types of whistleblower complaints that they require to be promptly reported to the audit committee and determine whether any changes to these procedures are appropriate.

### **[B] Keeping Whistleblower Appraised**

Whistleblowers who report internally have shown a commitment to the company and its compliance procedures. In addition, if a whistleblower is left wholly in the dark, he or she may assert to the Commission that the company’s internal investigation is inadequate. Thus, the company should consider apprising the internal whistleblower on the status and outcome of the investigation consistent with needs for confidentiality.

### **[C] Employee Interviews**

Companies should avoid revealing specific allegations of wrongdoing and underlying facts that support the allegations during employee interviews, to the extent possible, so as to avoid reputational injury to persons who have not, in fact, engaged in misconduct. Interviewers should remind employees not to reveal the existence of the investigation or the substance of the interview to anyone.

Companies should also consider advising employees that the interview is being conducted as part of an internal investigation and that they have an obligation to be candid with the company.

#### **[D] Use of Counsel**

All information obtained through a communication that is subject to the attorney-client privilege is not considered “original information,” and thus generally is not eligible for an award. Therefore, if appropriate to facilitate legal advice, companies should consider having an attorney conduct or participate in interviews. The SEC has stressed the importance of protecting the attorney-client privilege: “[I]f an attorney in possession of the information would be precluded from receiving an award based on his or her submission . . . , a non-attorney who learns this information through an attorney-client communication would be similarly disqualified.”<sup>108</sup> This exception does not apply if the privilege has been waived, and therefore companies should provide *Upjohn* warnings before all employee interviews to protect the privilege.<sup>109</sup>

#### **[E] Policies Regarding Privileged and Confidential Information**

The Whistleblower Rules appear to permit attorneys and others in possession of information protected by the company’s attorney-client privilege or the work product doctrine to disclose that information to the SEC or the CFTC under some circumstances. The rules provide for awards from reports made while an investigation is ongoing, creating added risk of disclosure of privileged information. In addition, it is foreseeable that whistleblowers will disclose confidential and proprietary business or customer information to the government without corporate authorization. Corporations should consider taking steps to prevent the misuse of confidential information by third parties. Thus, a company may wish to advise the SEC or the CFTC that an employee’s disclosure of privileged information was unauthorized and is not a waiver by the company.

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108. SEC Adopting Release, *supra* note 8, 76 Fed. Reg. at 34,315.

109. The “*Upjohn* warning” takes its name from the Supreme Court case *Upjohn Co. v. United States*, 449 U.S. 383 (1981), in which the court held that communications between company counsel and employees are privileged, but the privilege is owned by the company and not the individual employee. The purpose of the warning is to remove any doubt that the lawyer speaking to the employee represents the company, and not the employee. The warning also makes it clear that only the company, and not the employee, can waive any privilege associated with the communication.

## § 41:14 Implications of the Whistleblower Rules for Enforcement Practice

The Whistleblower Rules are intended to supplement the Commissions' ongoing efforts to encourage both individuals and companies to self-report and self-remediate securities and commodities law violations. The SEC previously has authorized the staff to enter into cooperation agreements with individuals and to resolve cases with entities that self-report violations and undertake remedial measures through non-prosecution agreements and deferred prosecution agreements. Experience with *qui tam* lawsuits under the False Claims Act suggests that whistleblower claims may become an important source of SEC and CFTC investigations and enforcement actions. For example, whistleblower claims have been central to several major government actions alleging health care fraud claims. It is uncertain how the Dodd-Frank Act and the new rules will affect the enforcement of federal securities and commodities laws, but several observations are in order.

### § 41:14.1 Self-Reporting

Historically, the SEC has said that it will consider lower sanctions or non-prosecution for companies who promptly self-report potential violations. A company which is investigating a possible violation must bear in mind the possibility that a whistleblower may seek to "win the race" to the SEC or CFTC doors, which, in turn, may adversely affect the amount of "credit" the company may claim for itself.

It should be noted that broker-dealers, pursuant to FINRA rule 4530, NASD rule 370 and New York Stock Exchange rule 351, are required to self-report a variety of misconduct including: (i) disclose any written grievance by a customer with whom the firm engaged in securities activities, and any securities-related written grievance by a customer with whom the firm sought to engage in securities activities in the firm's quarterly reports of statistical and summary information regarding written customer complaints; (ii) notify FINRA of certain regulatory, litigation, and related events; and (iii) file copies of certain criminal actions, civil complaints, and arbitration claims with FINRA.<sup>110</sup> But even though SRO rules may not mandate the reporting of a particular event, there may be occasions when a broker-dealer will still want to

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110. A broker-dealer must also report to FINRA any indictment, conviction, or guilty or no contest plea of the firm, or an associated person of the firm, that involves: (a) any felony; (b) a misdemeanor involving the purchase or sale of a security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, robbery, larceny, theft, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion or

notify the SEC or the CFTC of the information in order to foreclose a characterization of original information under the Whistleblower Rules.

### **§ 41:14.2     *Protect the Company's Privileges***

For several decades, practitioners have sought to enter into “limited waiver” agreements under which company counsel sought to provide privileged information and protected attorney work product to the Commissions while maintaining the privilege or protection as to third parties. Courts have not always honored such limited waiver agreements. Nevertheless, companies who wish to cooperate and share the results of an internal investigation and the evidence collected can defend against a subsequent claim of waiver in a private civil action by carefully defining the scope of communications with the Commissions, limiting the amount of attorney work product disclosed, and guarding against unauthorized disclosures of privileged information or attorney work product.

### **§ 41:14.3     *Assess Public Disclosure Issues***

Whistleblowers may raise issues that suggest that a company's previous periodic reports or press releases are inaccurate. These issues may also have implications for the accuracy of selling documents, prospectuses, or other sales literature distributed to customers or used by sales personnel. They may also identify previously unknown contingent liabilities. Public companies will need to assess whistleblower claims and subsequent internal investigations to determine whether corrective or additional disclosures are appropriate. Broker-dealers and investment advisers may need to assess whether corrective or additional disclosures to customers are required. Broker-dealers and investment advisers will also need to be mindful of their obligations to make reports to self-regulatory organizations and to state securities regulators.

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misappropriation of funds or securities; (c) activity that is substantially equivalent to any of the above; or (d) a conspiracy to commit any of those offenses or substantially equivalent activity. FINRA must also be notified if the broker-dealer or any of its associated persons is a defendant or respondent in civil litigation or arbitration that is related to securities or commodities, or is subject to a claim for damages by a customer or broker-dealer that is disposed of for an amount exceeding \$15,000 for associated persons, or \$25,000 for firms.