

## SEC Proposes Whistleblower Rules

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Yesterday the SEC **announced** and issued **proposed rules** that would implement the whistleblower provisions of the Dodd-Frank Act. The rules attempt to advance the Act's goal of encouraging whistleblowers while mitigating the perhaps unintended consequences inherent in providing large monetary incentives for providing information directly to the SEC. The proposed rules seek to:

- increase the volume of high-quality tips that the SEC receives;
- dissuade employees from bypassing internal corporate compliance programs;
- prevent individuals with compliance obligations – such as lawyers and accountants – from using their position to reap rewards;
- prevent wrongdoers from profiting from their misconduct; and
- spare the SEC from a tsunami of frivolous claims.

### Highlights of Proposed Rules

Dodd-Frank provides that any eligible whistleblower who voluntarily provides the SEC with original information that leads to the successful enforcement of an action brought by the SEC under the securities laws must receive an award of between 10 and 30 percent of the total monetary sanctions collected if the sanctions exceed \$1,000,000. The SEC release, which is 181 pages, outlines the scope of this whistleblower program, provides procedures and forms for applying for awards and sets forth the SEC's procedures for making decisions on the claims.

This newsflash focuses on elements of the proposal that attempt to address commonly expressed concerns about the Dodd-Frank whistleblower provisions. We will be releasing a webcast next week providing further information on the proposed rules, particularly with respect to their impact on corporate compliance programs.

### Support for Internal Compliance Programs

A widely expressed fear about the Dodd-Frank whistleblower provisions has been that they can create incentives for employees to bypass internal corporate compliance systems in order to be first in line to collect the statutory windfall. The proposed rules attempt to address this issue by providing incentives to employees to report under their internal compliance systems:

- the rules would give employees who first report information internally the benefit of the internal reporting date for purposes of the SEC program so long as the employee submits the same information to the SEC within 90 days of the initial disclosure.
- the rules would permit the SEC to consider, as part of the criteria for determining the amount of a whistleblower's award, higher percentage awards for whistleblowers who first report their information through effective company compliance programs.

The SEC also says that it expects that, in certain circumstances, the staff will, "upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back."

### Legal and Compliance Personnel Not Eligible for Awards

Another concern about the Dodd-Frank whistleblower provisions has been the incentive for legal or compliance personnel to abuse their special positions by making complaints to the SEC. The proposed rules seek to address this concern by generally providing that the SEC will not consider information to be

eligible for a whistleblower award if it was obtained by the would-be whistleblower in the following circumstances:

- through a communication subject to attorney-client privilege or as a result of legal representation (unless disclosure is permitted by attorney conduct rules);
- through an independent public accounting engagement;
- where the whistleblower has legal, compliance, audit, supervisory or governance responsibilities for an entity and the information was communicated to respond to the violation, unless the entity did not disclose the information within a reasonable amount of time or proceeded in bad faith;
- otherwise from or through any entity's legal, compliance, audit or other similar functions or processes, unless the entity did not disclose the information within a reasonable amount of time or proceeded in bad faith; or
- by a means or in a manner that violates federal or state law.

Employees of law enforcement and certain regulatory agencies and members of foreign governments are also ineligible for whistleblower awards.

### **Restrictions on Awards for Wrongdoers**

Dodd-Frank restricts employees who have been criminally convicted in connection with misconduct from receiving an award for reporting that misconduct. The proposed rules expand on this concept by limiting payment of awards to whistleblowers who have been required to pay monetary sanctions (such as in an SEC enforcement proceeding) or who directed, planned or initiated conduct that has led to entities being required to pay such sanctions.

### **Comments Regarding Whistleblower Program**

The SEC received limited **comments** on the Dodd-Frank Act's whistleblower provisions prior to yesterday's release. The comments reflect a highly polarized debate between those who are focused on maximizing whistleblower incentives and minimizing the risk of retaliation and those who are focused on the Act's sometimes perverse incentives and the danger they pose to internal corporate compliance procedures. The SEC has attempted to balance these concerns but the debate is far from over. The SEC is requesting comments on the proposed rules and says that it is particularly interested in comments regarding mechanisms to avoid paying awards to whistleblowers involved in the misconduct, even though they may not have been convicted or sanctioned. The comment period ends on December 17, 2010.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>Martine M. Beamon</b>	212 450 4262	<a href="mailto:martine.beamon@davispolk.com">martine.beamon@davispolk.com</a>
<b>Michael Kaplan</b>	212 450 4111	<a href="mailto:michael.kaplan@davispolk.com">michael.kaplan@davispolk.com</a>
<b>William M. Kelly</b>	650 752 2003	<a href="mailto:william.kelly@davispolk.com">william.kelly@davispolk.com</a>
<b>Scott W. Muller</b>	212 450 4359	<a href="mailto:scott.muller@davispolk.com">scott.muller@davispolk.com</a>
<b>Richard J. Sandler</b>	212 450 4224	<a href="mailto:richard.sandler@davispolk.com">richard.sandler@davispolk.com</a>
<b>Linda Chatman Thomsen</b>	202 962 7125	<a href="mailto:linda.thomsen@davispolk.com">linda.thomsen@davispolk.com</a>
<b>Raul F. Yanes</b>	202 962 7122	<a href="mailto:raul.yanes@davispolk.com">raul.yanes@davispolk.com</a>
<b>Janice Brunner</b>	212 450 4211	<a href="mailto:janice.brunner@davispolk.com">janice.brunner@davispolk.com</a>

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