The Law of the Lawyer

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What You Should Know About The SEC Whistleblower Rules And Program

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted by the U.S. Congress on July 21, 2010 ("Dodd-Frank"), the U.S. Securities and Exchange Commission ("SEC") adopted final rules (SEC Release No. 34-64545) to implement section 21F of the Securities and Exchange Act of 1934, as amended (Exchange Act) on May 25, 2011, which became effective on August 12, 2011. This article provides a brief overview of the whistleblower rules, discusses the nature of the tips received by the SEC under the new rules, and provides a brief overview of recent litigation involving the new rules.

Overview Of The Rules

Section 922 of Dodd-Frank added new section 21F, 15 U.S.C. §78u-6, to the Exchange Act which provides, generally, that pursuant to regulations prescribed by the SEC, the SEC shall pay an award to one or more whistleblowers who voluntarily provide original information to the SEC that leads to the successful enforcement of a judicial or administrative action brought by the SEC under the securities laws which in turn results in monetary sanctions exceeding $1 million. The award shall be equal to, in the aggregate, no less than 10 percent or more than 30 percent of the monetary sanctions collected from the action(s). All proceeds are paid from a separately designated Investor Protection Fund.

The SEC's final rules defined certain terms under the whistleblower program, outlined procedures for applying for awards under the whistleblower program, and generally explained the scope of the whistleblower program. Section 21F(a)(6) of the Exchange Act defines a "whistleblower" to be any individual who provides, or two or more individuals acting jointly who provide, information relating to a violation of the securities laws to the SEC, in a manner established, by rule or regulation, by the SEC. SEC rule 21F-2(a) further defines a whistleblower as an individual who, alone or jointly with others, provides information to the SEC relating to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. In addition, the rules provide that a whistleblower must be an individual and that a company or another entity is not eligible to be a

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whistleblower. The rules further provide that to be eligible for an award, an individual must submit original information to the SEC in accordance with its rules and procedures but the anti-retaliation protections apply whether or not an individual satisfies the requirements, procedures, and conditions to qualify for an award. Rule 240.21F-2; 17 C.F.R. §240.21F-2, SEC Release No. 34-64545 (May 25, 2011).

Number, Type, And Location Of Tips

Section 924(d) of Dodd-Frank also required the SEC to establish a separate office within the SEC to administer the whistleblower program and to have that office report annually to Congress on its activities, whistleblower complaints, and the responses of the SEC to such complaints. Section 21F(g)(5) of the Exchange Act also requires the SEC to report on the whistleblower program and to provide information about the Investor Protection Fund, in addition to other items. The SEC established the SEC Office of the Whistleblower (the "Office") to administer such requirements and in November 2011, the Office published its first annual report on the Dodd-Frank whistleblower program. U.S. Securities and Exchange Commission Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2011, November 2011, available at http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf ("2011 Report").

The 2011 Report provided detail from the effective date of the final rules, August 12, 2011, through the end of its 2011 fiscal year, September 30, 2011. The Office established a publicly available whistleblower hotline for members of the public to call with questions about the program. At the time of the 2011 Report, the Office reported that it had received over 900 phone calls from members of the public.

During this time period, the Office received 334 whistleblower tips from individuals in 37 states as well as several foreign countries. 2011 Report. The states with the highest reported tips include California (34 tips, approximately 10 percent of all tips), New York (24 tips, approximately seven percent of all tips), Florida (19 tips, approximately six percent of all tips) and Texas (18 tips, approximately five percent of all tips). Each of the other states had 10 tips or less. *Id.* at Appendix B. Eighty-seven tips did not indicate a location, which accounted for approximately 26 percent of all tips for this period.

In addition to tips from within the United States, 32 tips, or approximately 10 percent of all tips during the period, were from foreign countries. *Id.* Of the foreign countries reported, the most were from China (10 tips, or approximately 31 percent of all foreign tips). The United Kingdom had the next highest (nine tips, or approximately 28 percent of all foreign tips) followed by Australia (three tips, or approximately nine percent of all foreign tips). *Id.* at Appendix C.

The annual report also outlined the types of allegations with manipulation being the most common (54 tips or approximately 16 percent of all tips), followed by "offering fraud" (52 tips or approximately 15 percent of all tips) and "corporate disclosure and financials" (51 tips or approximately 15 percent of all tips). *Id.* at Appendix A. The classification of the type of an allegation was based upon the tipster's designation and selection of one of the predefined categories in the submitted questionnaire and thus "the data represents the whistleblower's own characterization of the violation type." *Id.* at fn 11. The Office stated that it is continuing to synchronize the categories in its questionnaires with the categories of cases of the SEC Division of Enforcement case tracking database so that it can further "calculate metrics, identify trends and evaluate the overall program." *Id.*

As of September 30, 2011, the Office reported that the Investor Protection Fund was fully funded and contained an ending balance of over $452 million, which was an increase of approximately $878,000 over fiscal year 2010. Because the dead-

line for submitting an application for an award in connection with a covered action under the whistleblower program had not passed at the time of the Office's 2011 Report, there were no awards to whistleblowers under the new rules during fiscal year 2011. Future annual reports from the Office may be useful in assessing the dollar amount and number of awards that led to tipster awards under the whistleblower program, which at this time is still too early ascertain. Also, future annual reports of the Office may be valuable in assessing the increase of funds available in the Investor Protection Fund.

While the annual report was useful in providing an initial gauge of the number, type, and location of tips, "[a]s a result of the relatively recent launch of the program and the small sample size, it is too early to identify any specific trends or conclusions from the data collected to date." 2011 Report, at 6. The Office expects "that the Annual Report for 2012 — with the benefit of a full year's worth of data — will yield such trends and conclusions." *Id.* As noted by the Office, at this time, we can only wait and see whether future tips will follow the initial trends and whether a large percentage of tips will continue to be from the United States and continue to center around manipulation. Addtionally, we also can only wait to see if the volume of tips and inquiries into the Office's hotline will continue to increase or if they will lose momentum. As of the date of this article, the Office has not indicated when its annual report for fiscal year 2012 is anticipated to be released.

Recent Litigation

Recent federal cases involving the whistleblower rules have centered around the anti-retaliation provisions under section 21F(h)(1)(A) of the Exchange Act. Section 21F(h)(1)(A) precludes an employer from discharging, demoting, suspending, threatening, harassing, directly or indirectly, or in any other manner discriminating against a whistleblower because of any lawful act by the whistleblower in: (i) providing information to the SEC in accordance with section 21F; (ii) initiating, testifying in, or assisting in any investigation or judicial or administrative action of the SEC based upon or related to such information; or (iii) making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Exchange Act (including section 10A(m) of the Exchange Act), 18 U.S.C. section 1513(e), and any other law, rule, or regulation subject to the jurisdiction of the SEC.

At issue has been the interplay between section 21F(h)(1)(A) and the definition of a "whistleblower," which is defined to require that information be provided to the SEC. This issue was initially addressed (before the SEC's adoption of the final whistleblower rules) by the United States District Court for the Southern District of New York in *Egan v. TradingScreen, Inc.* In this case, the Court noted that section 21F(h)(1)(A)(iii) "does not require that disclosure be made directly to the SEC." *Egan*, No. 10 Civ. No. 10 Civ. 8202 (LBS), 2011 WL 1672066, at *4 (S.D.N.Y. May 4, 2011). The court explained that the contradictory provisions are best harmonized by "reading [section 21F](h)(1)(A)(iii)'s protection of certain whistleblower disclosures not requiring reporting to the SEC as a narrow exception to [section 21F](a)(6)'s definition of a whistleblower as one who reports to the SEC." *Id.*, at *5. This topic was again recently addressed by the United States District Court for the Middle District of Tennessee (following the SEC's adoption of the final whistleblower rules) in *Nollner v. Southern Baptist Convention, Inc.*, No. 3:12 Civ. No. 00040, 2012 U.S. Dist. Lexis 46484 (M.D. Tenn. April 3, 2012). As explained by the Court in *Nollner*, "[b]y their own terms, the first two anti-retaliation categories protect whistleblowers who report potentially illegal activity to the SEC or who work with the SEC directly, in some manner, concerning potential securities violations. By contrast, the third category does not require that the whistleblower have interacted directly with the SEC

— only that the disclosure, to whomever made, was 'required or protected' by certain laws within the SEC's jurisdiction. *Id.* at *17 "[M]erely alleging the violation of a law or rule under the SEC's purview is not enough; a plaintiff must allege that a law or rule in the SEC's jurisdiction explicitly requires or protects disclosure of that violation." *Egan,* supra, 2011 WL 1672066, at *6. The *Nollner* Court further explained, "where an employee reports a violation of a federal law by the employer, [Dodd-Frank] only protects that employee against retaliation if the federal violation falls within the SEC's jurisdiction" and it refused to extend the anti-retaliation remedies under section 21F(h)(1)(A) where an alleged violation was outside the SEC's jurisdiction. *Nollner,* supra, 2012 U.S. Dist. Lexis 46484, at *21-22 (alleged violations of the Foreign Corrupt Practices Act would have been within the jurisdiction of the Department of Justice, not the SEC, therefore, the Dodd-Frank anti-retaliation provisions were not available).

As the Dodd-Frank whistleblower rules remain in the early stages of implementation, companies and individuals seeking the benefits and protections of these rules continue to wait to see how the SEC will carry out its direction to implement the whistleblower rules and how the rules may be further interpreted by federal courts.