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Employment Alert

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# The U.S. Securities and Exchange Commission's Proposed Regulation 21F: Implementation of Dodd-Frank's Whistleblower Provisions

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was enacted July 21, 2010. Among other things, it added new Section 21F to the Securities Exchange Act of 1934 ("Exchange Act"). This Section establishes a whistleblower program that directs the SEC (the "Agency") to pay monetary awards, or what has been viewed as "bounties," to whistleblowers who voluntarily provide the SEC with original information about violations of the securities laws. If the original information results in the SEC obtaining monetary sanctions exceeding $1 million, the whistleblower can recover between 10 percent and 30 percent of the monetary penalties. The Section also sets forth a robust anti-retaliation framework for whistleblowers. For a detailed discussion of Dodd-Frank's anti-retaliation provisions, please click here to see our earlier Alert, "Financial Regulators Set Out to Get Their Man: Federally Mandated Bounties and Anti-Retaliation Provisions Designed to Regulate the Financial Services Industry."

Consistent with the Congressional directives, the SEC has proposed Regulation 21F to implement Section 21F of the Exchange Act. The proposed regulations, as well as the proposed forms to be used in connection with the whistleblower program, are voluminous and total 181 pages. Despite the length and scope of the proposed regulations, the SEC requested comments on a very aggressive timetable—on or before December 17, 2010. However, given the substantial number of comments received and meetings held with the SEC on this subject, the timeline apparently did not dissuade those with an interest from being heard.

In its proposed regulations, the SEC acknowledges explicitly what has become the general consensus among most employers: that Section 21F of the Exchange Act, with its promise of high monetary awards, has the potential of reducing the effectiveness of an employer's existing internal compliance processes for investigating and responding to potential violations of the federal securities laws. This is also an issue for the Agency, which relies on internal compliance and self-reporting for some portion of the settled cases it brings every year. Corporate cooperation, in the form of self-reporting, independent investigations, and settlements, where appropriate, save the Agency substantial resources, and the Agency is unlikely to want to repurpose its already strained staff to do the job that corporate America is willing to do, in exchange for cooperation credit. 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, Securities Exchange Act Release No. 44969 (Oct. 23, 2001) ("The Seaboard Report").

Unfortunately, the Agency does not offer practical advice to employers on how to minimize the risk of a competition between the use of their internal corporate compliance programs and the promise of a bounty, although it does seek comments and suggestions on this issue. Based on the proposed regulations' content, battles are bound to be waged over the definitions of key terms, such as "whistleblower," "independent knowledge," "voluntary," "original information," and "perjury." However, this type of reactive litigation strategy offers little comfort to employers seeking to be proactive in addressing claims and reducing the risks of retaliation claims by whistleblowers.

Perhaps mindful of this deficiency, the proposed regulations seek to limit the universe of individuals who can be deemed a whistleblower. For example, the proposed regulations state that lawyers, accountants and individuals responsible for corporate compliance cannot qualify for an award because they do not have the "independent knowledge" required to be a whistleblower. However, the proposed rules simultaneously carve out an exception for employees involved in corporate compliance, where the company does not disclose information about its wrongdoing in a timely manner or otherwise acts in "bad faith." Under this exception, employees whose job it is to handle corporate compliance issues can file a report with the Agency and possibly qualify for a monetary award.

Further weakening the use of an employer's internal compliance program, the proposed regulations indicate an employee does not have to first utilize any internal reporting mechanism before providing information to the Agency. However, the Agency requests specific comments on this proposed provision, arguably with a view toward hearing debate (and possibly) requiring that an employee use the company's internal compliance program before coming to the Agency, if appropriate. As proposed, in the event an employee reports information internally, it appears that the company must act within 90 days. Depending on the nature of the complaint, this can be an onerous timetable for the employer. Notwithstanding this window, the employee still can go simultaneously to the Agency with the complaint. In the proposed release, the Agency's staff notes it anticipates "in appropriate cases, consistent with the public interest and our obligation to preserve the confidentiality of a whistleblower, our 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." Proposing Release at pp. 34–35. The staff further notes that the company can get cooperation credit for its actions in such circumstances, citing the Seaboard Report. The only apparent effort to harmonize the internal compliance function and the not insubstantial "carrot" of the whistleblower reward is that the Agency's proposed regulation provides that a whistleblower can go to the company's internal compliance first, and then within the 90-day window submit the whistleblower forms to the Agency, securing his or her position. See Proposing Release at p. 33. The Agency suggests that, among the many considerations that may go into determining the size of a whistleblower's eventual award, the fact that a whistleblower first reported to internal compliance may be a factor that will increase the award size, thus encouraging and promoting the use of internal compliance procedures. See Proposing Release at pp. 50–51.

The Agency recognizes that employers may be subject to spurious claims from employees who may have ulterior motives, such as an impermissible form of job protection. In an effort to weed out spurious claims, the proposed rules require a person to complete and sign his or her complaint "under penalty of perjury." Moreover, whistleblowers who submit information anonymously must be represented by counsel. Of course, it remains to be seen if these requirements will cause potential whistleblowers to think twice before completing the form, particularly given that proving perjury is not always an easy endeavor. However, to the extent that 18 U.S.C. § 1001 criminalizes false statements made to a governmental agency concerning information that would be "material" to the agency's functioning, the Agency is not left completely defenseless to prosecute those individuals who intentionally provide false information should it choose to pursue such deterrents.

Although it may take some time before the Agency's regulations are finalized, one primary issue is how the regulations will harmonize what appears to be the direct conflict between an employee's use of a company's internal compliance program, which the Agency has encouraged previously, and an employee's usurping the internal program in pursuit of a bounty. Reading between the lines of the proposed regulations, it appears the Agency may be persuaded to mandate that employees first use the company's internal compliance program in cases where the company is large (and can guarantee anonymity) and has a robust program in place. However, we will have to await the final regulations to see if such a carve-out occurs. We will continue to monitor these issues and keep you informed.

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