



► Compliance Corner

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The SEC's Whistleblower Rules: Their Impact on Investment Advisers

On May 25, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules implementing the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). These rules (the "Whistleblower Rules") create incentives for individuals to report possible violations of the federal securities laws to the SEC by rewarding individuals for credible tips that lead to successful enforcement actions and by protecting such individuals from retaliatory actions taken by their employers. This article will detail the requirements that must be met in order for an individual to qualify for an award under the Whistleblower Rules, the criteria that are considered in determining the amount of an award and the protections offered by the Whistleblower Rules for those individuals who do come forward. The article will also highlight the effects that the Whistleblower Rules will have on investment advisers and will suggest steps that should be taken to address the Whistleblower Rules from a compliance perspective.

Provisions of the Whistleblower Rules

Qualifications for the Award

Under the Whistleblower Rules, an individual who provides the SEC with original information relating to a possible violation of the federal securities laws that has occurred, is presently occurring or is about to occur, may qualify for an award if certain conditions are met.

First, the information supplied by the whistleblower must be "original." Information will be considered original if it is based on the whistleblower's own knowledge, is not gleaned from a public source, such as the media or an allegation made in the course of a hearing, an audit, a government report or an investigation, and is not currently known to the SEC. If information is reported internally as part of a compliance program before being provided to the SEC, and is then provided to the SEC within 120 days of the date on which it was provided internally, it will still be deemed "original" for purposes of the Whistleblower Rules. It is worth noting that the Whistleblower Rules do not require an individual to first report information internally in order to be eligible to receive an award. However, the Whistleblower Rules do provide an incentive to report information internally: a whistleblower that internally reports information before or at the time he or she reports such information to the SEC will receive full credit for any additional information later reported to the SEC by the individual's organization.

In addition to being original, information must be provided to the SEC on a voluntary basis. Individuals who are legally obligated to report possible violations of the federal securities laws, or who report information in response to a regulatory request or demand, will not be eligible for an award under the Whistleblower Rules.

Finally, the information provided must lead to a successful enforcement action that results in a monetary award of more than \$1 million. In determining

whether this minimum is met, the SEC may include civil monetary penalties, amounts paid as disgorgement, and any prejudgment interest that may have accrued. If more than one case arose out of the same set of facts, or if related actions are brought by other government agencies, the monetary awards of each may be combined to reach the minimum threshold.

An individual reporting information to the SEC under the Whistleblower Rules may elect to remain anonymous; however, any individual choosing to do so must be represented by an attorney and must disclose his or her identity prior to collecting an award.

Exclusions from Eligibility

Under the Whistleblower Rules, the following individuals and types of information are excluded from eligibility for an award, subject to certain exceptions discussed below:

- any individual that has a pre-existing legal or contractual obligation to report violations of the federal securities laws;
- the officers, directors, trustees or partners of any entity, if such individual learned of the reported violation as a result of another individual reporting such information to him or her or by means of the entity's process for identifying potential violations of the securities laws;
- compliance officers or other individuals whose chief function is to ensure

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compliance with federal securities laws and individuals retained to conduct compliance or internal audits or inquiries into possible violations;

- independent public accountants who acquire information through an engagement mandated under the federal securities laws;
- foreign public officials;
- information that is derived from communication protected by attorney-client privilege or obtained as a result of legal representation; or
- information that is gathered by means that violate applicable criminal laws.

If, however, an otherwise excluded individual meets one of the following criteria, he or she may nonetheless be deemed eligible to receive an award based on otherwise excluded information: (1) the individual had a reasonable basis to believe that disclosure of the information provided was necessary to prevent the entity being reported from committing substantial harm; (2) the individual had a reasonable basis to believe that the entity being reported was engaging in bad faith conduct that may have impeded an investigation; or (3) if the individual reporting the information was a director, officer or compliance officer and 120 days had passed since the individual reported the information internally.

Determination of Award

Individuals who are eligible for an award are entitled to between 10% and 30% of the amount recovered as a result of a successful enforcement action. In determining the size of the award, the SEC must consider several factors. Among the factors that may increase the size of an award are: the significance of the information provided by the whistleblower in the action, the level of interest law enforcement had in the action, the degree to which the whistleblower assisted in the

enforcement action and whether the whistleblower complied with internal reporting procedures prior to reporting to the SEC. The following factors may serve to decrease the size of an award: culpability of the whistleblower, unreasonable delay in reporting, and interference with internal compliance procedures. It should be noted that culpability of a whistleblower will not preclude the whistleblower from receiving an award, but may decrease the amount of the award received.

Protections from Retaliation

Equally as important as the provisions of the Whistleblower Rules that reward individuals for reporting possible violations of the federal securities laws are those provisions that protect



individuals from retaliatory actions taken against them by their employers as a result of their reporting. Provided that a whistleblower had a reasonable belief that the information he or she provided relates to a possible securities law violation, the protections from retaliation provided by the Whistleblower Rules would apply regardless of whether the whistleblower qualified for an award or whether an actual violation was found to have occurred. Under the Whistleblower Rules, a whistleblower has six years from the date on which retaliation occurs, or three years from the date on which the whistleblower becomes

aware, or should have become aware, of the retaliation, to bring an action against his or her employer. In no event can an action be commenced more than 10 years after the date on which the retaliation occurred. If successful in his or her action, a whistleblower is eligible for reinstatement of the seniority he or she would have had had it not been for the retaliatory act and may recover double back pay and reimbursement for costs and fees incurred in litigating his or her claim.

Effects of the Whistleblower Rules on Investment Advisers

Perhaps the greatest effect that the Whistleblower Rules will have on investment advisers is the increased likelihood that individuals will report possible violations of the federal securities laws to the SEC instead of, or in addition to, reporting such violations internally. Once a whistleblower does report information to the SEC, the Whistleblower Rules permit SEC employees to speak directly to whistleblowers whose employers are represented by counsel without having to first obtain the consent of counsel. This will make it difficult for an investment adviser, or any other type of entity being reported to the SEC, to control the flow of information, some of which may be deemed confidential or proprietary, being provided to the SEC. It is also worth noting that once other individuals in an organization become aware of a pending investigation, they may have greater incentives under the Whistleblower Rules to raise other, unrelated issues about which they may otherwise not have come forth, opening the door to the possibility of additional claims being brought against the organization. Finally, the Whistleblower Rules grant the SEC the power to charge retaliation against a whistleblower as an independent violation of the securities

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laws (in addition to the jurisdiction the Department of Labor would have over such actions). As such, employers should exercise extreme caution when taking any action with regard to an employee who may be a whistleblower.

Compliance with the Whistleblower Rules

In light of the passage of the Whistleblower Rules, there are several steps that investment advisers should take from a compliance perspective. First and foremost, investment advisers should review their existing compliance programs for any inconsistencies with the Whistleblower Rules. Investment advisers should ensure that they have clear policies in place for internal reporting of any possible violations of the securities laws. In an effort to encourage internal reporting, procedures should be straightforward and accessible to all employees. Such procedures can include the creation of a tip hotline that is open to employees at all levels or an anonymous email reporting system. Anonymity should be guaranteed to employees who seek it.

In the event that an investment adviser does receive an internal tip, it should have clear cut procedures in place for handling the investigation of the information received. Detailed records should be maintained regarding all tips received and the actions taken in response to each tip. Tips should be acted upon quickly, ideally within the 120 day window that employees have to report the information to the SEC and still have it be considered "original" information. However, investigations should not be rushed to be completed within this time frame. Any investigation should be complete and thorough. Investment advisers should consider keeping the whistleblower apprised on

a confidential basis, of the progress of the investigation so that he or she does not mistakenly think his or her tip is being ignored. Throughout the investigation process, investment advisers should seek the advice of outside counsel whenever necessary. In instances in which violations of the securities laws are found to have occurred, investment advisers should consider self-reporting to the SEC.

To avoid running afoul of the anti-retaliation provisions of the Whistleblower Rules, investment advisers should establish firm anti-retaliation policies and ensure that employees understand that any acts of retaliation will not be tolerated. All supervisors should be trained on how to handle a whistleblower, as it is likely that an employee may first approach his or her direct supervisor with concerns he or she may have. Any employment decisions made with respect to a whistleblower should be thoroughly and accurately documented. In the event that an action for retaliation is ever brought against the investment adviser by a whistleblower, records indicating that any adverse actions taken against the whistleblower were taken for legitimate reasons unrelated to the whistleblowing will be of crucial importance if the investment adviser is to successfully defend against the claim. Investment advisers should consider consulting counsel before taking any actions involving a whistleblower.

Lastly, and perhaps most importantly, investment advisers should strive to create a strong culture of compliance among all employees. Employees at all levels, including management, should be schooled in the importance of compliance. All employees should receive annual training on the investment adviser's compliance program and, ideally, should sign certifications

affirming that they have read, understand and agree to comply with the policies and procedures included in the program. Such certification may also include an attestation that the employee is not aware of any possible violations of the securities laws that he or she has not already reported. Advisers should consider how their whistleblower compliance policies and procedures are coordinated with any reporting requirements in their Code of Ethics. Training on the investment adviser's whistleblowing policies and procedures, including the anti-retaliation policy, should be included in annual training. Investment advisers may also consider adding a compliance factor to employee evaluations to stress the importance of compliance and to create an added incentive for employees to take compliance seriously.

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