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WHISTLEBLOWERS

A World of Whistleblowers: What Companies Should Know About Dealing With Third Parties Going Forward

BY GREGORY F. PARISI

The new United States whistleblower program is global in scope and provides incentives to a broad array of individuals. The new rules incentivize a much wider array of individuals than merely corporate insiders to become watchguards of corporate compliance with federal securities laws – including customers, stockholders and academics, market watchers and citizen activists, and third-party service providers. Of these groups, individuals working for third-party service providers are the most likely outside candidates to act on the financial incentives contemplated by the Dodd-Frank Act. They often have access to and work with sensitive corporate information.

Gregory F. Parisi is a partner with Hogan Lovells. His practice focuses on mergers and acquisitions, public and private offerings of securities, compliance with the federal securities laws and financial institution regulatory matters. Greg advises public companies and their boards on corporate governance, fiduciary duties, SEC reporting and national stock exchange compliance, and proxy matters. Greg has extensive experience advising financial institutions and their holding companies on a variety of corporate, securities, transactional and regulatory matters. Greg can be reached at gregory.parisi@hoganlovells.com

The new whistleblower program is causing many companies to take a close look at, and in some cases revise, their internal policies, procedures, communications and culture in connection with reporting and compliance. In doing so, companies should not ignore the implications of the whistleblower program with respect to third-party service providers. Because any report by a whistleblower, however frivolous, can result in substantial costs and distractions, companies should select, engage and manage third-party service providers in light of the new whistleblower rules.

This article provides a brief summary of the new whistleblower program[1] in the United States as it relates to third-party service providers, and discusses some of the particular implications and actions companies should consider going forward.

I. The New Whistleblower Program

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added new Section 21F to the Securities and Exchange Act of 1934, directing the SEC to pay awards of between 10% and 30% of the amount recovered to individuals who voluntarily provide the SEC with original information about a possible violation of the federal securities laws leading to an enforcement action resulting in monetary sanctions exceeding $1,000,000. The SEC's final rules implementing Section 21F became effective on August 12, 2011.

According to the SEC staff's recently released Annual Report on the Dodd-Frank Whistleblower Program for Fiscal Year 2011, the SEC received 334 whistleblower tips in the first seven weeks of the new whistleblower program.[2] The tips cited by the SEC covered a broad

[1] For simplicity, descriptions of the program in this article are based on the SEC's rules rather than those of the CFTC. The CFTC rules are generally similar to the SEC's, though some differences exist.

[2] The final SEC rules implementing the program became effective on August 12, 2011 and the report included data

range of alleged infractions, including, among others, market manipulation, offering fraud, insider trading, non-compliant corporate and financial disclosure, and FCPA violations.

A. Global Scope

Under the new rules, eligibility for an award as a whistleblower is not limited by geography. Published data and other evidence demonstrates that individuals the world over have been made aware of the substantial financial rewards available under the program. A surprising 32 of the 334 tips cited in the SEC's Annual Report on the whistleblower program originated from countries other than the United States. A recently published article in Australia's biggest-selling newspaper proffered that the ''new U.S. whistleblower rules could see Australian workers turn sleuths in the hope of discovering corporate wrongdoings and reaping millions of dollars in rewards.''[3]

Many global citizens will not be in a position to credibly offer the SEC the sort of information that would qualify them for a reward, and some individuals who would otherwise be in position to obtain or use such information are not permitted to do so under the rules. However, despite these limitations, the magnitude of potential rewards and the breadth of participant eligibility have clearly made the program newsworthy around the world. With nearly 10% of the tips provided under the program in its first seven weeks coming from abroad, companies should not ignore the implications of the new whistleblower program when dealing with entities or individuals outside the United States.

B. Broad ''Whistleblower'' Eligibility

The SEC did not provide data in its Annual Report on the whistleblower program regarding the number of tips that originated from within the allegedly non-compliant companies as compared to the number of tips that originated from external sources. Likewise, the SEC declined to provide information regarding the role or expertise of any particular categories of tipsters. Unlike the global reach of the program then, we have no hard data as to the extent to which employees of third-party service providers have attempted to participate in the whistleblower program. However, we can be sure from the rules themselves that the incentives are in place, with some important limitations, for individuals working for third-party service providers to participate in the whistleblower program.

Under the new rules, ''whistleblower'' is broadly defined, with eligibility for an award limited only by requirements that a whistleblower must:

- voluntarily provide the SEC ''original information'' relating to a possible violation of the securities laws;
- be an individual and not an entity, though a whistleblower may act jointly with others; and
- comply with certain procedures related to the submission of information to the SEC.[4]

There is no requirement that a whistleblower be an employee of the company that is possibly violating the securities laws. The definition of ''whistleblower'' therefore opens the door for individuals working for third-party service providers to qualify as whistleblowers. However, the requirement that whistleblowers provide ''original information'', together with the definition of that term and the related terms ''independent knowledge'' and ''independent analysis'' serve to limit the scope of individuals that may qualify as whistleblowers. In particular, certain potential whistleblowers are excluded from eligibility based on the type of work they perform and the nature of the information that comes into their possession.

The rules generally exclude from whistleblower eligibility attorneys acting on behalf of a company and, more broadly, other individuals who obtain information subject to attorney-client privilege. Specifically, the rules exclude from consideration as ''original information'' any information obtained by an attorney or other employee of a firm in connection with the legal representation of a client where the attorney or employee seeks to use the information to make a whistleblower claim for their own benefit. The rules further exclude from consideration as ''original information'' any information obtained ''through a communication that was subject to the attorney-client privilege'' without regard to who is attempting to use such information or for whose benefit a whistleblower claim is being made. Both of these restrictions are subject to certain exceptions, however, most notably where disclosure is necessary to prevent the company from committing a material violation of the law that is likely to cause substantial injury to the financial interest or property of the company or its investors.[5]

The rules also generally exclude from whistleblower eligibility individuals acting as auditors, compliance personnel and investigators of possible violations of law. Specifically, the rules exclude from consideration as ''original information'' any information obtained by (1) employees of, or other persons associated with, public accounting firms to the extent such information is obtained in the performance of audit services required by the securities laws; (2) employees or other associates of a firm retained to perform compliance or internal audit functions for an entity; and (3) employees or other associates of a firm retained to conduct an inquiry or investigation into possible violations of law. However, these exclusions do not apply where the individual reasonably believes (a) that disclosure of the information to the SEC is necessary to prevent a company from engaging in conduct likely to cause significant injury to the financial interest or property of the company or investors or (b) that the entity is engaging in conduct that will impede an investigation of possible wrongdoing. The exclusions also do not apply where at least 120 days have elapsed since the individual provided the information to the company's audit committee or chief legal or compliance officer, or to the individual's supervisor.[6]

through September 30, 2011, the end of the SEC's fiscal 2011. The 334 tips cited excludes tips from individuals who did not wish or were not eligible to be considered for awards under the whistleblower program.

[3] ''US Law Offers Huge Potential Rewards to Aussie Whistleblowers,'' by Susannah Moran, The Australian, November 7, 2011.

[4] Rule 21F-2, 17 C.F.R. § 240.21F-2.

[5] Rule 21F-4(b)(4), 17 C.F.R. § 240.21F-4(b)(4).

[6] Id.

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Under the rules, performers of legal and audit services generally have been eliminated from whistleblower eligibility, likely to avoid interfering with such activities and the open avenues of communication between companies and their attorneys and financial auditors. Similarly, the rules restrict compliance and investigative service providers from whistleblower eligibility, as any chilling effect on communication or trust with such personnel would be counterproductive to the larger goals of the whistleblower program. Individuals performing other functions and working with other types of third-parties are eligible for rewards under the program.

C. Use of Publicly Available Information

Importantly, the rules permit information that is obtained solely through examination and evaluation of publicly available information to qualify as ''original information'' as long as the resulting information is not generally available to the public.[7] As a result, individuals working for a third-party service provider could qualify as whistleblowers based both on confidential information obtained from a company directly or on information obtained as a result of analysis performed, individually or collectively, on publicly available information. This is important in that it means that individuals working for third-party service providers who do not have access to non-public information can still be successful whistleblowers.

D. No Impeding Communications

Significantly, the rules also prohibit companies from taking actions to impede individuals from communicating with the SEC regarding possible securities law violations, including by enforcing or threatening to enforce a confidentiality agreement.[8] As a result, confidentiality agreements or provisions and other contractual obligations cannot be utilized or relied on to prevent individuals at third parties from acting as whistleblowers.

II. Third-party Whistleblowers

A. What Third Parties?

Potential candidates for whistleblowing activity may work for a variety of third-party service providers. Some may merely handle confidential company information in the course of performing other, often technical services, such as individuals who work for financial printers, proxy solicitors and third-party monitors of reporting hotlines.

Employees of non-financial auditors, appraisers and evaluators are also potential whistleblower candidates. These firms and individuals are typically engaged for their expertise in a particular subject matter specific to the company in question. These service providers could include, for example, environmental audit firms, loan portfolio evaluators, FCPA auditors, and asset valuation experts. Of course, as described above, providers of legal, financial audit and compliance services generally would not qualify.

Employees of third parties that are hired to help a company evaluate a particular transaction such as an acquisition may also be whistleblower candidates. Examples include many of the same specialized appraisers and evaluators discussed above, as well as forensic accountants and other parties (other than attorneys) that might assist with due diligence efforts. These individuals could be whistleblowers with respect to either the company on which they are performing diligence (i.e., the seller or target) or the acquiror assuming the acquisition closes and the transaction is structured in a manner under which the acquiror inherits any compliance issues of the target.

B. How Are Third-party Whistleblowers Different from Internal Employees?

Individuals that work for the types of firms described above are different in some important ways from internal employees who may be potential whistleblowers. For better or worse, individuals employed by a third-party service provider typically will not have the same level of familiarity and experience with the company as internal employees. Service providers may therefore be less loyal to the company or its executives, which could in turn lead to a greater likelihood of making a bad faith whistleblower report or bypassing internal reporting procedures with respect to a good faith report in the hope of receiving a reward. Employees of third-party service providers are also less likely than internal employees to be familiar with the company's policies and procedures for internal reporting, the preferred formal and informal channels of communication at the company, and the company's overall culture or emphasis with respect to compliance.

III. What Should Companies Be Doing?

No company wants to face an SEC inquiry or investigation into allegations of non-compliance with the securities laws, even where it is certain it will be ultimately exonerated. Given the new incentives for whistleblowers to report potential violations and the broad group of individuals eligible to be awarded, companies should take certain steps, in addition to compliance with the securities laws, to minimize the risk of such allegations and to increase the likelihood that reports are brought to the company's attention first. In particular, companies should consider the following:

- Make third-party service providers aware of your internal reporting system and compliance culture, and your preference that any issues be brought first to the attention of internal employees (such as a chief compliance officer) in accordance with company policy. Much has already been said and written regarding actions companies should consider in light of the new whistleblower program in general – steps such as reinforcing an emphasis on ethics from the top levels of the company on down, updating and stressing internal reporting policies and systems, empowering a senior level compliance officer, and creating a culture where internal reporting is rewarded and valued and those who make such reports are protected. These steps can make a difference with respect to third-party service providers as well as internal employees, provided that the policies, procedures, and culture are communicated effectively to third parties.
- Where appropriate, have outside counsel engage third parties in connection with legal representation. Although this may not be an option in all circumstances, where work is being performed in

[7] Rule 21F-4(b), 17 C.F.R. § 240.21F-4(b).
[8] Rule 21F-17(a), 17 C.F.R. § 240.21F-17(a).

connection with a legal representation, companies will benefit from having their counsel engage and manage third-party service providers because information shared with or obtained from the third parties may be protected by the attorney-client privilege. Such information would not qualify as eligible for an award under the whistleblower program.

- Make clear where third-party service providers are being engaged for compliance or internal audit functions. Like information that is subject to the attorney-client privilege, information obtained or produced for purposes of such compliance or audit work will not easily qualify as eligible for a reward. Discussions with third-party management, as well as more formal steps such as contractual recitals, acknowledgements and representations can be useful in managing the incentives perceived by third-party service provider employees and the procedures they are inclined to follow.
- Where possible, include the existence and quality of internal reporting policies among the criteria used for selecting third-party vendors. Third-party vendors with effective internal policies that require employees to first report complaints and compliance issues related to customers internally (and then, where appropriate, to the customer) are preferable to those that have no policy or a weak policy. While no such policy can entirely eliminate the incentives of the whistleblower program or negate the potential for frivolous claims, engaging third parties that have strong policies or are willing to put such policies in place can certainly help.

IV. Conclusion

In light of the substantial potential rewards under the new United States whistleblower program and the broad scope of eligibility, companies that are smartly examining their compliance culture, policies and procedures should also focus on how they select, engage and manage third-party service providers.

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