

THE SEC'S WHISTLEBLOWER PROGRAM: WHAT THE SEC HAS LEARNED FROM THE FALSE CLAIMS ACT ABOUT AVOIDING WHISTLEBLOWER ABUSES

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INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act's ("Dodd-Frank Act") sweeping overhaul of the financial system now requires the SEC to pay substantial monetary awards to whistleblowers who disclose wrongdoing by publicly traded companies, financial services institutions, and other covered entities, and it prohibits employers from retaliating against SEC whistleblowers.¹ On May 25, 2011, the SEC adopted final rules implementing these new mandates.² Although the rules become effective 60 days after publication in the Federal Register, they apply retroactively to tips provided on or after July 21, 2010, Dodd-Frank's enactment date. The SEC's new whistleblower program borrows heavily from the whistleblower provisions of the civil False Claims Act ("FCA"), albeit with important distinctions that reflect an attempt by the SEC to distance itself from some of the problems plaguing FCA enforcement.

The concept behind the SEC's whistleblower program, initially proposed by University of Alabama Law School Professor Pamela (Bucy) Pierson in a seminal article

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¹ The SEC promulgated its whistleblower program under Section 21F of the Securities Exchange Act of 1934, 15 U.S.C. 78u-6 ("Section 21F"), which was added by Section 922 of the Dodd-Frank Act. *See* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, §921 (2010).

² The SEC's final rules ("SEC Rules") are to be codified in 17 C.F.R. Parts 240 and 249. Prior to codification, the rules can be found in the SEC's adopting release. *See* Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300 (June 13, 2011) ("SEC Adopting Release").

published nine years ago, is based on the view that so-called “*qui tam* enforcement” had worked so well in enforcing the FCA that it should be imported to enforce the securities laws.³ Indeed, although a 2006 revision to the IRS whistleblower program served as a model for the award levels and appeals process under the SEC’s program,⁴ a number of elements in the SEC’s whistleblower provisions derive from the FCA. For example, the 10–30% whistleblowers’ share levels, the “original information” requirement, and the “voluntarily provided” requirement are similar to FCA requirements. In its proposed whistleblower rules, the Commission noted that the FCA provided “helpful guidance” on whistleblower legal standards, and the SEC’s adopting release relied on a number of FCA decisions in defining the standards for the program.⁵ However, the overall balance struck between the competing interests of whistleblowers, companies, and the government in the SEC’s whistleblower program results in a program that differs from the FCA and enables the SEC to curtail some of the whistleblower abuses that have occurred under the FCA’s *qui tam* enforcement mechanism.

THE SEC’S WHISTLEBLOWER PROGRAM HAS NO *QUI TAM* ENFORCEMENT

The most significant distinction between the SEC’s whistleblower program and the FCA’s enforcement regime is that the SEC program does not allow *qui tam* enforcement. The FCA gives the federal government powerful enforcement resources, but it also empowers private plaintiffs, referred to as *qui tam* relators, to pursue claims on behalf of the United States even when the United States decides not to prosecute actions on its own. The term “*qui tam*” is derived from a Latin phrase, “*qui tam pro domino rege quam pro se ipso*,” or “who pursues this action on our Lord the King’s behalf as well as his own.”⁶ As this phrase indicates, the *qui tam* action arose in early English common law as a device for permitting private individuals to litigate claims on the sovereign’s behalf. Like relators in modern FCA actions, early *qui tam* litigants not only gained standing to sue that they otherwise would lack, but they also received a share of any recovery obtained on the sovereign’s behalf as a result of the *qui tam* action.⁷ Significant FCA amendments in 1986 strengthened relators’ rights and increased their potential bounties, thus dramatically increasing the incentives to filing suit. FCA amendments in 2009 and 2010 further enhanced relators’ ability to share in recoveries and added additional

³ See Pamela H. Bucy, *Private Justice*, 76 S. Cal. L. Rev. 1 (2002).

⁴ See S. Rep. No. 111-176, at 111 (2010); Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, §406, 120 Stat. 2958 (2006).

⁵ The SEC issued proposed rules to implement its whistleblower program on November 3, 2010. See Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-63237 (Nov. 3, 2010); 75 Fed. Reg. 70488 (Nov. 17, 2010) (“SEC Proposing Release”).

⁶ Vermont Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 769 n.1 (2000).

⁷ See John T. Boese, CIVIL FALSE CLAIMS AND QUI TAM ACTIONS (Wolters Kluwer Law & Business) (4th ed. 2011) § 1.01[A] (hereinafter “BOESE”).

protections against retaliation.⁸

While the original purposes of the FCA *qui tam* enforcement mechanism included “setting a rogue to catch a rogue,”⁹ the FCA actually prevents recovery of an award by a whistleblower convicted of criminal conduct related to the action. It also restricts the ability of a relator with unclean hands to collect a *qui tam* bounty.¹⁰ However, while the FCA specifically provides that a prevailing relator’s attorneys’ fees are paid by the defendant, a prevailing defendant may recover reasonable attorneys’ fees only if the *qui tam* action was clearly frivolous, vexatious, or brought in bad faith under the FCA.¹¹ And, under FCA case law, *qui tam* defendants may not bring claims for indemnification against relators, even those who assisted in perpetrating the fraud.¹² Given these parameters, there is plenty of room for whistleblower abuses under the *qui tam* enforcement mechanism.¹³

The potential for similar abuses may be curtailed under the SEC’s program because it is an administrative process with limited circuit court review of the SEC’s discretionary decisions on awards.¹⁴ SEC whistleblowers are afforded no special powers to investigate potential violations or to bring administrative or judicial enforcement actions based on violations. Thus, while the SEC’s program requires the SEC to pay whistleblowers for information from the proceeds of successful actions, the fact that the program is essentially an administrative enforcement process enables the SEC to maintain complete control of enforcement of the securities laws, including whether, when, and how to exercise its prosecutorial discretion in enforcement matters.

The decision to keep the SEC in charge reflects a legislative recognition that,

⁸ See Boese, §§1.09, 1.10, 1.11.

⁹ See Cong. Globe, 37th Cong., 3d Sess. 955–56 (1863) (remarks of Sen. Howard).

¹⁰ See 31 U.S.C. §3730(d)(3).

¹¹ 31 U.S.C. §3730(d)(4).

¹² See, e.g., *Mortgages, Inc. v. U.S. Dist. Court of Nev.*, 934 F.2d 209 (9th Cir. 1991) (dismissing defendants’ counterclaims against relators and finding no right of action under the FCA for indemnification to “ameliorate the liability of wrongdoers by providing defendants with a remedy against a *qui tam* plaintiff with ‘unclean hands’”).

¹³ See, e.g., *United States ex rel. Cafasso v. General Dynamics C4 Sys., Inc.*, No. CV06-1381-PHX-NVW, 2009 WL 3723087, at 6 (D. Ariz. Nov. 4, 2009) (finding that “every principle of substantive and procedural law cut against Cafasso’s self-help discovery tactic”); *United States ex rel. Rigsby v. State Farm Ins. Co.*, No. 1:06-CV-0433 LTS-RHW, 2008 WL 2130314 (S.D. Miss. May 19, 2008) (finding that relators had “purloined” documents from the employer’s files, that the consulting arrangement between the relators and their attorney was a sham, and ruling that stolen documents could not be introduced into evidence unless produced in discovery). Some relators have been shown to be untrustworthy even by their own counsel. See *United States v. Resnick*, No. 05CR9-1 (N.D. Ill. July 2, 2010) (order requiring MFCU to turn over relator’s share of *qui tam* award to relator’s counsel pursuant to stipulation in garnishment proceeding).

¹⁴ See Section 21F(f); SEC Rule 21F-13.

while paying whistleblowers for information about violations may make economic sense, giving them Article II power to enforce the laws absent intervention or participation by the Department of Justice (“DOJ”) is a bad investment. Indeed, less than three percent of FCA recoveries and almost all adverse case law come from *qui tam* cases litigated without the DOJ’s involvement.¹⁵ The SEC, on the other hand, is able to pursue its programmatic interests and enforcement goals with whistleblowers’ help, but without their interference.

As under the FCA, the SEC’s rules exclude any whistleblower convicted of a criminal violation related to the action from receiving an award,¹⁶ and a whistleblower’s culpability or involvement in the underlying wrongful conduct is considered in determining the amount of an award.¹⁷ The SEC’s rules also specifically bar awards to whistleblowers who obtained the information in a manner that violates federal or state criminal law,¹⁸ and in instances where liability stems from conduct substantially directed by the whistleblower, that conduct cannot factor into the \$1 million threshold for an award.¹⁹ Like the text of the FCA, the SEC’s rules are silent on the issue of indemnification actions against whistleblowers, which leaves that issue open to interpretation.

Under the FCA, the entire *qui tam* complaint is kept under seal until DOJ either intervenes or seeks court approval to partially unseal the complaint to seek the defendant’s comments—a cumbersome process. Although the SEC’s rules permit a whistleblower to submit information anonymously,²⁰ these confidentiality provisions are focused on the whistleblower’s identity and thus their effect on litigation and settlement is more limited than the FCA’s broad seal requirements, which should allow for better communication between the SEC and target companies. Both the FCA and the SEC broadly protect whistleblowers from retaliation.²¹

¹⁵ See Boese, § 1.04[H] n. 99 (“The vast majority of *qui tam* recoveries . . . came from cases with federal government intervention”).

¹⁶ Section 21F(c)(2)(B). See SEC Rule 21F-8(c)(3).

¹⁷ SEC Rule 21F-6(b)(1).

¹⁸ SEC Rule 21F-4(b)(4)(iv).

¹⁹ SEC Rule 21F-16.

²⁰ SEC Rule 21F-7(b). Under Rule 21F-7(a), disclosure of the whistleblower’s identity and submission is allowed in certain circumstances, including disclosure to a defendant as required in a federal court or administrative action, or, when the Commission determines it is necessary, disclosure to DOJ or other regulatory authorities.

²¹ For a discussion of how the SEC’s retaliation provisions compare to the FCA’s provisions, see FraudMail Alert No. 11-06-27 available at <http://friedlive.icvmgroup.net/siteFiles/Publications/Fried%20Frank%20FraudMail%20Alert%20No.%2011-06-27.pdf>; FraudMail Alert No. 11-06-30, available at <http://friedlive.icvmgroup.net/siteFiles/Publications/Fried%20Frank%20FraudMail%20Alert%20No.11-06-30.pdf>.

The Commission's rules do not include any provision for attorneys' fees, which is an issue that is frequently disputed under the FCA's fee-shifting provision. Instead, the SEC leaves the issue of attorneys' fees to state bar authorities and to contractual arrangements between whistleblowers and their attorneys.²²

ELIGIBILITY TO RECEIVE AN AWARD UNDER THE SEC'S WHISTLEBLOWER PROGRAM

The SEC's rules require whistleblowers to follow certain procedures in order to qualify for an award. Specifically, to be eligible for an award under the SEC's program, (1) a "whistleblower" (2) must "voluntarily provide" the Commission (3) with "original information" about possible violation of the securities laws (4) that "leads to a successful enforcement action" (5) resulting in "monetary sanctions" of more than \$1 million. While the SEC program eligibility requirements differ from the FCA in a number of respects, it is worth noting at the outset that enforcement of the SEC's eligibility requirements will be left to the SEC. Unlike the FCA, where defendants have the ability to contest the *bona fides* of a *qui tam* relator, there is no such vehicle for testing whistleblower eligibility under the SEC program.

1. "Whistleblower"

The SEC defines a "whistleblower" as an individual who, alone or jointly with others, provides the Commission with information relating to a "possible violation" of the securities laws.²³ Whereas virtually any person or entity (other than a former or present member of the Armed Forces)²⁴ can be a *qui tam* relator under the FCA, the SEC's program expressly excludes a company or other entity from eligibility as a whistleblower.²⁵ A "possible violation" under the SEC's rules broadly encompasses a violation that "has occurred, is ongoing, or is about to occur."²⁶

a. Summary of Eligibility Exclusions

Section 21F specifically excludes any whistleblower who acquired the information submitted to the SEC through employment at

- "an appropriate regulatory agency,"
- the DOJ,
- the Public Company Accounting Oversight Board ("PCAOB"),
- a self-regulatory organization, or

²² SEC Adopting Release, 76 Fed. Reg. 34333.

²³ See SEC Rule 21F-2.

²⁴ See 31 U.S.C. 3730(e)(1).

²⁵ See SEC Rule 21F-2.

²⁶ *Id.*

- a law enforcement organization.²⁷

It also excludes anyone convicted of a criminal violation related to the action that would otherwise be the basis for an award,²⁸ or one who gained the information through an audit required under the securities laws.²⁹

The SEC incorporates all of these exclusions into its eligibility rules, adding seven additional exclusions.³⁰ For example, the rules exclude a person—including close relatives—who acquired the information as an employee at the Commission.³¹ They also exclude members, officers, or employees of a foreign government or a foreign regulatory authority,³² and a person who makes or uses false or fraudulent statements with the intent to mislead or hinder the Commission.³³

In addition, as further explained below, the rules exclude as not “voluntarily provided” whistleblower submissions that are made after a request by certain specific authorities (such as the SEC, Congress, federal authorities, state attorneys general, or state securities regulatory authorities).³⁴ They also exclude information that is not considered “original information” because of the individuals (e.g., attorneys, company principals, accountants) who acquired it and the circumstances under which it was gathered.³⁵

b. Specific Exclusions for Submissions by Government Employees and Whistleblowers with a Preexisting Duty to Report Violations to the SEC

Under the FCA, there is no express prohibition against awards to government employees or those with a preexisting duty to report fraud, such as in-house counsel, auditors, and compliance officers.³⁶ Indeed, while the government has argued vigorously against awards to government employee whistleblowers, many courts have continued to allow recoveries to government employee relators.³⁷ In *United States ex rel. Fine v. Che-*

²⁷ Section 21F(c)(2)(A)(i)–(v).

²⁸ Section 21F(c)(2)(B).

²⁹ Section 21F(c)(2)(C).

³⁰ SEC Rule 21F-8(c)(1)–(7).

³¹ SEC Rule 21F-8(c)(1), (5).

³² SEC Rule 21F-8(c)(2).

³³ SEC Rule 21F-8(c)(7).

³⁴ SEC Rule 21F-4(a).

³⁵ SEC Rule 21F-4(b).

³⁶ See, e.g., *X Corp. v. Doe*, 805 F. Supp. 1298 (E.D. Va. 1992), *aff'd sub nom. Under Seal v. Under Seal*, 17 F.3d 1435 (4th Cir. 1994) (in-house corporate counsel allowed to use privileged information to bring *qui tam* case against his client).

³⁷ See, e.g., *United States ex rel. Maxwell v. Kerr-McGee Oil & Gas Corp.*, 540 F.3d 1180 (10th Cir. 2008) (government auditor allowed to bring *qui tam* case); *United States ex rel. Williams v. NEC Corp.*, 931 F.2d 1493 (11th Cir. 1991) (Air Force attorney allowed to bring *qui tam* case); *United States ex*

vron, U.S.A., Inc., the government argued that permitting employees of the Office of the Inspector General to act as relators created undesirable incentives:

To spend work time looking for personally remunerative cases . . . rather than doing their assigned work; to conceal information about fraud from superiors and government prosecutors so that they can capitalize on it for personal gain; to race the government to the courthouse to file ongoing audit and investigatory matters as *qui tam* actions before those cases have been sufficiently developed by the government to justify a lawsuit, thus prematurely tipping off the target, undermining the likely effectiveness of the case, and diverting unnecessarily up to 30% of the government's recovery to the government employee; and to use the substantial powers of the federal government conferred upon public investigators . . . to advance their personal financial interests Public confidence in the integrity and impartiality of government audits and investigations will necessarily decrease.³⁸

Rather than leaving this critical issue vague or unresolved, Section 21F of the Dodd-Frank Act expressly denies awards to anyone who was an employee of “an appropriate regulatory agency,” the DOJ, the PCAOB, a law enforcement organization, or a self-regulatory organization at the time the information was acquired. This reflects an effort to maintain the integrity of the government’s regulatory process by barring those in charge of that process from pursuing personal monetary gain or adopting conflicting roles.

While the SEC rules incorporate these exclusions, the SEC’s definition of an “appropriate regulatory agency” narrows them so that there is no blanket exclusion for all government employees engaged in doing their jobs. Specifically, the rules define an “appropriate regulatory agency” as:

the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act (15 U.S.C. 78c(a)(34)).³⁹

rel. Hagood v. Sonoma County Water Agency, 929 F.2d 1416 (9th Cir. 1991) (government attorney who was counsel to Corps of Engineers brought *qui tam* suit). Other courts have used the “original source” bar to dismiss *qui tam* cases brought by government employees. *See, e.g., United States ex rel. Biddle v. Board of Trs. of the Leland Stanford, Jr. Univ.*, 161 F.3d 533 (9th Cir. 1998) (government employee obliged to alert superiors to wrongdoing by contractor could not “voluntarily” provide information to the government for purposes of bringing a *qui tam* suit); *United States ex rel. Schwedt v. Planning Research Corp.*, 39 F. Supp. 2d 28 (D.D.C. 1999) (same).

³⁸ 72 F.3d 740, 745 (9th Cir. 1995).

³⁹ SEC Rule 21F-4(f). The SEC’s rules define “an appropriate regulatory authority” more broadly as a regulatory agency other than the Commission in connection with other exclusions (a preexisting duty

This definition includes government employees in certain agencies who would be expected to investigate or report conduct that could violate the securities laws to the Commission, but it does not extend to all personnel who investigate underlying conduct that may give rise to violations. For example, the SEC's program does not exclude employees at EPA or FDA, which regulate conduct that may give rise to or be relevant to a securities law violation.

2. A Submission Must Be “Voluntarily Provided”

In order to be eligible for an award, the SEC whistleblower's submission must be “voluntarily provided,” meaning that it must be made before a request by certain authorities. Submissions by whistleblowers who are subject to certain preexisting legal duties are also excluded on this basis. The SEC's “voluntarily provided” exclusion focuses on the person to whom a request was directed, the authorities making the request, the type of request made, the type of preexisting duty owed, and the authority to whom the preexisting duty is owed. Even so, these parameters may not be sufficient to avoid some of the conflicts that occur under the FCA.⁴⁰

a. Before a Request

In order to be “voluntarily provided,” the whistleblower's submission to the Commission must be made before a request, inquiry, or demand:

- by the Commission,
- in connection with an investigation, inspection, or examination by the PCAOB, a self-regulatory organization, or
- in connection with an investigation by Congress, any authority of the federal government, a state Attorney General or state securities regulatory authority.⁴¹

This exclusion is limited in several ways. First, it contains a narrow list of authorities whose requests require exclusion. Second, while a subpoena is not required

or a prior request for information) under the “voluntarily provided” requirement. *See* SEC Rule 21F-4(g).

⁴⁰ *See, e.g.,* United States *ex rel.* Maxwell v. Kerr-McGee Chem. Worldwide, LLC, No. 04CV01224-PSF-CBS, 2006 WL 1660538, at *3, 6–7 (D. Colo. June 9, 2006) (government employee who obtains information about fraud in scope of employment and is required to report it is a “person” under FCA), *rev'd on reconsideration*, 486 F. Supp. 2d 1217 (D. Colo. 2007) (government employee relator's disclosure to government was not “voluntary”), *rev'd and remanded*, 540 F.3d 1180, 1184 (10th Cir. 2008) (“1986 amendments allow suits based on...information [already known to the United States] as long as it is not publicly disclosed, and therefore do not prevent federal employees from acting as relators”).

⁴¹ SEC Rule 21F-4(a)(1)(i)–(iii).

for the exclusion to apply and any request or inquiry by the Commission triggers the exclusion, requests from the PCAOB and self-regulatory organizations are subject to a broader exclusion than other federal and state authorities, whose requests must be investigatory for the exclusion to apply. Third, rather than treating a request to an employer as directed to all employees, the request must be made to the whistleblower or a representative.⁴² Importantly, an employee contacted for information during the course of an internal investigation is not automatically excluded from voluntarily providing the information to the Commission.

b. Preexisting Legal Duties

Submissions by individuals under certain preexisting legal duties are not considered “voluntary” under the rules.⁴³ Again, this list of excluded duties is narrow, covering a duty to report to the Commission, but not a duty to report information to an authority other than the Commission. Instead, where other authorities are concerned, the exclusion issue is governed by the whistleblower’s contractual duty to those authorities.⁴⁴

3. “Original Information”—Requirements, Exclusions, and Exceptions

The whistleblower must provide factual “original information” to be eligible for an award, meaning that the information must:

- come from the whistleblower’s “independent knowledge” or “independent analysis,”
- not already be known to the Commission (unless the whistleblower is the “original source” of the information), and
- not be “exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source

⁴² SEC Rule 21F-4(a)(1).

⁴³ SEC Rule 21F-4(a)(3) excludes those who:

are required to report [their] original information to the Commission as a result of a preexisting legal duty, a contractual duty that is owed to the Commission or to one of the listed other authorities set forth in paragraph (1) of this section, or a duty that arises out of a judicial or administrative order.

⁴⁴ For example, disclosures by a person under a cooperation or similar agreement with DOJ which requires the person to report to the Commission are excluded. SEC Adopting Release, 76 Fed. Reg. 34309. The Commission specifically noted that, although Congress expressly declared certain categories of whistleblowers to be ineligible as a result of preexisting duties, the definition of the term “voluntarily” was left up to the Commission. *Id.* at 34309 & n. 85. By defining the term “voluntarily” narrowly, the rules narrow the statute.

of the information.”⁴⁵

This information must be provided after July 21, 2010 (the date that the Dodd-Frank Act became law).⁴⁶

a. “Independent Knowledge” and “Independent Analysis”

The SEC defines “independent knowledge” as factual information gained from the whistleblower’s experiences, communications, and observations that is not derived from publicly available sources.⁴⁷ “Independent analysis” is defined as the “examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.”⁴⁸ These requirements focus on the type of knowledge and analysis that would be valuable to the Commission, rather than unduly restricting the sources of publicly available information as the 2010 amendments to the FCA’s public disclosure provision have done. They differ from the FCA (prior to its amendment in 2010) in that the FCA required an “original source” to have both “direct and independent knowledge” of the information, and courts generally defined “direct” as first-hand. There is no such direct, first-hand knowledge requirement under the SEC’s definition of “original information,” which allows for information that is based on the whistleblower’s experience or analysis.⁴⁹

Whistleblowers whose information derives from allegations in hearings, government reports, and the news media are specifically excluded under the SEC’s rules, but only if their information was “exclusively derived” from those sources. The SEC does not limit this bar to federal sources, as the FCA’s public disclosure bar now provides.⁵⁰ However, the SEC’s “exclusively derived” test may be easier for whistleblowers to skirt than the “substantially the same allegations or transactions” language that triggers the FCA’s public disclosure bar and the claim-by-claim assessment required under it.

⁴⁵ SEC Rule 21F-4(b)(1)(i)–(iii).

⁴⁶ SEC Rule 21F-4(b)(1)(iv).

⁴⁷ SEC Rule 21F-4(b)(2).

⁴⁸ SEC Rule 21F-4(b)(3).

⁴⁹ See SEC Rule 21F-4(b)(3). See also SEC Adopting Release, 76 Fed. Reg. 34312 & n. 104 (citing 31 U.S.C. § 3730(e)(4), *United States ex rel. Fried v. West Indep. School Dist.*, 527 F.3d 439 (5th Cir. 2008), and *United States ex rel. Paranich v. Sorgnard*, 396 F.3d 326 (3d Cir. 2005)). The Commission’s proposing release described a Freedom of Information Act (“FOIA”) response as “generally available to the public” and therefore not a basis for “independent knowledge.” See SEC Proposing Release, 75 Fed. Reg. 70492. This view is consistent with the Supreme Court’s recent decision interpreting the word “report” in the FCA’s public disclosure provision to include responses to FOIA requests. See *Schindler Elevator Corp. v. United States ex rel. Kirk*, 131 S. Ct. 1885 (2011).

⁵⁰ See Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10104(j), 124 Stat. 119, 901-02 (2010) (amending 31 U.S.C. § 3730(e)(4)) (“PPACA”).

b. Attorneys

While the FCA has no express prohibition against *qui tam* suits brought by attorneys, at least one court has dismissed a *qui tam* action based on attorney-client privileged information in an FCA case.⁵¹ The SEC's rules specifically exclude attorneys who obtain their information through legal representation of a client⁵² or through attorney-client privileged communications,⁵³ unless disclosure is permitted under the Commission's attorney conduct rules, state bar rules, or otherwise.⁵⁴ The purpose of these exclusions is to

send a clear, important signal to attorneys, clients, and others that there will be no prospect of financial benefit for submitting information in violation of an attorney's ethical obligations.⁵⁵

These exclusions apply to both attorneys and non-attorneys (if the non-attorney learns the information through a confidential attorney-client communication),⁵⁶ and they apply to all counsel—whether retained or working in-house.⁵⁷ The exclusions do not apply, however, if disclosure of the information is permitted under SEC Rule 205.3,⁵⁸ state statutes or state bar rules, or if disclosure is permitted through a waiver of the attorney-client privilege.

c. Other Exclusions

While the SEC excludes information gathered in violation of federal or state criminal law,⁵⁹ the FCA has no provision that protects the information gathering process from criminal conduct. Nor does the FCA exclude company principals, employees, or those retained by the company to investigate violations from bringing a *qui tam* suit. The SEC specifically excludes—from the definition of “original information” that derives from “independent knowledge or independent analysis”—information gathered by certain

⁵¹ See *United States ex rel. Fair Lab. Practices Assocs. v. Quest Diagnostics, Inc.*, 2011 WI 1330542 (S.D.N.Y. Apr. 5, 2011).

⁵² SEC Rule 21F-4(b)(4)(i).

⁵³ SEC Rule 21F-4(b)(4)(ii).

⁵⁴ SEC Rule 21F-4(b)(i), (ii).

⁵⁵ SEC Adopting Release, 76 Fed. Reg. 32315.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ SEC Rule 205.3 permits attorneys to disclose confidential information to the Commission (1) to prevent the issuer from committing a material violation likely to cause substantial injury to financial or property interests of the issuer or investors, (2) to prevent perjury in a Commission investigation or proceeding, or (3) to correct a material violation by the issuer that caused or may cause substantial injury to financial or property interests of the issuer or investors. See SEC Adopting Release, 76 Fed. Reg. 34314 & n. 119.

⁵⁹ SEC Rule 21F-4(b)(4)(iv).

individuals:

- officers, directors, trustees, or partners who receive the information through the company's internal compliance process,⁶⁰
- employees whose principal duties involve compliance or internal audit responsibilities,⁶¹
- those retained to investigate possible violations of law,⁶² and
- employees and persons associated with a public accounting firm who learn the information through an engagement required under the securities laws.⁶³

An exception to these exclusions threatens to swallow the rule—that is, an excluded individual is able to become a whistleblower if at least 120 days have passed since the individual either provided the information through the company's internal reporting system or received it in circumstances indicating that the company was aware of it.⁶⁴ In that case, the 120-day period is a beginning point for the whistleblower rather than a time limit. A second exception allows an excluded individual to become a whistleblower if he has a reasonable basis to believe that disclosure is necessary to prevent conduct likely to cause substantial injury to the financial interest or property of the entity or investors.⁶⁵ Finally, the individual may be a whistleblower if he has a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation.⁶⁶

4. Information That Leads to Successful Enforcement

The SEC's rules lower the standards that were originally proposed for assessing the requirement that the whistleblower's original information "leads to successful enforcement." Under the standards adopted in the final rules, the Commission will consider this requirement to be met where: (1) "sufficiently specific, credible, and timely" original information caused the staff to commence an investigation, reopen a closed investigation, or inquire into different conduct in a current examination or investigation; or (2) original information "significantly contributed" to the success of an action already under examination by the Commission, Congress, a federal government authority, state Attorney General or securities regulatory authority, self-regulatory organization, or the PCAOB.

⁶⁰ SEC Rule 21F-4(b)(4)(iii)(A).

⁶¹ SEC Rule 21F-4(b)(4)(iii)(B).

⁶² SEC Rule 21F-4(b)(4)(iii)(C).

⁶³ SEC Rule 21F-4(b)(4)(iii)(D).

⁶⁴ SEC Rule 21F-4(b)(4)(v)(C).

⁶⁵ SEC Rule 21F-4(b)(4)(v)(A).

⁶⁶ SEC Rule 21F-4(b)(4)(v)(B).

While the “sufficiently specific, credible, and timely” standard in (1) and the “significantly contributed” standard in (2) are lower than the standards originally proposed,⁶⁷ they nevertheless prevent whistleblowers from sharing in the government’s recovery when they provide no valuable or new information on allegations or transactions that the government is already investigating. That is far different from the FCA regime, where, under the First Circuit’s interpretation of the “original source” standard in *United States ex rel. Duxbury v. Ortho Biotech Products, L.P.*, despite the government’s vigorous arguments to the contrary, a *qui tam* relator would face no such bar.⁶⁸ The SEC’s “significantly contributed” and “specific, credible and timely” standards are more direct and effective than the FCA’s “materially adds” standard in preventing parasitic suits while encouraging whistleblowers to provide their information about fraud to the government prior to the government’s initiation of an investigation.

5. Monetary Sanctions of Over \$1 Million in an Action

The whistleblower’s award is based on the SEC’s collection of monetary sanctions of over one million dollars in an enforcement action. Monetary sanctions are defined under the SEC’s rules as money, penalties, disgorgement, and interest ordered to be paid as a result of the action, including money deposited into a disgorgement fund as a result of a Commission action or pursuant to Section 308(b) of the Sarbanes-Oxley Act.⁶⁹ The rules define “action” as a single captioned judicial or administrative proceeding brought by the Commission.⁷⁰ The SEC revised its proposed rules to provide that the Commission will treat additional proceedings as an “action” if they arise out of “the same nucleus of operative facts.”⁷¹ Thus, the award could cover allegations that were not included in a whistleblower’s original disclosure under the SEC’s program.⁷² The \$1 million dollar threshold may also create some interesting incentives for the SEC, particularly for cases valued at approximately that amount. For instance, if the SEC had

⁶⁷ See SEC Adopting Release, 76 Fed. Reg. 34324.

⁶⁸ 579 F.3d 13 (1st Cir. 2009) (holding that, despite the government’s long-standing investigation of fraud allegations and multiple public disclosures about it, the timing of relator’s *qui tam* filing was not a factor to be considered under the FCA’s “original source” standard). See FraudMail Alert No. 10-02-23, available at <http://friedlive.icvmgroup.net/siteFiles/Publications/4828E492A22CA9C8657B60F8366AF296.pdf>; FraudMail Alert No. 09-08-19, available at <http://friedlive.icvmgroup.net/siteFiles/Publications/7C08F71E1BFBB2C1F7FC02728F4F6F2F.pdf>. The PPACA amendments to Section 3730(e)(4) do not fix this problem in the FCA’s public disclosure bar because they continue to allow the relator this option in addition to the option of reporting the fraud prior to a public disclosure.

⁶⁹ SEC Rule 21F-4(e) (citing 15 U.S.C. §7246(b)).

⁷⁰ SEC Rule 21F-4(d).

⁷¹ SEC Adopting Release, 76 Fed. Reg. 34327.

⁷² Cf. *Rockwell Int’l Corp. v. United States ex rel. Stone*, 549 U.S. 457 (2005) (barring claims by relator who was not an “original source” of publicly disclosed allegations because he did not have direct and independent knowledge of the allegations in the government’s amended complaint).

the opportunity to settle an action for \$950,000 rather than \$1 million, the argument could be made that the SEC would be “better off” opting for the \$950,000 settlement which it would not have to share with the whistleblower, rather a \$1 million settlement that could result in lower net recovery to the SEC after accounting for the whistleblower award.

SEC WHISTLEBLOWERS ARE ENCOURAGED TO REPORT MISCONDUCT INTERNALLY

The issue of whether whistleblowers should be required to exhaust internal reporting procedures before reporting possible violations to the SEC was hotly contested prior to the final rules, with business interests in favor of the requirement and whistleblower advocates opposed.⁷³ Although the SEC decided not to require whistleblowers to report internally, the rules provide incentives for doing so. For example, the whistleblower’s use of internal reporting processes is one of the factors considered in determining the amount of an award.⁷⁴ Also, a whistleblower may establish his “place in line” in the SEC’s whistleblower program as the date he reported the conduct internally (provided he also notified the Commission of the conduct within 120 days of the internal report).⁷⁵ And, if the company self-reported violations to the SEC after the whistleblower reported them internally, the whistleblower is given credit for the self-reported information in addition to his own submission.⁷⁶

APPEAL AND REVIEW

Under Section 3730(d) of the FCA, neither the determination of whether to pay an award to the relator nor the amount of the award is a discretionary decision by DOJ, and contentious disputes between DOJ and relators have arisen in relators’ share determinations.⁷⁷ In contrast, the potential for such disputes under the SEC’s program is

⁷³ See FriedFrank SECMail No. 11-06-21, *Living with the SEC’s Whistleblower Rules*, at 3 (issued June 21, 2011) (“SECMail No. 11-06-21”), available at <http://www.friedfrank.com/index.cfm?pageID=25&itemID=6386>.

⁷⁴ SEC Rule 21F-6(a)(4).

⁷⁵ SEC Rule 21F-4(c)(3). The 120-day “grace period” for whistleblowers is not intended to be a deadline for companies to self-report to the Commission. In his statement in support of the Staff’s recommendation on this issue, Director of Enforcement Robert Khuzami explained that

the 120-day grace period applies only to whistleblowers, and that the final rules do not change the fact-based analysis that each entity should conduct when considering whether and when to report potential securities violations to the Commission. We will continue to expect companies to self-report on a timely and responsible basis.

In practice, this 120-day period could dramatically limit the window of time that companies have in which to complete the process of conducting thorough internal investigations into the alleged conduct and considering whether to self-report it to the SEC. See SECMAIL No. 11-06-21, at 5–6.

⁷⁶ See SEC Adopting Release, 76 Fed. Reg. 34325.

⁷⁷ See, e.g., *United States ex rel. Marchese v. Cell Therapeutics, Inc.*, No. CV06-0168MJP, 2007

limited because of the broad SEC discretion in making awards, and because the whistleblower's right to appeal the SEC's decisions is limited.

Section 21F gives the SEC discretion to make any determination under its program, including whether to make an award, to whom, and in what amount.⁷⁸ Although the statute establishes the range for an award as from 10 to 30 percent and provides criteria for determining the amount of an award, Section 21F also expressly states that the Commission's decision on the amount of an award may not be appealed if the award falls within the statutory mandate,⁷⁹ effectively creating a "safe harbor" in which awards within the statutory range are unreviewable.⁸⁰ If the SEC exercises its discretion to provide no award under the program, that determination is subject to U.S. Circuit Court review.⁸¹

CONCLUSION

The SEC has reported that it "successfully resolved" 92 percent of the 681 enforcement cases it brought in 2010.⁸² The Commission estimates that it will receive 30,000 tips each year as a result of its whistleblower program.⁸³ Time will tell whether the anticipated volume of tips will actually occur and whether the SEC's past success rate will keep pace. If so, the SEC's whistleblower program could continue unchanged. However, Section 21F also requires the SEC's Inspector General to assess a number of aspects of the program, including whether Congress should consider allowing whistleblowers who use the SEC's program to bring suit on behalf of the government and themselves.⁸⁴ In other words, Congress could still authorize *qui tam* enforcement of the securities laws, and the SEC's efforts to eliminate the abuses seen under the FCA's *qui tam* enforcement mechanism could still be thwarted. The SEC Inspector General's report is due in January 2013.

WL 4410255 (W.D. Wash. Dec. 14, 2007); United States *ex rel.* Merena v. SmithKline Beecham Corp., 52 F. Supp. 2d 420 (E.D. Pa. 1998).

⁷⁸ Section 21F(f).

⁷⁹ Section 21(c)(1)(A). The SEC's rules also include factors that may be considered in increasing or decreasing the amount of an award. *See* SEC Rule 21F-6(a)(1)–(4); SEC Rule 21F-6(b)(1)–(3). One of these factors is whether the whistleblower reported the violation through an internal compliance system—an issue of major concern to companies that commented on the proposed rules. The SEC responded to this concern not by requiring whistleblowers to report internally before reporting to the Commission, but by making such internal reports a basis for increasing awards. In addition, whistleblowers' interference with an internal compliance system to prevent or delay detection is a basis for decreasing awards.

⁸⁰ *See* SEC Rule 21F-13(a).

⁸¹ Section 21F(f). *See* SEC Rule 21F-13(a).

⁸² SEC 2010 Performance and Accountability Report at 49, *available at* <http://www.sec.gov/about/secpar/secpar2010.pdf#2010review>.

⁸³ 76 Fed. Reg. 34354.

⁸⁴ Section 21F(d)(1)(G).

Meanwhile, the SEC is in the process of establishing and staffing its Whistleblower Office in anticipation of a large number of quality tips. Companies should be prepared for a dramatic increase in internal investigations, and should ensure that their compliance programs are ready to receive and promptly react to internal reports of misconduct.