



H.S. Grace & Company, Inc.

SEC Issues Whistleblower Rules – Uncertain Future for Internal Compliance Systems

On May 25, 2011, the SEC announced new rules under the whistleblower provision of Section 21F of the Securities Exchange Act of 1934 added last year by the Dodd-Frank Act. The rules are effective August 12, 2011. Under the new rules individuals who provide original information to the SEC leading to a successful enforcement action are entitled to an award of 10 to 30 percent of total monetary sanctions collected if the sanctions exceed \$1 million. The new rules also provide for anonymous reporting and include anti-retaliation provisions. See 17 C.F.R. 240.21F (2011). The final rules are available at <http://www.sec.gov/rules/final/2011/34-64545.pdf>.

Internal Compliance Systems

Business groups have expressed great concern both publicly and to the SEC that failure to require corporate whistleblowers to first report through internal channels will undermine internal compliance systems. The SEC, however, rejected rules that would require whistleblowers to first use corporate channels to report securities violations. Instead, the SEC adopted an incentivizing system, which SEC Chairman Mary Schapiro says is “more likely to encourage a strong internal compliance culture.” Incentives include rules designed to place a whistleblower who utilizes an internal compliance systems in the same position as one who goes directly to the SEC, if the whistleblower reports the information provided internally to the SEC within 120 days of the internal report. The SEC will also consider the extent to which the whistleblower used the internal compliance system in determining the amount of an award.

The rules also generally provide that certain categories of individuals cannot claim whistleblower awards, e.g. compliance personnel, internal audit, directors and officers who learned of the alleged violation because another person reported the issue to them or who learned through the internal compliance process, external auditors and attorneys. There are exceptions to these broad categories of exclusions, which must be scrutinized closely to determine award eligibility.

The effect of the new rules on internal compliance systems is uncertain. Former SEC Chairman Harvey Pitt has criticized the new bounty systems, arguing that the new rules will “undermine corporate governance.” Legislation has also recently been introduced by New York Congressman Michael G. Grimm, “The Whistleblower Improvement Act of 2011” (H.R. 2483), to require, among other things, that whistleblowers first report alleged violations through internal compliance systems, in many cases, before reporting to the SEC.

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