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Client Alert

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Accountants and Auditors as SEC Whistleblowers

Nearly every public company and financial industry firm subject to the enforcement jurisdiction of the US Securities and Exchange Commission (SEC) employs both internal and external accountants and auditors. Under the SEC's complicated whistleblower rules promulgated under the Dodd-Frank Act, these accountants and auditors may be able to use information obtained while performing their professional duties to blow the whistle on a client or employer and get a monetary award. This *Alert* is intended to make those rules relatively easy to understand. We will close with steps companies can take to deal with whistleblower risk.

"120 days after a company becomes aware of a possible securities law violation, its corporate accountants and internal auditors, and even forensic accountants it has retained, could begin to report out to the SEC seeking a whistleblower award."

Categories of Persons Eligible or Not Eligible for SEC Whistleblower Awards

In general, individuals who provide information useful to SEC enforcement fall into three categories as to their eligibility for monetary awards under the SEC whistleblower program.

The first category covers individuals who are completely ineligible to receive any award. This category includes persons associated with the SEC or a similar organization, those convicted for crimes related to their disclosure or who knowingly provide false information to the SEC, and external auditors who fail to file a required report with the SEC about a possibly illegal act and instead provide the information to the SEC seeking a whistleblower award.

The second category covers individuals with compliance responsibilities, who can become eligible for an award under certain circumstances. This category includes officers and directors, compliance and internal audit personnel, internal and external accountants, external auditors doing non-audit work, and attorneys.

The third category covers everyone else. This category includes the entity's ordinary employees, customers, and agents.[1]

Basic SEC Whistleblower Award Eligibility Requirements

Ordinary individuals (category three above) and, under certain circumstances, individuals with compliance responsibilities (category two above) can become eligible for a monetary whistleblower award by voluntarily providing the SEC with

"original information" that leads to a successful SEC enforcement action in which the SEC recovers more than $1 million. When that occurs, the SEC must pay the whistleblower anywhere from 10 percent to 30 percent of amounts recovered in the SEC action and certain related actions.

"Original information" means information (i) derived from the "independent knowledge" or "independent analysis" of the whistleblower (see definitions below); (ii) not already known to the SEC from any other source (unless the whistleblower is the original source); and (iii) not 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 of the information). Even if the SEC already knows some information about a matter, a whistleblower can still satisfy the "original information" requirement by providing new information that "materially adds to the information that the Commission already possesses."[2]

"Independent knowledge" means any factual information in the whistleblower's possession that is not derived from publicly available sources. Notably, in order to qualify as "independent," the rules do not require knowledge to be direct or personal to the whistleblower — information picked up in a conversation at the water cooler could suffice if it otherwise qualifies.[3]

"Independent analysis" generally means the whistleblower's own examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.[4]

Award Eligibility Exclusions

Even if someone meets these basic eligibility requirements, they may be excluded from eligibility if they obtained the original information:

1. because they worked as an employee in the compliance or internal audit area, or worked for a firm retained to perform compliance or internal audit functions;
2. because they were associated with a firm retained to conduct an inquiry or investigation into possible violations of law;
3. because they were associated with a public accounting firm, if they obtained the information through the performance of an engagement required by the federal securities laws (other than a financial statement audit of an issuer) and the information relates to a violation by the client or the client's directors or employees;[5]
4. because they were an officer, director, trustee, or partner of an entity and another person informed them of allegations of misconduct or they learned the information in connection with the entity's processes relating to possible violations of law; or
5. through a privileged communication or in connection with the legal representation of a client on whose behalf the would-be whistleblower or their employer or firm is providing services, unless an attorney would be allowed to disclose the relevant information.

These exclusions are intended to ensure that those most responsible for an entity's compliance with laws are not incentivized to seek personal whistleblower awards at the expense of their employers' or clients' ability to detect, address and self-report violations. The exclusion for auditors performing engagements required by the securities laws (apart from issuer audit engagements) also reflects the SEC's

view that these individuals occupy a special position under the securities laws, which requires their use in performing a critical role intended to protect investors. However, the SEC whistleblower rules allow for these individuals to become eligible for awards under certain circumstances.

Different rules apply to blowing the whistle on an audit client. External auditors who directly blow the whistle on an audit client or the client's directors or employees based on information obtained in the course of conducting a financial statement audit are not just *initially* excluded from eligibility for awards — they are *unconditionally* excluded. No exceptions can apply, including those discussed in the two sections below. This is because Section 10A of the Exchange Act requires an audit firm that detects or otherwise becomes aware of a possible illegal act in the course of conducting an audit of an issuer to ensure that the issuer has taken appropriate remedial measures and to cause a report to the SEC in certain situations.[6]

Exceptions to the First Four Award Eligibility Exclusions

The SEC carved out three exceptions to the first four conditional exclusions from award eligibility above (those that do not relate to privileged communications or legal representations). Those four exclusions do not apply — and the accountant or auditor can submit original information to the SEC and become eligible for an award — if any of these three circumstances exist:

1. The accountant or auditor learns of misconduct at the relevant entity that might cause substantial injury to the financial interest or property of the entity or investors, and reasonably believes that disclosing information to the SEC is necessary to stop the misconduct. The SEC has made clear that this exception does not require the whistleblower to reasonably believe that the entity might commit a "material violation"; rather, the whistleblower will generally only need to demonstrate that responsible management or governance personnel at the entity were aware of an "imminent violation" and were not taking steps to prevent it;[7]
2. The accountant or auditor reasonably believes that the relevant entity is obstructing an internal or SEC investigation (*e.g.*, destroying documents or improperly influencing witnesses); or
3. At least 120 days have elapsed since the accountant or auditor either provided information of a possible violation to the relevant entity's management (*i.e.*, audit committee, chief legal officer, chief compliance officer (or their equivalents) or — for an internal accountant or auditor — to their supervisor) or received information of the violation under circumstances indicating that management or the supervisor was already aware of the information. In other words, once the accountant or auditor learns that information about a possible violation is in the hands of those responsible for the entity's compliance, if the entity fails to report to the SEC and no eligible individual blows the whistle first, the accountant or auditor can wait for the 120-day period to run, report the information to the SEC, and become eligible for a whistleblower award. Conversely, the accountant or auditor cannot become eligible for a whistleblower award by learning of possible misconduct, realizing that those responsible for the entity's compliance are not aware of the possible misconduct, failing to provide the information to them, waiting for the 120-day period to run, and then reporting the information to the SEC.[8]

Exception to the Award Eligibility Exclusion Related to Attorneys

The fourth conditional exclusion from award eligibility relates to privileged communications or legal representations. This exclusion does not apply if under the same circumstances an attorney would be permitted to disclose the information. That would be the case, for example, if the attorney-client privilege had been waived or a crime-fraud exception to the privilege applied, or if the disclosure is otherwise permissible under a rule governing the ethical behavior of attorneys.[9] Thus, if an attorney would be permitted to submit the information to the SEC, a non-attorney such as an accountant or auditor would similarly be able to submit the information to the SEC and be eligible for a whistleblower award.[10]

Professional Confidentiality Requirements Applicable to Accountants and Auditors

During the SEC whistleblower rule adoption process, a number of commenters pointed to accountant-client confidentiality obligations under state law and argued that the SEC should exclude from award eligibility information submitted in breach of those obligations. The SEC declined, "because to do so could inhibit important federal-law enforcement interests."[11] Despite that decision, accountants and auditors considering blowing the whistle to the SEC might note that the SEC rules and the Dodd-Frank Act do not directly protect them from disciplinary actions under state law for breaching accountant-client confidentiality.

Yet the risks of state law disciplinary action might be more theoretical than actual. It is unclear whether any state board will ever have the opportunity and desire to discipline an SEC whistleblower, in part because the SEC has publicly committed to protecting whistleblowers' identities to the fullest extent possible.[12] The SEC rules permit whistleblowers to maintain anonymity even from the SEC up to the point of actually receiving an award. Before the whistleblower can get an award, the whistleblower's identity must be disclosed to the SEC, but the SEC is unlikely to share the identity of a whistleblower accountant or auditor it is rewarding with a state board considering disciplinary action against the whistleblower.

Suggestions for Senior Executives and General Counsel

- Plan ahead — have a whistleblower action plan ready so you can move fast when an issue of potential interest to SEC Enforcement arises. At that point, a current or former employee or some other knowledgeable person could already be talking to the SEC in hopes of getting a whistleblower award.
- Either internally or with outside help, investigate every possible violation of the securities laws, even if only alleged by an anonymous tipster, unless investigation is clearly unwarranted.
- Avoid non-privileged communications relating to possible violations.
- Move investigations along and report to the SEC quickly — no later than 120 days after first awareness — if reporting out is advisable. 120 days after you become aware of a possible violation, your corporate accountants and internal auditors and forensic accountants you've retained could begin to report out to the SEC seeking a whistleblower award.

Endnotes

[1] Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545 (May 25, 2011) (Final Rule Release).

[2] Final Rule Release at 251.

[3] *Id*. at 46.

[4] *Id*. at 50.

[5] The federal securities laws require that registered broker-dealers and investment advisers have certain engagements done by public accounting firms. Auditors who do these types of engagements are subject to these initial exclusions from award eligibility and can also take advantage of the exceptions to the exclusion described in the next section. Different rules apply to audits done for issuers, as noted herein.

[6] Final Rule Release at 140. The SEC believes quarterly reviews are "in the course of conducting an audit" for section 10A purposes. *Id*. at 143.

[7] *Id*. at 74.

[8] *Id*. at 76.

[9] *Id*. at 55-56. The SEC's attorney conduct rules permit attorneys representing issuers to reveal to the SEC confidential information to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury, suborning perjury, or committing any act that is likely to perpetrate a fraud upon the SEC; or (3) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used. As for state statutes and bar rules, determining whether the privilege has been waived, or whether an exception to the privilege such as the crime-fraud exception applies, can be difficult, and the analyses vary from state to state. *See* Auburn K. Daily & S. Britta Thornquist, *Has the Exception Outgrown the Privilege?: Exploring the Application of the Crime-Fraud Exception to the Attorney-Client Privilege*, 16 Geo. J. Legal Ethics 583 (2003).

[10] Final Rule Release at 59.

[11] *Id*. at 54, n.117.

[12] 17 C.F.R. § 240.21F-7; Office of the Whistleblower, SEC, *Frequently Asked Questions* (last visited Jan. 25, 2013); http://www.sec.gov/about/offices/owb/owb-faq.shtml#P21_5971 FAQ 10.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

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