HONIGMAN ALERT

Joint Alert – Corporate and Securities Department
and the Securities and Corporate Governance Litigation Practice Group

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SEC Adopts Final Rules for Whistleblowers

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) significantly expanded the financial incentives and protections for those "whistleblowing" to the SEC. In particular, the Act directed the SEC to reward whistleblowers who voluntarily provide "original information" with 10 to 30 percent of monetary penalties in cases where the SEC recovers over $1 million. It also provided substantial protections to whistleblowers, including allowing employees who have been retaliated against to bring a private suit in federal court and greatly expanding the time period within which a whistleblower can come forward with a retaliation claim.

Recently, by a 3-2 vote, the SEC adopted the final version of the rules for the Act's whistleblower program. The new rules will take effect August 12, 2011, 60 days after publication in the Federal Register. While the final rules are substantially similar to the proposed rules, including maintaining the large financial incentives and staunch protections, there are some important changes:

The SEC now has discretion to pay larger awards to whistleblowers that report potential violations through internal company compliance procedures before going to the SEC and smaller award amounts to whistleblowers that interfere with internal company investigations.

Whistleblowers are eligible for a reward and credited for all information reported in an internal company procedure if the company subsequently passes the information on to the SEC and the information leads to a successful action.

The relation back period, where the whistleblower can report the information to the SEC after first reporting the information to the company, is expanded from 90 to 120 days.

The categories of eligible "information" are broadened, including rewarding whistleblowers who provide information that causes the SEC to reopen a case or pursue a new line of investigation in an existing case.

The protections available to whistleblowers are enhanced, including protecting a whistleblower who provides tips that turn out to be unfounded provided that the whistleblower possesses a reasonable belief that the information provided relates to a possible securities law violation.

The final rules create new exceptions for attorneys, auditors, and internal compliance personnel to receive rewards, such as when there is a "reasonable basis to believe" disclosure is necessary to prevent conduct likely to cause substantial injury to the financial interest or property of the company or its investors.

In response to the final rules, all companies subject to federal securities and commodities laws should review and update their internal compliance policies. The final rules go further than the proposed rules to encourage employees to first go through their company's internal procedures before going directly to the SEC. The company, therefore, must ensure that the internal reporting programs facilitate and encourage that process. Proper internal compliance policies can significantly minimize the time and expense involved in dealing with a possible SEC investigation.

Sixth Circuit Clarifies Scienter Analysis For Motions to Dismiss and Pleading Requirements for Control Person Liability Under the Securities Exchange Act

In its recent opinion of *Frank v. Dana Corp*., Case No. 09-4233, 2011 WL 2020717 (6th Cir. May 25, 2011), the Sixth Circuit reversed the dismissal of a class action shareholder suit and changed its approach to analyzing the adequacy of allegations concerning scienter for claims under Section 10(b) of the Securities Exchange Act (the Act). The court also held that it would follow the holdings of other circuits regarding the pleading requirements for control person liability under Section 20(a) of the Act.

The Private Securities Litigation Reform Act requires a plaintiff asserting a Section 10(b) claim to allege facts with "particularity" that give rise to "a strong inference that the defendant acted with" scienter. Prior to *Frank*, the Sixth Circuit scienter analysis consisted of sorting through each allegation individually before conducting a collective evaluation. The district court had followed this approach in dismissing the shareholders' claims. The *Frank* court, however, found that focusing on individual allegations is contrary to the United States Supreme Court's recent decision in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309 (2011). The *Frank* court understood *Matrixx Initiatives* to require a consideration of scienter allegations "holistically" and not an individual analysis of such allegations. Using this approach, the Sixth Circuit found that the plaintiffs had adequately pled scienter and reversed the dismissal of the Section 10(b) claims.

The Sixth Circuit also defined the elements that must be alleged to establish control person liability under Section 20(a). Section 20(a) provides that an individual that controls a person or entity that violates a provision of the Act also shall be liable jointly and severally with the controlled person, unless the controlling person acted in good faith and did not induce the act constituting the violation. The district court dismissed the shareholders' Section 20(a) claim because, among other matters, the shareholders failed to adequately plead that the defendants did not act in good faith. The Sixth Circuit reversed and adopted the holdings from other circuits that have found that good faith is an affirmative defense and is not required to be pled by plaintiffs.

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