An Ounce of Prevention, a Pound of Cure: Mitigating the Impact of Dodd-Frank's Whistleblower Provisions

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). While the Act's many provisions garnered immediate press coverage, Section 21F, the Act's whistleblower provisions, was of particular interest to the securities enforcement bar.

The Dodd-Frank Act whistleblower provisions provide unprecedented incentives for employees to eschew internal compliance procedures and instead take their compliance concerns directly to the Securities and Exchange Commission (SEC). In this brave new world, companies that have spent countless millions of dollars enhancing their compliance programs and stress testing their corporate governance principles in the wake of Enron-era scandals and as mandated by the Sarbanes-Oxley Act (SOX) now face in the Dodd-Frank Act the prospect of fresh regulatory and legal challenges fueled directly by a new army of government operatives: their own employees.

This article examines the Dodd-Frank Act's SEC whistleblower provisions,[1] identifies some of the challenges inherent in the new whistleblower environment, and proposes a set of preventative measures that executives and managers can use to mitigate the impact of the new whistleblowing law.

Dodd-Frank's Whistleblower Provisions

For more than 20 years, the SEC has had a bounty program designed to reward whistleblowers who provide information leading to the recovery of a civil penalty related to insider trading.[2] Readers who are unfamiliar with that program (which has now been repealed) are not alone; even the most seasoned practitioners have had little experience with the legacy SEC whistleblower program. After all, the provisions (1) pertained solely to insider trading cases; (2) capped awards—which were discretionary—at 10 percent of the penalties collected; and (3) in over 20 years of operation, resulted in a paltry total of $1,159,537 awarded to only six claimants, $1 million of which was awarded in August 2010.[3] Even the SEC's Office of Inspector General criticized the moribund predecessor program as "not fundamentally well-designed to be successful."[4]

In the wake of its embarrassing failure to detect Bernard Madoff's epic ponzi scheme, the SEC has been empowered, via the Dodd-Frank Act, to reward whistleblowers in unprecedented ways. Specifically:

- Bounties are awarded in exchange for the voluntary submission of original information about *any* securities law

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violation (not only insider trading cases);[5]

- The award is *mandatory* where the tip results in a recovery of more than $1 million from the wrongdoer(s);[6]
- The award will equal *10 to 30 percent* of the penalties collected in an SEC enforcement action or related action, including federal and state criminal proceedings and proceedings brought by regulatory agencies;[7] and
- A person can qualify for an award, even without insider knowledge, by providing the SEC with analysis that leads to uncovering fraud,[8] a provision likely inspired by independent financial fraud investigator Harry Markopolos, who repeatedly tipped the SEC in a futile attempt to expose the Madoff ponzi scheme far earlier than its discovery in late 2008. This provision may inspire gadflies to scour disclosures and other documents for inconsistencies, with an eye toward presenting analysis that helps uncover fraud and leads to a whistleblower's payday.

The Dodd-Frank Act not only rewards, but also protects, informants who consider bringing information to the SEC. For example, the Act prohibits the SEC from disclosing a whistleblower's identity until such disclosure is required in connection with a proceeding instituted by the government.[9] And, in what may be described as a "sleeper" provision, the Act empowers whistleblowers by prohibiting retaliatory adverse employment action in the form of termination, demotion, suspension, harassment or discrimination of any kind in connection with one's terms and conditions of employment, and allows a victim of retaliation to receive two-times any lost back pay. Even non-employees who suffer retaliation or harassment because of protected activity have a private right of action under the Act. Moreover, whistleblowers have up to six years after the retaliation (or three years after its discovery) to file retaliation claims and may file those claims directly in federal court, without first exhausting their administrative remedies, as required by SOX.[10]

To be sure, the Dodd-Frank Act will not be implemented entirely as it was signed into law in July 2010. Indeed, one section of the Act, which enabled the SEC to exempt some data from the Freedom of Information Act, has already been repealed.[11] The crux of the Act, however, is here to stay, and executives who underestimate the impact of Dodd-Frank's whistleblower provisions do so at their own peril. Indeed, the Act's application to but one area of the SEC's purview—the Foreign Corrupt Practices Act (FCPA)[12]—portends the enormous impact the Act likely will have for years to come. In the last 12 years, the government has recovered over $3 billion in FCPA-related corporate settlements and other penalties,[13] a figure sure to entice would-be whistleblowers who are employed by myriad companies conducting business overseas and who stand to take home 10 to 30 percent of any FCPA recovery.[14]

Challenges of the New Whistleblower Environment

The most significant challenge presented by the Act is that it incentivizes external, as opposed to internal, reporting. A whistleblower with knowledge of a compliance violation will be loath to risk losing original source status and the opportunity to reap a financial reward by reporting such misconduct internally to compliance personnel and, thereby, allowing another informant to win the race to the SEC. Whereas immediate contact with the agency offers the potential of a handsome bounty, the prospect of a corporate slap on the back, accompanied by scorn from colleagues when a compliance hotline turns out to be less than confidential, simply cannot compete.

Recognizing this problem, on November 3, 2010, the five SEC commissioners voted unanimously to propose new rules to govern the Dodd-Frank Act's whistleblower program.[15] Specifically, the proposed rules, on which the SEC is accepting comments until December 17, 2010, seek to incentivize internal reporting by providing that the date on which a whistleblower reports misconduct to internal

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compliance personnel functions as the date of disclosure for reward purposes, so long as the individual reports the misconduct to the SEC within 90 days of the initial internal disclosure.[16] Still, a whistleblower may prefer to report directly to the SEC rather than provide the company with an opportunity to remediate and contain the problematic conduct, where that opportunity might result in a lesser penalty paid in connection with an enforcement action and, thus, a smaller whistleblower's reward.[17]

Another challenge of the new whistleblowing environment is the inevitable rise of bounty hunters who will report even minor issues to the SEC. Such reports will surely consume agency investigation and enforcement resources—not to mention considerable taxpayer dollars. At the same time, such complaints—even if pedestrian and exclusively reported internally—will tie up the legal and compliance resources of many a company. Even worse, if reported to regulators, such complaints can become a serious distraction for senior executives and even tug at a company's stock price.[18]

The Act also enables wrongdoers to metamorphose from potential targets to well-rewarded whistleblowers. Both the rank-and-file employee and the senior manager with a substantial hand in planning and executing improper conduct may regularly lose sleep over their actions. The opportunity to turn fate on its head and to be hailed as the impetus for a solution instead of reviled as part of the problem—and be handsomely rewarded, to boot—can be irresistible. While those who are convicted of a criminal violation related to the conduct they expose may be ineligible to collect a bounty under the Act,[19] the whistleblower's own misconduct may easily be lost amidst the flood of information unleashed by the tip. Moreover, even an unsophisticated whistleblower (especially one represented by sophisticated counsel) can realize the opportunity to exchange valuable information for a more lenient, non-criminal assessment and disposition of the whistleblower's own wrongdoing.

Preventative Measures

Executives and management need not watch helplessly as employees and agents train one eye on work and the other on discovering, exposing and profiting from the company's or their colleagues' flaws. Indeed, while the Dodd-Frank Act's whistleblower provisions offer opportunities to a particular breed of whistleblower, they also offer tangible benefits to companies that heed the Act's call to utilize appropriate compliance and governance measures, many of which may already be in place and need only be enhanced and appropriately communicated to employees.

Avoid Issues Entirely

Obviously, the best way to "remediate" issues is to take steps to ensure that they never arise. If followed, this simple, yet undeniable truism may prove to be the most valuable weapon in an executive's or manager's toolbox. Proactive training regarding legal, compliance and ethical obligations—delivered regularly and customized based upon industry, geography and responsibility—can pay enormous dividends. So, too, can a board of directors' attention to compliance programs and emphasis on selecting executives who will cultivate a culture of compliance and set an appropriate tone at the top. The costs associated with hiring the right employees and retaining experienced legal counsel and consultants to craft, vet, and work with internal personnel to implement, cutting-edge training and compliance programs can be dwarfed by the costs associated with cleaning up a legal, regulatory, and public relations mess that might otherwise ensue.

Identify and Remediate Issues Before They Fester

While prevention is the best cure for whistleblowing ills, in the real world even the best-run companies must deal with compliance and governance challenges. How a company does so can make all the difference.

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As with many ills, early identification is key. Companies should implement systems that go well beyond the whistleblower hotlines mandated by SOX. User-friendly reporting mechanisms that exploit our ever-changing technology are a must. Avenues for truly anonymous reporting can also help ferret out wrongdoing. So, too, can frank discussions and solicitation of information during regular divisional meetings and annual reviews. And a company-wide sense that the enterprise genuinely cares about doing things the right way—even at the expense of short-term profit—will make those who *can* expose wrongdoing comfortable actually *doing* so.

Of course, even the finest compliance systems will not help if management refuses to act on the information those systems detect. Companies that ignore warnings about misconduct (or even take adverse employment action against the whistleblowing employee) often pay a hefty financial, regulatory and public relations price. Instead, companies should take tips seriously, investigate each one promptly, take decisive corrective action in consultation with counsel, and document and publicize such action as appropriate.

Incentivize Internal Whistleblowing

Even the most well-intentioned companies must recognize that the Dodd-Frank Act creates a strong financial incentive to file complaints with the SEC. The very best managers will work with outside counsel to counter with creative programs of their own. The first step is the type of reporting mechanisms discussed above, and creating both the impression and reality that complaints are taken seriously and investigated promptly. Whistleblowers should be briefed during the course of the investigation, if appropriate, and made to feel confident in the integrity and confidentiality of the investigative process.

Internal whistleblowers who do not wish to remain anonymous should be given recognition before superiors and colleagues, and their compliance efforts should be prominently noted in employment reviews. In extraordinary cases, they should also be given strong consideration for promotions. Finally, internal whistleblowers should be eligible for extra bonus pay and might even receive financial rewards for tips that expose material misconduct. Of course, many of these measures will have no impact on outsiders, who are free to serve as whistleblowers under the Act. But they are sure to reach the core group—company employees—that is most likely to possess the class of information that lends itself to whistleblowing.

"Beat 'em to the Punch:" Self-reporting and Related Options

Companies are often loath to self-report remediated misconduct to regulators. But lesser steps, such as communicating with government personnel or seeking a formal agency opinion regarding questionable business practices, are easier to take and can have enormous benefits. And even formal self-reporting can result in a cooperative investigation and penalty negotiation (even nullification) that can be far preferable than the alternative: an adversarial action initiated when a whistleblower exposes conduct that garners extended and painful press coverage and an accompanying cry for a punitive financial penalty, criminal corporate resolution and executive scalps. The mainstream business media regularly reports on penalties incurred by companies that would have benefited from early communication with the government.

Conclusion

While the Dodd-Frank Act certainly presents executives with a fresh set of challenges, it offers no guarantees to the myriad employees who mistakenly view it as the answer to their get-rich-quick dreams. Such prospectors have, in the months since the Act was passed into law, flooded the SEC with an avalanche of tips.[20] Overwhelmed and perhaps unprepared for the reaction to but one of thousands of provisions of the Act, and facing a plethora of pedestrian tips coupled with a paucity of tips from true insiders with knowledge of substantial, headline-grabbing fraud, the SEC has stressed that what matters most is the *quality*, not

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the *quantity*, of tips that it receives. And most whistleblowers will soon face the grim reality that they will reap no financial benefit at all from their whistleblowing efforts. While trends cannot yet be drawn from the Act, which is in its infancy, statistics associated with the *qui tam* provisions of the False Claims Act (FCA) are instructive: since the *qui tam* provisions of the FCA were amended and enhanced in 1986, the overwhelming majority of *qui tam* whistleblowers have pocketed no reward at all.[21]

Still, the Act adds a very substantial arrow to the whistleblower's quiver and its dangers are real. It will certainly lead to more agency investigations and an increase in enforcement actions related to conduct that otherwise would not have been scrutinized. And the Act's impact on remediation efforts is not to be forgotten: executives who previously were able to capitalize on internal tips by discreetly investigating and aborting misconduct early on may be forced by the Act to report or, worse, respond to allegations of improper conduct that have been exacerbated by the passage of time, regulator scrutiny, and media glare. The SEC whistleblowing genie has escaped its bottle, and executives and managers would be wise to take prophylactic measures to mitigate its impact.

In the wake of the Dodd-Frank Act, Benjamin Franklin's sage advice resonates: an ounce of prevention is surely worth a pound of cure.

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[1] The Dodd-Frank Act also contains whistleblower provisions under the Commodity Exchange Act. This article focuses on the SEC bounty program.

[2] 15 U.S.C. § 78u-1(e).

[3] SEC Litigation Release No. LR-21601 (July 23, 2010).

[4] *See* SEC Office of Inspector General, Report No. 474 (Mar. 29, 2010).

[5] Section 922, creating Section 21F(a)(1) of the Securities Exchange Act of 1934 (Exchange Act).

[6] Section 922, creating Section 21F(b)(1).

[7] *Id.*

[8] Section 922, creating Section 21F(a)(3).

[9] Section 922, creating Section 21F(h)(2)(A).

[10] Section 922, creating Section 21F(h)(1).

[11] In a bipartisan effort, on October 4, 2010, President Obama signed Congress' repeal of Section 929I of the Act, which permitted the SEC to withhold information obtained in its investigations through a broad exemption from the Freedom of Information Act, even in response to subpoenas served upon it.

[12] 15 U.S.C. § 78dd-1, et seq.

[13] *See U.S. Foreign Bribery Enforcement Statistics*, U.S. Department of Justice.

[14] The gravity of the Act's whistleblower provisions is underscored by the fact that the SEC already has set aside $452 million to fund anticipated bounties. *See Annual Report on Whistleblower Program*, SEC Staff (Oct. 2010).

[15] *See* SEC Press Release No. PR-2010-213 (Nov. 3, 2010).

[16] *See* Proposed Rule 21F-4(b) under the Exchange Act, SEC Release No. 34-63237 (Nov. 3, 2010), File No. S7-33-10. The SEC can also award a larger bounty to one who first reported the offending conduct to internal compliance personnel. *See* Proposed Rule 21F-6.

[17] The proposed rules also make clear that a submission is not "voluntary"—and thus, is not eligible for a financial reward—if the whistleblower has a duty to report the information to the SEC or other authorities

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(such as pursuant to an SEC request). They would also preclude a reward in exchange for information obtained through attorney-client privileged communications, from an independent public auditor of the company, or by a person with legal, compliance, supervisory or governance responsibilities where the information was communicated to the person with the expectation that he would take responsive action. *See* Proposed Rule 21F-4.

[18] The drain on company personnel and legal department budgets will be heightened if, as some expect, plaintiffs' firms race to recruit whistleblowers whose insider knowledge can form the backbone of a securities class action. If nothing else, that will serve as additional incentive for companies to forestall external reporting and promptly remediate material issues.

[19] Section 922, creating Section 21F(c)(2)(b).

[20] While no statistics are yet available on the number of tips received since the passage of the Act, lawyers who represent whistleblowers have reported a "flood of inquiries." *See Larger Bounties Spur Surge in Fraud Tips*, WALL ST. J. (Sept. 7, 2010). This certainly represents an increase on the 30 bounty applications received by the SEC in the five years preceding passage of the Act. *See* supra note 4. The SEC expects the wave of complaints to continue unabated. *See Whistleblower Bounties Pose Challenges*, WALL ST. J. (Dec. 13, 2010).

[21] *See Fraud Statistics: Qui Tam Intervention Decisions & Case Status*, U.S. Department of Justice, Civil Division (as of Sept. 30, 2008).

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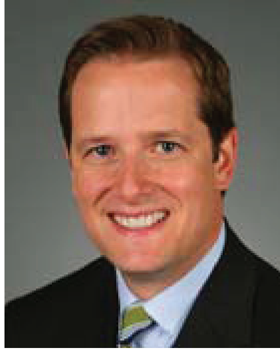

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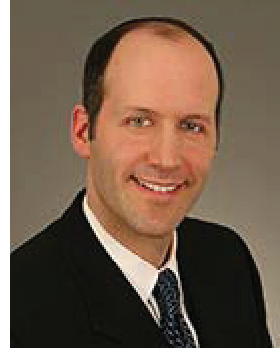

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