Dodd-Frank’s Whistleblower Provisions and the SEC’s Rules: Compliance and Ethical Considerations

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The Securities and Exchange Commission (the “SEC” or “Commission”) has issued the final rule (the “Rules”) that implements the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). The Act provides for the payment of substantial financial awards to whistleblowers who voluntarily provide the SEC with information about violations of federal securities laws that results in monetary sanctions of $1 million or more.

The Act marks a dramatic shift away from the compliance approach embodied in the Sarbanes-Oxley Act (SOX). SOX requires public companies to establish ethics guidelines and hotlines, and emphasizes self-policing. By contrast, under the Rules, a whistleblower need not internally report a possible securities law violation in order to be eligible for a bounty equal to 10 percent to 30 percent of monetary sanctions resulting from an enforcement action. Accordingly, companies will be faced with the

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prospect that their employees, suppliers, customers, consultants, advisors and others may report possible violations directly to the SEC without providing the companies with an opportunity to first investigate the allegations and remediate any violations. Under the Act, employers are prohibited from retaliating against whistleblowing employees.

The Act and Rules could have several significant consequences for US companies. First, companies are increasingly likely to be involved in conducting internal investigations and reacting to SEC investigations triggered by whistleblower submissions to the Commission. The SEC has estimated that it will receive 30,000 whistleblower reports a year, a staggering number. Because of its limited resources, the SEC will be unable to itself investigate many of these reports on its own, and the onus will be on companies to conduct their own investigations and propose appropriate remedial measures to the Commission.

Second, there is likely to be a significant increase in enforcement actions under the Foreign Corrupt Practices Act (the “FCPA”), in particular. The SEC and the Department of Justice (DOJ), enforce the FCPA, and a violation thereof can serve as the basis for a whistleblower award under the Act. The last few years have seen a dramatic increase in the number of FCPA investigations and in the size of FCPA settlements; indeed, eight of the ten largest FCPA settlements have been entered into since 2010. The Act’s whistleblower provisions likely will bolster this trend as whistleblowers attempt to capitalize on opportunities to collect sizable bounties predicated on FCPA violations.

Third, to preempt potential whistleblower reports or in response to awards paid to whistleblowers under the Act, many companies are likely to spend considerable time and an increasing portion of their budgets educating their directors, officers and employees about securities law compliance and internal compliance programs, and investigating and settling whistleblower complaints. The cost of operating a company within the SEC’s enforcement reach has just increased.

Part One of this Article summarizes and comments on key provisions of the Act and Rules. Part Two discusses certain ethical and other considerations relating to the use of attorney-client privileged information in whistleblower reports by lawyers and non-lawyers. Part Three touches on the interplay between heightened FCPA enforcement and the new whistleblower provisions. Part Four covers anticipated practical consequences of the Act and Rules for corporate compliance programs, internal investigations and corporate culture. Part Five sets forth steps that companies can take to reduce the risk of securities law violations and to prepare for and respond to whistleblower reports.

I. SUMMARY OF NOTABLE PROVISIONS OF THE ACT AND RULES

A whistleblower may receive a bounty under the Act and Rules if:

- the whistleblower is an “eligible person”;
- the whistleblower has “voluntarily” provided information to the SEC;
- the information provided is “original”;
- the information has resulted in a “successful enforcement” action; and
- the Commission obtains monetary sanctions of $1 million or more in one or more related actions.

Below, each of these requirements is summarized, the SEC’s criteria for determining the amount of whistleblower awards are briefly described, and the Act’s confidentiality, anti-retaliation and no amnesty provisions are highlighted.

Who Can and Cannot Be a Whistleblower

Rule 21F-2(a) provides that a whistleblower can be any individual or group of individuals
who provides information to the SEC that relates to a "possible" past, present or future violation of the federal securities laws. A whistleblower can be an employee of the company to which the information relates, but importantly, a whistleblower also can be an individual employed by a supplier, customer, consultant, investor or financial advisor to the company, or another person with knowledge of a possible securities law violation. Consequently, companies may want to consider reviewing the extent to which outsiders have access to sensitive company information and restrict such access in the future, as appropriate.

Corporations and other entities may not be whistleblowers. This effectively prevents the formation and financing of entities for the purpose of identifying, asserting and profiting from whistleblower claims. A whistleblower who is convicted of a criminal violation related to original information that he submitted to the SEC, and those who mislead or hinder the Commission by knowingly making false or fraudulent statements, also may not recover awards. However, a whistleblower who is culpable but is either not prosecuted or, if prosecuted, is not convicted of a crime relating to original information that he submitted, may receive an award. Finally, foreign officials and certain US regulatory officials may not be whistleblowers.

Information Must Be “Voluntarily” Provided to the SEC

The Rules incentivize employees and others who would be whistleblowers to disclose information soon after it comes to their attention and before the SEC or another authority initiates an investigation and thereby renders them ineligible for awards. Specifically, under Rule 21F-3(a)(1), information submitted to the SEC must be submitted “voluntarily” to be eligible for an award. Under Rule 21F-4(a), information will be deemed to be submitted voluntarily if it is submitted to the SEC before a request, inquiry or demand that relates to the information submitted is directed to the whistleblower or his representative by the SEC, or in connection with an investigation by the Public Company Accounting Oversight Board (PCAOB), a self-regulatory organization, Congress, any federal government agency or a state attorney general or state securities regulator. If a whistleblower has provided information to one of these bodies, it will be considered voluntarily submitted if the submission pre-dates the SEC’s request, inquiry or demand.

If the SEC or another authority has sent a request, inquiry or demand to a whistleblower’s employer, but not to the whistleblower or the whistleblower’s counsel, then submission of information by the whistleblower to the SEC related to the same subject matter as the authority’s request will be considered voluntary unless, before making the submission, the whistleblower is interviewed by government examiners or asked by the Commission to provide information in connection with such a request. Thus, requests, inquiries and demands to a company will not be treated by the SEC as requests to all of the company’s employees, and it may be possible for an enterprising employee to “voluntarily” provide the SEC with information after learning of the initiation of an investigation. In such circumstances, however, in order to be eligible for an award, the whistleblower’s submission would have to have “significantly contributed” to a “successful enforcement” action, a requirement that may be difficult to satisfy if the SEC has already initiated an investigation.

Notably, if a company conducts an internal investigation on its own initiative (i.e., not in response to a request, inquiry or demand), one who learns of, or is interviewed as part of, the investigation may attempt to make a “voluntary” submission to the SEC. In such instances, the whistleblower may be barred from receiving an award because he did not have “independent knowledge” of such information (see the section entitled “Information Must Be ‘Original,’” below). Although, as discussed further below, companies are likely to strive to be circumspect and careful about how they conduct their internal investigations so as not to inadvertently encourage employees to divulge the existence of an investigation to the SEC with an eye toward receiving an award, they also will need to be
careful not to discourage whistleblowers from submitting information to the Commission because this could contravene the Rules and exacerbate penalties against them.

Information Must Be “Original”

Rule 21F-4(b) requires that information submitted to the Commission be “original,” which means that it must be derived from the whistleblower’s (a) independent knowledge, i.e., experiences, communications and observations, and not derived from publicly available sources, or (b) independent analysis, i.e., examination and evaluation of information (including publicly available information), that reveals information not generally known or available to the public. The definition of “independent analysis” is such that it permits one to submit “original” information by offering a highly probative, expert analysis of publicly-available data, including data about which the whistleblower may not have first-hand knowledge.

Information will generally not be considered “original,” if the whistleblower (a) is a fiduciary or professional engaged by the company and (b) obtained the information through his access to, or participation in, certain corporate functions or work related to the engagement, as follows:

- The whistleblower is a director, officer, trustee or partner of the company and either (a) another person informed him of the alleged violation or (b) he learned of the information in connection with the company’s procedures for identifying, reporting and addressing possible violations of the law;

- The whistleblower is a company employee whose principal duties involve, or an outside advisor retained to perform, compliance or internal audit responsibilities;

- The whistleblower is an outside advisor retained to conduct an investigation into possible violations of the law; or

- The whistleblower is an employee of a public accounting firm, and the information was obtained during the performance of an engagement required to be performed by an independent public accountant under the federal securities laws, and relates to a violation by the client or the client’s directors, officers or employees.

Under Rule 21F-4(b)(4)(v), information submitted to the SEC by the categories of fiduciaries and professionals listed above may nevertheless be considered “original” under the following circumstances:

- The whistleblower has a “reasonable basis to believe” that disclosure is necessary to prevent the company from engaging in conduct that is likely to cause substantial injury to the company’s or its shareholders’ financial interests or property;

- The whistleblower has a “reasonable basis to believe” that the company is attempting to impede an investigation into its
misconduct, by, for example, destroying documents or improperly influencing witnesses; or

- 120 days have passed (a) since the whistleblower has provided information about a possible securities law violation to the company’s audit committee, chief legal officer, or chief compliance officer, or the whistleblower’s supervisor, or (b) since the whistleblower received information about the possible violation under circumstances indicating that the company’s audit committee, chief legal officer, or chief compliance officer, or the whistleblower’s supervisor, knew of the information (the “120-day waiting period”).

The 120-day waiting period is intended to ensure that these fiduciaries and professionals are not precluded from becoming whistleblowers and to “enhance the incentives for employees to report wrongdoing through their company’s established internal procedures.” Similarly, under the 120-day “look back” provision of Rule 21F-4(b)(7), if a whistleblower decides to report possible securities law violations internally, his information nevertheless will be considered “original” so long as he also reports that information to the SEC at the same time or within 120 days after making the internal report.

In light of these 120-day provisions, some companies that receive internal reports of possible securities law violations will see themselves as having 120 days within which to conduct investigations, implement or propose to implement remedies and determine whether to self-disclose any violations to the Commission. It may be difficult, if not impossible, for companies to complete investigations within 120 days in many instances, particularly where reports suggest investigative challenges of scope or complexity with respect to the events in question, (e.g., a large number of possible violations or violations that cover a period of many years, occurred in multiple countries, involved complex fact patterns multiple people or subsidiaries, or implicate former employees or individuals who cannot be located or who are inaccessible or dead).

Despite these difficulties, the SEC has made clear that this aspect of the Rules is not intended to suggest that companies have a “grace period” for determining how to respond to possible securities law violations and that companies are not necessarily expected to complete internal investigations before making self-disclosures. Indeed, in some cases, the SEC may elect to await the results of an internal investigation by a self-disclosing company before initiating its own investigation. Given its limited resources, the SEC in many cases can be expected to provide companies with an opportunity to conduct and conclude internal investigations, particularly where there is no imminent threat of a securities law violation, the SEC views the internal investigation as credible and sufficiently supported by the company involved, and the SEC believes that the company is committed to minimizing the
risk of recurring violations and is respectful of the right of prospective whistleblowers (e.g., the investigation is being handled by counsel or third parties with appropriate independence and authority, the company has effective whistleblower policies and procedures in place, has not discouraged employees from reporting misconduct, has a favorable enforcement history, and is committed to prohibiting retaliation against whistleblowers).

The SEC also has made clear that the Rules are “not intended to, and [do] not, create any new or special duties of disclosure on entities to report violations or possible violations of the law to the Commission or to other authorities.” Nevertheless, when the Commission determines the extent to which it will be lenient with companies, it will consider their cooperation with the SEC and the promptness of their self-disclosures. Companies that have received a report or whose executives or managers have knowledge of a possible securities law violation therefore will need to determine when to self-disclose, if at all, on a case-by-case basis, weighing the advantages and disadvantages of doing so.

Information Must Result in a “Successful Enforcement” Action

Under Rule 21F-4(c), a whistleblower will be eligible for an award if his original information leads to a successful judicial or administrative action (i.e., one or more proceedings brought by the SEC arising out of the same nucleus of operative facts) in any of the following three circumstances:

• Conduct not previously under investigation: if the SEC, Congress, the PCAOB, or any federal agency, state Attorney General or securities regulator or self-regulatory organization was already examining or investigating the conduct in question, and the whistleblower submits original information to the SEC that “significantly contributed” to the success of the action; or

• Conduct previously under investigation: if the SEC receives information about a securities law violation from a person (Individual B) who learned of the violation from someone else (Individual A) who possesses “original” information within the meaning of the Rules and later makes his own whistleblower report to the

These various avenues for recovery of a whistleblower award provide prospective whistleblowers with an incentive to be the first to file a report with the SEC, because, by doing so, they can avail themselves of the less stringent standard applied to those whose original information causes the Commission to initiate an examination or open an investigation. Conversely, individuals who delay reporting may find that another whistleblower has already submitted original information to the SEC, making subsequent reports subject to the higher “significantly contributed” standard for submissions of information relating to conduct already under investigation. The “significantly contributed” standard is a comparatively high one, but is consistent with the Commission’s goal of incentivizing whistleblowers to “come forward early with information of possible violations of the securities laws . . .”

These standards establish how the SEC is to determine who has the right to an award when the SEC receives information about a securities law violation from a person (Individual B) who learned of the violation from someone else (Individual A) who possesses “original” information within the meaning of the Rules and later makes his own whistleblower report to the
SEC (i.e., after Individual B’s report). In this situation, the SEC may consider Individual A to be the original source of the information and Individual B to have submitted the information based on his “independent knowledge” such that both individuals could be eligible to receive an award. However, Individual A, as the first to file, may be more likely to be eligible for an award because information submitted by the first-filer must only be sufficiently “specific, credible, and timely to cause” the SEC to open an investigation that leads to a successful enforcement action, whereas the second to file (Individual B), must submit information that “significantly contribute[s]” to the success of the enforcement action.15 Although the SEC has stated that “[u]ltimately, we believe that whistleblowers are in the best position to assess whether reporting potential securities violations through their companies’ internal compliance and reporting systems would be effective,”16 these differing standards likely will not only disincentive individuals with original information to share that information with others, but also incentivize them to be the first to report to the SEC.

Monetary Sanctions Must Be at Least $1 Million

For a whistleblower to be eligible for an award, the Commission must obtain monetary sanctions in an action or related action or actions exceeding $1,000,000 in the aggregate. Rule 21F-16 provides that, when determining whether the $1,000,000 threshold has been met, the Commission may not take into account any monetary sanctions that the whistleblower or a company whose liability is substantially based on the whistleblower’s conduct are ordered to pay or actually pay.

Other Relevant Provisions

Criteria for Determining the Amount of an Award. Whistleblowers who satisfy the requirements for receiving an award will be granted an award of between 10 percent and 30 percent of the monetary sanctions collected in successful SEC and related actions. The Commission may allocate an award between or among multiple whistleblowers. Under Rule 21F-6, in determining the size of a bounty, the SEC will consider the following criteria, but it will have broad discretion to give greater or lesser weight to any particular criterion based on a “highly individualized” review of the facts and circumstances of each case:

Factors that may increase the amount of an award:

- The significance of information submitted, including its reliability and completeness;
- The assistance provided by the whistleblower to the SEC, including its extent and timeliness, hardships the whistleblower has faced as a result of submitting information and assisting the Commission, and resulting resources conserved by the SEC;
- The Commission’s programmatic interest in deterring violations; and
- Whether the whistleblower reported possible securities law violations through internal, company compliance systems and the extent to which the whistleblower cooperated with any internal investigations.

Factors that may decrease the amount of an award:

- The whistleblower’s culpability in the Commission’s action or a related action;
- Whether the whistleblower unreasonably delayed reporting the securities law violation to the SEC; and
- Whether the whistleblower interfered with the company’s internal compliance and reporting systems, by, for example, making false statements.

Much has been made of the fact that the SEC can take into consideration whether a whistleblower has reported a matter internally when determining the size of a bounty. But, it is yet to be seen whether this criterion will counteract
incentives under the Rules for whistleblowers to make submissions directly to the Commission without first reporting internally.

As noted above, whistleblowers who are convicted of a criminal violation related to original information that they submit to the SEC may not recover awards, but under the criteria for determining the amount of a bounty, whistleblowers who are not criminally convicted, even though they are culpable, civilly liable or the subject of a cease-and-desist order, could still be entitled to a bounty of 10 percent or more.

Confidentiality. Rule 21F-7 permits a whistleblower to submit original information to the Commission on an anonymous basis if the whistleblower is represented by counsel and counsel’s name and contact information are provided at the time of the submission. The whistleblower must disclose his identity, however, in order to be paid an award. The Commission may not reveal the identity of a whistleblower except (a) in connection with a federal lawsuit or administrative action or in a proceeding filed by another governmental authority, or (b) to certain US governmental authorities and foreign securities and law enforcement authorities as may be necessary to further the purposes of the Exchange Act and protect investors. The first exception ensures, for example, that in a criminal prosecution by DOJ, any defendant has the right to confront his accusers as required by the Constitution. The second exception facilitates investigations and enforcement actions by other governmental bodies; the Commission is obligated to obtain assurances from foreign governments that they will abide by the confidentiality requirements of Section 21F(h) of the Exchange Act.

Anti-retaliation. The anti-retaliation protections of the Act and Rules protect a whistleblower from adverse actions by his employer, regardless of whether the whistleblower is ultimately entitled to an award, as long as the whistleblower submits information to the SEC pursuant to the Rules’ reporting procedures and the whistleblower genuinely and reasonably believes that that information relates to a possible securities law violation. Under Section 922(h)(1)(A) of the Act, employers may not “discharge, demote, suspend, threaten [or] harass” an employee who has become a whistleblower. The Act provides employees with a right to file suit against an employer in federal district court (without the need to make a filing with the Department of Labor, as required of whistleblowers under SOX), and employees who prevail in their cases are entitled to reinstatement and two times back pay otherwise owed (plus interest thereon), as well as compensation for litigation costs, expert witness fees and reasonable attorneys’ fees. A whistleblower may bring suit within six years of an adverse action or within three years of the date on which “facts material to the right of action are known or reasonably should have been known,” as long as such date is within 10 years of the date of the retaliatory action. The Act prohibits employees from waiving their anti-retaliation rights and bars employers from requiring employees to waive or limit those rights.

The Act’s anti-retaliation provisions may cause some companies to become less aggressive and more conciliatory when terminating or taking other adverse personnel action against employees and others with access to information that could be reported under the Act. Whether this is advisable will depend on the facts of each case, but employers should remember that they may have defenses to retaliation claims, including, if true, the fact that they would have taken actions adverse to the whistleblowers irrespective of their reports to the SEC.

No Amnesty for Whistleblowers. Rule 21F-15 provides that whistleblowers will not obtain amnesty from SEC investigations and enforcement actions as a result of providing information to the Commission.

II. ETHICAL ISSUES RELATED TO LAWYERS AS WHISTLEBLOWERS

Under certain conditions, the Rules permit a lawyer, without consent of his client, to
submit a whistleblower report “for [his] own benefit,” using information regarding a possible securities law violation that the lawyer obtained through attorney-client privileged communications or, more generally, “in connection with the legal representation of the client.”18 Specifically, outside counsel and in-house lawyers alike may make such reports when “permitted . . . pursuant to [an SEC attorney-conduct rule (17 CFR § 205.3(d)(2))], the applicable state attorney conduct rules, or otherwise.”19

Under 17 CFR § 205.3(d)(2), a lawyer representing an issuer before the SEC may reveal confidential client information to the Commission, without the client’s consent, to the extent that the lawyer “reasonably believes necessary” to, among other things, “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,” or “[t]o 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.” “Material violation” is defined as “a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.”20 The attorney conduct rules of various states, consistent with the Model Rules of Professional Conduct, contain similar provisions permitting lawyers to disclose attorney-client privileged information under specified circumstances.21

Under the Rules, a non-lawyer who learns of possible securities law violations “through a communication that was subject to the attorney-client privilege” is both prohibited and permitted to make a whistleblower report based on those possible violations to the same extent as a lawyer would be in the same circumstance.22 “Thus, for example, if an employee only learns about possible violations because he or she is interviewed in the course of a company internal investigation [covered by the attorney-client privilege],” the employee will be barred from seeking a whistleblower award as long as the lawyers involved are themselves barred.23

Notably, if a lawyer (or derivatively, a non-lawyer) is permitted to disclose attorney-client privileged information as part of an SEC whistleblower report, he can do so immediately; there is no specified “waiting period” that would allow the company or another person to interpose a self-disclosure or whistleblower report, respectively, either of which occurrence could render a subsequent report by the lawyer non-original and preclude him from receiving a bounty. Moreover, it bears emphasis that, with respect to ongoing or future conduct, the Rules merely require that a whistleblower “reasonably believe” that disclosure thereof is necessary to prevent a “material violation that is likely to cause substantial injury to the financial interest or property” of the company or its shareholders. The gap between reasonable belief and demonstrable fact, of course, can be wide, and the other qualifying terms of this provision add layers of ambiguity and subjectivity that can further broaden the scope of what may be deemed a “reasonable belief” in particular circumstances.

The SEC’s guidance on this topic, set forth below, provides scant comfort for those who care about the privilege and the candor between lawyer and client that the privilege is intended to foster:

For purposes of Rule 21F-4(b)(4)(v), in order for a whistleblower to claim a reasonable belief that disclosure of information to the Commission is necessary to prevent the relevant entity from committing substantial harm, we expect that in most cases the whistleblower will need to demonstrate that responsible management or governance personnel at the entity were aware of the imminent violation and were not taking steps to prevent it.24

As to most genuine concerns about potential imminent securities law violations that arise within a company, management and governance personnel quickly become aware of the
concerns—and painfully so; indeed, that is precisely why lawyers often are brought into such matters (as legal advisors or internal investigators), if they were not the initial recipients of the information. Moreover, it should be noted that, in the eyes of a whistleblower, “imminent” may not necessarily connote that a substantive violation is ongoing or anticipated to occur in short order. Rather, the Rules leave open the possibility that a whistleblower, under the guise of revealing an imminent violation, could disclose a purely historical violation that would otherwise be cloaked by the attorney-client privilege (perhaps one that occurred and was completed years ago), on the ground that the company’s failure to appropriately disclose or account for that violation (e.g., in an 8-K, 10-Q, or 10-K) is itself a securities law violation that would work a “substantial harm” on shareholder interests.

Additionally, lawyers who are not directly involved in addressing a particular compliance concern and non-lawyers (e.g., employees interviewed in internal investigations) who learn of “imminent violations,” typically will have comparatively less, if any, appreciation for whether the company is “taking steps to prevent” the prospective violation (or they simply may disagree with the efficacy of any remedial steps taken), or whether the prospective violation is “material.” Such persons therefore may believe, quite reasonably but mistakenly, that they are within their rights to proceed with a report to the SEC. Accordingly, there likely will be cases in which lawyers and non-lawyer employees who reveal attorney-client privileged information without the company’s consent and in pursuit of whistleblower bounties will later be deemed ineligible for awards because, for example, breaching the privilege was not warranted in the first instance. While disappointing for the whistleblower, such an outcome would provide small consolation for the company involved, insofar as privileged information will have been revealed to the SEC in the meantime. There are no provisions in the Rules restricting the SEC’s use of information supplied by persons deemed ineligible to receive whistleblower awards. In this context, a company will not be able to put the genie back in the bottle and will have to ready itself for a probable SEC investigation.

III. FCPA ENFORCEMENT: ADDITIONAL INCENTIVES FOR WHISTLEBLOWERS

The advent of new and greater incentives for individuals to make whistleblower reports to the SEC under the Act and Rules comes at a time when the SEC and other law enforcement officials are dedicating even more attention and resources to FCPA enforcement. Companies with exposure to potential FCPA violations should be particularly attuned to the changes embodied in the Act and Rules, and the potential impact of those changes on FCPA compliance and associated whistleblower activity.

As set forth above, the Rules substantially increase the incentives for whistleblowers to report possible violations of law externally to the SEC, with or without first reporting the same internally to compliance departments or other company personnel. Previously, SEC whistleblower awards were restricted to insider trading cases, and the award in any such case was capped at 10 percent of the financial penalties imposed. By authorizing awards for any federal securities laws violations, converting the 10 percent figure from a ceiling to a floor, and trebling the maximum award to 30 percent, while safeguarding whistleblowers with robust anti-retaliation measures, the SEC has set the stage for a sea change not just in the incidence of whistleblower reports, but also in how corporate officers and employees address compliance concerns internally and vis-à-vis the SEC.

To be sure, the meager results of the SEC’s prior whistleblower program, coupled with high-profile (and long undetected) cases of gross financial misconduct (e.g., the Madoff ponzi scheme), justify the basic policy goal of promoting more whistleblower activity. But,
given the implications of the Act and Rules, it is fair to ponder whether Congress and the SEC have overcompensated and swung the pendulum too far in favor of encouraging external whistleblowing, to the potential detriment of companies’ efforts to effectively self-police and timely terminate and remediate instances of non-compliance.

Anticipating a Dramatic Rise in Whistleblower Reports of FCPA Violations

This concern is no more evident than in the area of FCPA enforcement. The FCPA’s anti-bribery provisions prohibit certain entities and individuals (e.g., US companies) from paying, or offering or promising to pay, bribes to foreign government officials for the purpose of obtaining or retaining business. The FCPA also requires issuers of securities traded on US exchanges to maintain books and records that accurately and completely describe expenditures and to have in place internal controls adequate to ensure that expenditures are appropriate and duly authorized.

Both the SEC and DOJ enforce the FCPA, and increasingly work together (and sometimes also with foreign authorities) to investigate and resolve FCPA cases. Over the past several years, these agencies have transformed a once largely ignored statute into the centerpiece of the federal government’s international anti-corruption strategy—and a significant source of revenue. The SEC and DOJ each now have a unit dedicated to FCPA enforcement, and their investigative tactics have become considerably more aggressive. For instance, investigators have conducted broad “sweeps” of particular industries, simultaneously probing multiple participants in those industries, executed search warrants, and conducted “stings” and other covert activities historically more prevalent in “street crime” investigations.

As the government has struck with these “sticks,” it has also extended “carrots” in the form of cooperation policies designed to encourage companies to voluntarily disclose FCPA violations. The enforcement agencies have represented that cooperation will inure to a company’s benefit when the agency involved decides whether to launch its own investigation and how to resolve the matter in question. In this way, the SEC and DOJ have, in effect, partially outsourced the investigation of FCPA violations. Even when it is apparent to companies that the government is probably unaware of possible FCPA violations, companies frequently feel compelled to conduct internal investigations given the stakes involved and the prospect that the government already knows, or will eventually learn, of the conduct at issue.

The uptick in FCPA investigations and enforcement actions is reflected in the government’s enforcement statistics. In 2010, DOJ and the SEC brought more than 70 FCPA enforcement actions—nearly twice the number of actions brought the year before and more than a six-fold increase over the number of actions brought just five years earlier (2005). Many of these enforcement actions—when triggered by corporate self-disclosures or government investigations—have been resolved through heavily negotiated non-prosecution or similar agreements pursuant to which the targeted companies agree to satisfy certain conditions relating to FCPA compliance and to pay substantial financial penalties. Thus, while successful FCPA enforcement actions do not regularly yield criminal charges against entities or individuals, they invariably include monetary settlements in amounts that, particularly in light of the SEC’s new whistleblower rules, are bound to capture the attention and imagination of would-be whistleblowers.

Put simply, there is, and will continue to be, significant money to be made in the reporting of FCPA violations, in particular. Indeed, DOJ’s and the SEC’s heightened emphasis on FCPA enforcement shows no signs of abating. To the contrary, unequivocal and repeated pronouncements from the leadership of DOJ and the SEC, greater cooperation and coordination among countries in cross-border corruption investigations, and related initiatives in other parts of the world (most notably,
the UK Bribery Act 2010) clearly signal that global anti-corruption efforts, generally, and FCPA enforcement, specifically, will remain high priorities of US federal law enforcement. This, coupled with the Act’s financial incentives, likely will spur more whistleblower cases involving alleged FCPA violations in the future, and companies subject to FCPA enforcement, particularly US companies with substantial foreign sales and operations, would therefore be well advised to closely monitor developments in this area.

IV. IMPLICATIONS FOR CORPORATE GOVERNANCE, COMPLIANCE & CULTURE

While companies should prepare for more whistleblower reports founded on purported FCPA violations, in particular, it is reasonable to expect more whistleblower reports premised on other purported securities law violations as well. As described below, companies should be on guard against ways in which the greater incidence of whistleblower reports overall may adversely affect company operations and corporate culture.

More Whistleblower Reports, But Not Necessarily Better Ones

The inevitability of greater numbers of whistleblower reports will be matched, just as inevitably, by more reports (in absolute and, probably, relative terms) that are unfounded or made by persons who mistakenly believe themselves to be eligible for whistleblower awards (and might not have blown the whistle had they known of their ineligibility). In this sense, more will mean less.

It is, understandably, often difficult for any agency to assess up front the factual basis and legal legitimacy of an alleged violation based solely on a whistleblower’s report. Had the SEC chosen to require internal reporting prior to any report to the SEC, as many in the corporate community strongly urged during the comment period for the Commission’s preliminary rules, the task of conducting this qualitative assessment would have rested in the first instance with the companies involved. In conjunction with such an assessment, a company could (and in all likelihood would) determine whether (a) other, related compliance concerns were present, (b) to take personnel or other action based on any established violations, (c) to enhance applicable internal controls or (d) to disclose any violations to the government.

In the absence of a requirement to initially report possible securities law violations internally, and, indeed, in the presence of rules that arguably tilt whistleblowers toward bypassing internal compliance departments, the SEC will likely often be the initial recipient and evaluator of whistleblower information. Companies should be wary of this dynamic for several reasons. First, and most obviously, the information that the SEC receives from a whistleblower will necessarily have been filtered (and perhaps distorted) through the whistleblower’s recollection and analysis, and the agency will have little immediate visibility into the whistleblower’s veracity and motivations (beyond the self-evident desire to recoup an award). In other words, the SEC will receive reports from knowledgeable, good-faith complainants, as well as pure opportunists utterly lacking knowledge (and every type in between), but the Commission will not at the outset have ready access to the sort of information on which companies routinely rely to make qualitative judgments about a whistleblower’s allegations (e.g., the larger context for the alleged violations, other versions of the facts that may conflict with the whistleblower’s, and the whistleblower’s employment performance and status).

This difficulty is compounded by how the Commission has constructed its requirement that, in order to be “original,” a whistleblower’s information must be “[d]erived from [his] independent knowledge or independent analysis.”28 The Rules specify that “independent knowledge” is “factual information” in the whistleblower’s “possession that is not derived from publicly available sources,” and may be gained “from
[the whistleblower’s] experiences, communications and observations in . . . business or social interactions.” This requirement eschews what is normally regarded as a baseline for reliability: personal knowledge. That is, under the Rules, a whistleblower need not have personal knowledge of the purported securities law violations that underlie his report, nor must he have learned of the subject violations from someone who did have personal knowledge. Further, not only are hearsay reports permitted by the Rules, but there is no limit to the number of levels of hearsay upon which a whistleblower’s report may be premised.

In addition, unlike the False Claims Act, the Act and Rules do not authorize qui tam suits. As a result, SEC whistleblowers are relieved of any obligation to meet pleading and proof standards applicable to litigation. This means that even whistleblowers without personal knowledge of the facts underlying their submissions need not conduct any due diligence into their own allegations or otherwise invest time or resources in the matter beyond completing the whistleblower forms incorporated into the Rules. The whistleblower’s contribution is his information—even if undeveloped and speculative—while the task of substantiating the allegations may be left entirely to the government (or those managing internal corporate investigations in consultation with the SEC).

Potential Delay in the Discovery of Violations by Companies

By inducing more whistleblower reports to the SEC, the Rules will undoubtedly result in investigations and enforcement actions as to actual securities law violations that might otherwise have gone undetected and therefore unsanctioned. Without concomitant measures inciting the making of meritorious reports, however, companies are likely to be occasionally confronted with allegations that have little basis in fact. These allegations, though, will not necessarily announce themselves as meritless and unworthy of substantial inquiry. Instead, they will tend to entail significant cost and business disruption for the companies involved, as they are called to respond to government requests for information and conduct related internal investigations—all for allegations that could have been more quickly and efficiently identified as frivolous had they initially surfaced internally.

The Rules likewise threaten to work mischief for compliance-minded companies that, in fact, had or have bad actors in their midst. This is so because it is far from clear that the SEC will be able to keep up with the increased inflow of whistleblower reports sufficiently to avoid delays in the agency’s commencement and completion of investigations. Delay on the part of the agency could, in turn, delay the discovery of the subject conduct by the affected companies, the termination of that conduct and the remediation of the attendant harm. Thus, far from promoting compliance, the uptick in whistleblower reports that the SEC is already experiencing may have the unintended, and ironic, consequence of allowing compliance problems to persist and fester.

Potential Effect on Culture of Turning Officers and Employees into Informants

The sheer magnitude of SEC whistleblower bounties may insidiously affect corporate cultures. Someone who is self-interested and opportunistic usually needs only the prospect of marginal personal benefit (weighed against any prospect of personal risk) to be induced to reveal company information to outside authorities. But, in many cases, the prospect of a significant recovery (10 percent to 30 percent of $1 million, the minimum amount under the Rules) will be enough to make even loyal company employees consider whether to bypass internal reporting procedures and instead report possible securities law violations directly and initially to the SEC. Further, employees may entirely abandon inclinations to report violations internally if they believe that they could recover much larger bounties while still incurring little personal risk with little effort.

The Rules seek to mediate the inherent tension between an employee’s loyalty to his company
and his self-interest, but, at least arguably, the Rules could too quickly turn employees into informants against their employers with inadequate safeguards as to the quality of their information. The same is true—and even more concerning—with respect to certain high-level employees and professionals with fiduciary and other key responsibilities, including directors, officers, compliance and audit personnel, and outside accountants and investigators.

Although these persons are generally ineligible to receive whistleblower bounties, the exceptions could in many instances swallow the rule. Under one exception, as noted above, such a fiduciary or professional may report allegations of securities law violations to the SEC after 120 days have elapsed since he (a) provided the information to his or her supervisor (if he or she is an employee of the company at issue), or the company’s audit committee, chief legal officer or chief compliance officer, or (b) received the information “under circumstances indicating the audit committee, chief legal officer, chief compliance officer . . . , or [his] supervisor was already aware of the information.” It is clear, then, that the Rules do not categorically bar even the highest-ranking company personnel or those engaged to perform audit and investigative functions related to the very conduct in question from becoming whistleblowers, but instead merely set conditions on their eligibility.

By permitting these individuals to become whistleblowers based solely on the passage of time (and not much time at that) rather than on a case-specific consideration of whether the company, at relevant times, addressed the underlying compliance issues with reasonable dispatch and otherwise in good faith, the Rules have the potential to erode the underpinnings of corporate compliance departments—the trust and confidence reposed in department personnel and functions—and to subvert the overarching objectives of preventing, detecting and remediating corporate misconduct on an enterprise-wide basis.

It should also be noted that, once a director, officer, compliance or audit official, or outside professional makes a whistleblower report to the SEC, the agency is authorized by Rule 21F-17(b) to communicate directly with that whistleblower, even if (a) the whistleblower continues to work for the company and (b) the SEC knows the company to be represented by counsel. In fact, Rule 21F-17 expressly permits the SEC to engage in such communications without seeking consent of the company’s counsel (and therefore presumably without the company’s knowledge). This raises the distinct possibility that employees with decision-making authority, having blown the whistle on their companies, will continue to provide information of alleged violations to the SEC, while their companies are simultaneously having to (a) make important decisions—ones that might ordinarily fall within the whistleblowers’ job responsibilities—that flow from the whistleblower reports (e.g., responding to and defending against SEC investigations and enforcement actions, conducting internal investigations, remediating non-compliance) and (b) avoid personnel action against the employee-whistleblowers that could be construed as retaliatory (e.g., diminishing decision-making authority).

Implications for Internal Investigations

The ability of a whistleblower to rely on hearsay information, combined with the ability of anyone to become a whistleblower either immediately or after a 120-day waiting period, has profound implications for how companies conduct internal investigations. In this regard, the concern is not that internal processes for accepting and reviewing allegations of misconduct will be bypassed, but, paradoxically, that they will be accessed and that the circle of persons with direct and indirect knowledge of the conduct in question will thereby be enlarged.

As a practical matter, this concern may be unavoidable in many internal investigations, given that the participating investigators will have to gather documents from custodians and interview or otherwise communicate with persons believed (correctly or incorrectly) to be fact witnesses, as well as others who may have no
factual knowledge, but performed relevant corporate functions (e.g., compliance, audit, governance). Each person initially without knowledge who is thus advised of the existence of a compliance issue through an internal investigation is an additional potential whistleblower. And, while in some instances it may be advisable not to fully reveal the purpose of the investigation or the substance of the underlying compliance issue, excessive circumspection or obliqueness in interactions with witnesses, and avoiding fact-gathering from potentially knowledgeable sources altogether, run the obvious risk of depriving an investigation of important information.

To manage the competing risks of not getting enough, and imparting too much, information through an internal investigation, companies should be prepared to conduct internal investigations with all deliberate speed—that is, thoughtfully and expeditiously. In particular, companies should develop and implement an investigative plan promptly, modifying it as appropriate while the investigation unfolds and making carefully considered decisions about whether, when and how to expose the conduct under investigation to additional persons through interviews or other means. An appropriately expeditious and well-executed internal investigation will enable the company to determine early and on an informed basis whether to self-disclose any violations to the government, and also increase the odds that a self-disclosure will include a reasonably accurate account of material facts and occur prior to any whistleblower report that may not be as factually fulsome and balanced.

V. TIPS FOR ENHANCING COMPLIANCE & RESPONDING TO WHISTLEBLOWER REPORTS

A company can minimize the likelihood of being the subject of whistleblower reports of possible securities law violations and position itself to respond effectively to such reports by taking the following steps, as appropriate:

“Tone at the Top”

- Ensure that the board and senior management are timely and adequately informed of material compliance concerns and are actively engaged in assessing and managing associated risks.
- Promote a culture of compliance throughout the organization by, among other things, ensuring the effective and sufficiently regular communication of messages reinforcing that culture from the top of the organization.

Ethics / Compliance Education, Training & Processes

- Create or amend company policies and handbooks to cover securities law compliance and non-retaliation against whistleblowers, and, if necessary, amend employment and consulting contracts.
- Train officers, managers, supervisors, in-house counsel and human resources personnel to understand and give effect to anti-retaliation policies.

Means and Positive Incentives to Report Misconduct Internally

- Establish or, if necessary, enhance hotlines and other mechanisms (e.g., ombudsman program) for persons to internally report misconduct, and ensure that employees understand how to use available mechanisms and the importance and role of internal reporting.
- Regularly assess efficacy of hotline systems and implement modifications, if advisable (e.g., enable or better facilitate anonymous reporting by employees and outsiders).
- Consider providing employees who report misconduct internally with monetary awards (from company funds) or other recognitions, and, with the approval of the employees involved, consider openly advising other employees of these internal reports and the resulting benefits to the employees and the company.
Auditing Transactions & Monitoring Ethics/Compliance Functions

• Track and evaluate hotline reports and the company’s responses to them (e.g., review whether employees who lodge complaints are appropriately advised of the status and outcomes of their internal reports).

• Instruct internal audit to routinely review how transactions are recorded and accounted for, flag and escalate instance of suspected fraud and implement accounting safeguards to minimize the risk that transactions are not being recorded (accurately or at all). Invest in and integrate information technology across operations and subsidiaries to ensure similar risk-mitigation steps are taken system-wide.

Due Diligence & Information Management

• In the context of prospective acquisitions, carefully evaluate the target’s compliance culture, history, policies and safeguards, and obtain appropriate representations and indemnities from the target concerning its compliance with securities laws.

• Consider whether and to what extent it is appropriate for employees, suppliers, customers, consultants and other outsiders to have access to sensitive company information, and determine whether existing internal controls over the dissemination of material, non-public information are adequate.

Rapid Response & Internal Investigations

• Establish procedures for promptly responding to reports of possible securities law violations (e.g., notifications to the board or board committees, counsel, managers and supervisors, and human resources personnel; preservation of electronic data, hard-copy documents, and other potentially relevant information).

• Budget sufficient funds to enable timely and adequate responses to SEC investigations and enforcement actions and related internal investigations, as well as effective compliance activities.

• Develop plans for responding to inquiries from employees, equityholders, customers, suppliers, the press, the public and other constituencies.

• Consult with counsel experienced in compliance, investigations, enforcement and corporate governance.

• Assess the validity of reports of possible securities law violations as quickly as practicable through internal investigations or otherwise.

VI. CONCLUSION

The full, long-term impact of the Act and Rules remains to be seen, but if they generate anywhere near the additional whistleblower activity that is anticipated, companies will face significant legal and operational challenges. The time to prepare for the “sea change” that the Rules promise is now, and implementation of the practical steps set forth above, as appropriate, will help companies effectively respond to SEC investigations and enforcement actions, conduct internal investigations of alleged securities law violations, and nurture what is, in the end, the best antidote for non-compliance and whistleblower reports: corporate cultures founded on personal integrity and institutional and employee loyalty.

Notes


4. The Act’s reliance on financial bounties as a tool for improving securities law enforcement may be viewed as an implicit acknowledgement that the SEC does not have the resources to identify most securities law violations on its own.

5. A whistleblower will not be eligible for an award unless he provides information to the SEC in the manner set forth in the Rules. See Rule 21F-2(a)(2).

6. A whistleblower must have a “reasonable belief” that his information relates to a possible securities law violation. See Rule 21F-2(b)(1)(i).

7. Rule 21F-4(c).

8. A whistleblower will not be eligible for an award if he obtained information through an audit and making a submission would be a violation of Section 10A of the Exchange Act. Rule 21F-8(c)(4). Thus, the Rules do not excuse auditors from complying with the “reporting up” requirements of Section 10A, under which a public accounting firm must report to a company’s board of directors, and under certain circumstances, to the Commission, if (a) the accounting firm has detected illegal acts in the course of an audit and has reported those acts to a company’s audit committee or board, (b) the acts would have a material effect on the company’s financial statements, and (c) the auditors have concluded, among other things, that the company’s senior management has not taken “timely and appropriate remedial actions.” In addition, the Rules are not intended to prohibit employees of public accounting firms from making whistleblower submissions alleging that their employers violated the federal securities laws or professional standards by, for example, failing to “report up” as required by Section 10A of the Exchange Act. See Rules at 73.

9. In most instances, this exception to the general prohibition against whistleblowing by high-level insiders, fiduciaries and professionals will apply only if the company involved was not taking steps to prevent an “imminent violation” of the securities laws.

10. Rules at 69.

11. Rules at 76-77.

12. Rules at 76.

13. Id.

14. Rules at 100.

15. See Rules at 85-86.


17. Cf. Egan v. TradingScreen, Inc., Case No. 10-cv-8202 (S.D.N.Y., May 4, 2011) (For purposes of invoking the anti-retaliation provisions, the submission of information to the SEC by a company’s outside counsel will be deemed to constitute a submission of information by a plaintiff-employee where such counsel submitted information to the Commission as a result of an investigation that was initiated because of the plaintiff-employee’s internal reporting of violations and the plaintiff-employee had actual knowledge of such counsel’s transmission of information to the Commission.).


19. Id.

20. 17 CFR § 205.2(i).

21. See, e.g., ABA Model R. Prof. Conduct 1.6 (Confidentiality of Information); Ill. R. Prof. Conduct 1.6 (Confidentiality of Information). It should be noted that there are important differences between the various state attorney-conduct rules that authorize—or under certain circumstances require—a lawyer to disclose, without the client’s consent, privileged or other information relating to the attorney-client relationship. As such, a lawyer who relies on a state attorney-conduct rule when submitting such information to the SEC as part of a whistleblower report must be cognizant of which state’s law applies and whether that state’s professional conduct rules are sufficiently broad to permit the disclosure. A lawyer who is not so cognizant or is mistaken in this regard risks subjecting himself to an administrative disciplinary proceeding and/or an injunction or other legal action by the company involved.


23. Rules at 83.


26. The Insider Trading and Securities Fraud Enforcement Act of 1988 authorized the SEC to award whistleblowers in insider trading cases up to 10 percent of financial penalties imposed. From the inception of this program through the issuance of a report on the program by the SEC’s Inspector General in March 2011, the SEC made payments to only five whistleblowers in an aggregate amount of approximately $160,000. See Assessment of the SEC’s Bounty Program (Mar. 29, 2010 Memorandum from H. David Kotz, SEC Inspector General, to Robert Khuzami, Director, SEC Division of Enforcement) at 5 (available at http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf).

27. In 2010, the SEC and DOJ assessed approximately $1.8 billion against companies based on FCPA violations.

29. Rule 21F-4(b)(2).

30. On May 25, 2011, during the open meeting at which the SEC approved the Rules (by a 3-2 vote), the SEC’s Director of Enforcement, Robert Khuzami, stated that the Commission had experienced an “uptick” in, but not a “flood” of, whistleblower reports under the whistleblower program authorized by the Act.


32. Similarly, a company now cannot shield from SEC probes current or former employees with whom the company has entered into confidentiality agreements, even if the agreements were entered into in specific contemplation of the possibility that the employees might provide government authorities with potentially damaging company information and the employees received valuable consideration in return for their agreements. Specifically, Rule 21F-17(a) prohibits companies from attempting to enforce confidentiality agreements against current or former employees, as a means of “imped[ing the employee] from communicating directly with the Commission staff about a possible securities law violation.”