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# Dodd-Frank Bounty Awards and Protections Change Whistleblower Stakes – Will Opportunity for Personal Gain Frustrate Corporate Compliance?

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Executives and corporate boards rely on quality information from others for the business and fiduciary decisions they must consider and make – a principle which is especially vital in matters of internal or external compliance mandates. The Securities and Exchange Commission (SEC) wrestled with this reality before issuing its Final Rule on May 25, 2011 implementing whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] – and it declined to require internal reporting as a prerequisite to qualification for a bounty award.[2]

For businesses newly affected by the major reforms of Dodd-Frank, compliance has become more complicated by the tension between the personal gain available to whistleblowers from bounty awards and organizational compliance objectives. Under Dodd-Frank, whistleblowers stand to share 10 percent to 30 percent of monetary sanctions obtained by the SEC or through other enforcement actions aided by original information offered voluntarily by a whistleblower.[3] Dodd-Frank further protects certain whistleblowers against employment reprisals.[4]

The dilemma for the SEC – and now for businesses subject to its Final Rule – is that Dodd-Frank's architecture, which could have made the government a partner in advancing corporate compliance, instead establishes a lure of bounty awards with the potential to distort the priorities of whistleblowers having valuable information of wrongdoing and thwart corporate programs designed to encourage internal reporting and correction. After all, most corporate compliance programs are constructed so that departures from policy will be disclosed and addressed with appropriate responses at the most natural source – within the organization.

*Award Predicates Under the Statutory Framework*

Dodd-Frank establishes three predicates to obtaining a bounty award:

- conduct attributable to the company must be sufficiently severe that a sanction exceeding $1 million is imposed;[5]
- one or more whistleblowers must have provided "original" information or analysis voluntarily to the SEC leading to the successful enforcement of a judicial or administrative action brought by the SEC or certain other regulatory and enforcement authorities;[6] and

- the whistleblower must qualify by status and conduct to receive a bounty award.[7]

*How the Final Rule Implements the Statute*

The Final Rule is formatted as a conversation with whistleblowers – not affected businesses – repeatedly referring to "you" (the whistleblower), starting with its first section that introduces its features and procedures:

- "You are a whistleblower if …."
- "To be eligible for an award, you must …."
- "For purposes of the anti-retaliation protections …, you are a whistleblower if …."[8]

The Final Rule also announces how the SEC will qualify individuals for at least a minimum – 10 percent – award. Qualifying factors affecting how the SEC will exercise its discretion to grant a larger award include (a) consideration of the significance of the whistleblower's information, measuring its reliability and completeness aiding the successful imposition of monetary sanctions and conservation of SEC resources;[9] (b) the whistleblower's assistance, including cooperation, timeliness of internal and SEC reporting, encouragement of others to cooperate, remediation efforts, and hardship experienced for reporting and assisting the enforcement action;[10] and (c) the SEC's programmatic interest in deterring violation of the securities laws, taking account of SEC enforcement objectives and priorities, encouragement of others to report, and the amount, extent, and type of harm to investors and others.[11]

While it does not mandate internal reporting, the Final Rule anticipates upward adjustment towards the 30 percent ceiling in circumstances where a whistleblower, directly or through a legal representative, participates in internal compliance systems before, or at the same time as, reporting them to the SEC, assessing also the extent to which a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations.[12] Announced as an inducement for internal reporting, the Final Rule provides potential enhancements for internal reports leading to corporate reporting that yields larger sanctions than would result solely from the whistleblower's own report[13] and for actions arising out of the same nucleus of operative facts.[14]

For businesses subject to SEC jurisdiction, the Final Rule signals what they must weigh to assure effective compliance programs. Whatever the other challenges with respect to promoting internal reporting, the Final Rule clarifies that whistleblowers are not required to report internally and may qualify for handsome bounty awards even if they bear culpability for breaching corporate policies and codes and creating exposure in the first place.

Individuals with some degree of culpability understandably may be reluctant to report within established corporate compliance channels. The SEC and other enforcement authorities may be more tolerant – or even permissive – than a corporate employer met with investigations and enforcement proceedings occasioned – in whole or in part – by wrongful actions or inactions of an individual who creates liability and then emerges as a whistleblower seeking a bounty award and other benefits conferred by Dodd-Frank and the SEC's Final Rule.

*Disqualifying Factors and Those that Merely Reduce the Bounty Award*

The Final Rule utilizes definitions to disqualify certain individuals from receiving bounty awards by reason of their status or activity (or the status of activity of those from whom they obtain information).[15] For a disclosure to qualify as voluntary, a whistleblower must not have a pre-existing legal or contractual duty to the SEC or another authority to report to the SEC[16] and the submission of information must occur before a request, inquiry, or de-

mand that relates to the subject matter of the submission is directed to the whistleblower or his or her representative.[17] Additionally, tipsters are not eligible to be considered for an award if they fail to supply initial and supplemental information and cooperation in the form and manner prescribed by the SEC,[18] or based on certain status, relationships, or legal or contractual obligations relative to:

1. a position within the SEC or certain law enforcement or regulatory agencies, or self-regulatory organizations;
2. a position with a foreign government or a designated foreign financial regulatory authority;
3. a criminal conviction related to the SEC action or a related action;
4. the audit of a company's financial statements;
5. an immediate family or household member holding a position with the SEC;
6. the receipt of information from another ineligible person; or
7. a knowing and willful false, fictitious, or fraudulent statement or representation, or the knowing use of any false writing or document containing any false, fictitious, or fraudulent statement or entry intended to mislead or hinder the SEC or another authority.[19]

Because original information or analysis necessary for a bounty award must be derived from the independent knowledge or analysis of the whistleblower,[20] the Final Rule presents additional absolute as well as conditional bars. With certain exceptions for permissible attorney disclosures, the SEC generally will not consider information to be derived from independent knowledge or independent analysis if the whistleblower obtained it through a communication that was subject to the attorney-client privilege or in connection with the whistleblower's service as legal representative of a client,[21] or unlawfully under federal or state criminal law.[22]

Original information or analysis also may be conditionally disqualified if the individual supplying it: (a) serves as an officer, director, trustee, or partner of an entity and was informed about allegations of misconduct, or learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law; (b) is an employee whose principal duties involve compliance or internal audit responsibilities, or who is otherwise associated with a firm retained to perform compliance or internal audit functions for an entity; (c) is employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or (d) is employed by, or associated with, a public accounting firm, the information was obtained through the performance of an engagement required of an independent public accountant under the federal securities laws, and that information related to a violation by the engagement client or the client's directors, officers, or other employees.[23]

A conditional disqualification may be lifted 120 days after the whistleblower provides the information to an audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's own supervisor, or 120 days after the whistleblower receives the information, if it was received under circumstances indicating that those recipients already were aware of the information.[24] Of course, the whistleblower controls the individuals to whom disclosures will be made, and reporting to a supervisor complicit in wrongdoing or without sufficient authority to address, report, or otherwise respond to initial disclosures can be problematic – for the whistleblower and the entity.

Apart from the passage of time, a conditional disqualification may be lifted based on a whistleblower's reasonable belief that (a) disclosure of the information to the SEC is necessary to prevent the entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;[25] or (b) the enti-

ty is engaging in conduct that will impede an investigation of the misconduct.[26]

Perhaps most disconcerting to some businesses will be the factors representing individual choices and actions of tipsters that will not disqualify them from receiving a bounty award altogether, but instead will only reduce potential awards from the statutory maximum of 30 percent to not less than the 10 percent statutory minimum. There are three classes of personal conduct that the SEC's Final Rule considers relevant: whistleblower culpability, whistleblower delay in reporting, and whistleblower interference with internal compliance and reporting systems. The SEC will assess:

- the culpability or involvement of the whistleblower, including any role in the securities violations; the whistleblower's education, training, experience, and position of responsibility at the time the violations occurred; whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations; whether the whistleblower financially benefitted from the violations; whether the whistleblower is a recidivist; the egregiousness of the underlying fraud committed by the whistleblower; and whether the whistleblower knowingly interfered with the SEC's investigation of the violations or related enforcement actions.
- whether the whistleblower unreasonably delayed reporting the securities violations, taking into account, such factors as:
  - whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;
  - whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and
  - whether there was a legitimate reason for the whistleblower to delay reporting the violations.
- whether a tipster who "interacted with his or her entity's internal compliance or reporting system undermined the integrity of such system" by such conduct as knowingly:
  - interfering with established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation;
  - making any material false, fictitious, or fraudulent statements or representations that hindered the entity's efforts to detect, investigate, or remediate the reported securities violations; and
  - providing any false writing or document knowing the writing or document contained any false, fictitious, or fraudulent statements or entries that hindered the entity's efforts to detect, investigate, or remediate the reported securities violations.[27]

Among many employers, culpable conduct listed by the SEC would be grounds for employment termination, or at least serious consequences. Such employers will have to weigh carefully how they are to proceed in such circumstances, relative to the Final Rule.

Consistent with its policy decision against mandatory internal reporting, the SEC will not penalize individuals who elect to refrain from internal reporting, even where such a mandate clearly is established by agreement, job description, and corporate policies and codes of conduct or ethics. The SEC also will not consider a failure to adhere to internal policies a basis for preventing a tipster from attaining a full 30 percent share of a monetary sanction. Furthermore, while an individual providing willfully false, fictitious, or fraudulent statements or writings to the SEC is completely disqualified from receiving an award,[28] it appears that the same sort of interference with internal compliance and reporting sys-

tems will be a factor only to the extent that the SEC may reduce the award to not less than 10 percent of the monetary sanction.[29]

Potentially, whistleblower culpability will be relevant to the amount of an award in two significant respects: (a) the SEC will not take into account any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated; and (b) any amounts that the whistleblower or the entity pays in sanctions as a result of the SEC action or related actions will not be included within the calculation of the amounts collected for purposes of making payments to a whistleblower.[30] As a consequence, the $1 million threshold for a qualifying monetary sanction may not be met when the sum attributable to whistleblower wrongdoing is backed out.

*Protections Against Retaliation*

The Final Rule protects whistleblowers from retaliation if: (a) an individual possesses a "reasonable belief" that the information provided relates to a "possible" securities law violation (or certain violations of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)) that has occurred, is ongoing, or is about to occur, and (b) the information is reported in a manner prescribed by the SEC.[31] Protection against retaliation is not conditioned upon whether a tipster actually satisfies requirements, procedures, and conditions to qualify for a bounty award.[32]

The Final Rule broadly proscribes any action to impede an individual from communicating directly with SEC staff about a possible securities law violation, including enforcing, or threatening to enforce, confidentiality agreements with respect to such communications, with an exception for privileges related to legal representation.[33] The SEC expressly reserves the right to enforce the anti-retaliation provisions in an action or proceeding.[34]

*Compliance Considerations*

Compliance has to do with internally and externally set codes governing behavior. And who should know and care more about upholding those standards than mutually dependent organizations and those working for them? The simple, if unduly optimistic, theorem holding that whistleblowers and the organizations with which they are associated have a common cause may be upset by Dodd-Frank's architecture and the SEC's Final Rule implementing it.

Under certain statutory schemes, reporting within an organization is either required as a condition of whistleblower protection – or at least one of the features of it.[35] Dodd-Frank abandons that model for something wholly different. And the consequences for affected organizations are real. While Dodd-Frank may be hailed in some circles as a legislative triumph for its expansion of coverage, there is justifiable concern that the Dodd-Frank system of awards for original information offered voluntarily to the SEC (or the CFTC) will incentivize individuals with knowledge of a compliance breach to withhold information that corporate leaders need to know in favor of going to the government as the highest bidder for essential business information not otherwise known to corporate leaders.

Incongruously, Dodd-Frank's new bounty awards for original information may operate to divert whistleblowers away from internal reporting channels at the very time when their compliance-driven cooperation is most valuable. Companies will face the prospect that individuals having multiple outlets for their original information or analysis may favor and select the path of highest personal advantage – in preference to direct and meaningful resort to corporate hotlines and other internal pathways to effective response. To address a potential distortion in priorities, companies may need to reassess their compliance programs and procedures, giving consideration to:

- Announcing and communicating policies;
- Confirming awareness and obtaining acknowledgments;
- Training and orientation;
- Monitoring;
- Responding appropriately;
- Assuring that communications inform of policy and reinforce compliance;
- Fashioning positive and negative incentives that encourage compliance; and
- Building reporting into job descriptions and evaluations.

Dodd-Frank presents new realities for corporate compliance and related reporting, receipt of reports, and appropriate responses. More than ever, it will matter that employees at all levels within an organization know about preferred corporate avenues for reporting if they become aware of deviations from established codes of conduct, codes of ethics, and other norms. Employment communications, offer letters, job descriptions, policies, manuals, handbooks, and employment and separation agreements should be utilized to reinforce a consistent message of corporate compliance objectives.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010). Unless otherwise noted, further statutory citations will be to Section 922 of Dodd-Frank (Section 21F of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-6) or to the Final Rule "Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934," SEC Release No. 34-64545 (Section 21F to be codified in 17 C.F.R. § 240.21F). The many facets of Dodd-Frank's whistleblowing awards and protections are detailed in Bloomberg Law Reports® —Securities Law, *The Sounds of New Whistleblower Awards and Protections under the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Aug. 2, 2010).

[2] The Final Rule will become effective 60 days after publication in the Federal Register.

[3] 15 U.S.C. § 78u-6(b)(1). Companion provisions apply under the Commodity Exchange Act (CEA), 7 U.S.C. § 1, *et seq.,* subject to the jurisdiction of the Commodity Futures Trading Commission (CFTC).

[4] 15 U.S.C. § 78u-6(h)(1).

[5] 15 U.S.C. § 78u-6(a)(1). A monetary sanction may include penalties, disgorgement, and interest. 17 C.F.R. § 240.21F-4(e).

[6] 15 U.S.C. 78u-6(a)(3), (b)(1).

[7] 15 U.S.C. 78u-6(c)(2)(A)-(D), (i).

[8] 17 C.F.R. § 240.21F-2(a), (b).

[9] § 240.21F-6(a)(1).

[10] § 240.21F-6(a)(2).

[11] § 240.21F-6(a)(3).

[12] § 240.21F-6(a)(4).

[13] § 240.21F-4(c)(3).

[14] § 240.21F-4(d)(1),(2).

[15] § 240.21F-4(b)(4).

[16] § 240.21F-4(a)(3).

[17] § 240.21F-4(a)(1),(2).

[18] § 240.21F-8(a), (b).

[19] § 240.21F-8(c).

[20] 15 U.S.C. 78u-6(a)(3)(A).

[21] § 240.21F-4(b)(4)(i), (ii).

[22] § 240.21F-4(b)(4)(iv).

[23] § 240.21F-4(b)(4)(iii).

[24] § 240.21F-4(b)(4)(v)(C).

[25] § 240.21F-4(b)(4)(v)(A).

[26] § 240.21F-4(b)(4)(v)(B).

[27] § 240.21F-6(b).

[28] § 240.21F-8(c)(7).

[29] § 240.21F-6(b)(3).

[30] § 240.21F-16.

[31] § 240.21F-2(b)(1)(i),(ii).

[32] § 240.21F-2(b)(1)(iii).

[33] § 240.21F-17(a).

[34] § 240.21F-2(b)(2).

[35] Compare Section 34:19-4 of New Jersey's whistleblower law, known as the Conscientious Employee Protection Act (CEPA) (to obtain relief for disclosure to a public body, the employee must have given the employer written notice of the activity, policy, or practice and afforded the employer a reasonable opportunity to correct the activity, policy, or practice – unless the employee is reasonably certain that the activity, policy or practice is known to one or more supervisors or the employee reasonably fears physical harm as a result of the disclosure and the situation is emergency in nature) with Section 806(a)(1) of Sarbanes-Oxley (protection for disclosure to employer equally with other specified law enforcement or regulatory authorities).