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Latest on Dodd-Frank's Whistleblower Rules

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Section 21F of the Securities Exchange Act of 1934 (the Exchange Act), which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), directs the SEC to provide monetary awards to whistleblowers, subject to certain conditions and limitations, who voluntarily provide original information relating to a violation of the securities laws that leads to a successful enforcement action resulting in the imposition of over $1 million in monetary sanctions. Awards are to be made in amounts between 10 percent and 30 percent of the monetary sanctions, depending on factors set forth by the SEC.

According to the SEC, it has received 334 whistleblower tips since August 2011, when the SEC's final rules implementing Section 21F became effective. The most common complaint categories were market manipulation (16.2 percent), corporate disclosures and financial statements (15.3 percent) and offering fraud (15.6 percent). The SEC already has set aside $452 million for whistleblower compensation. Although no whistleblower awards have been announced to date, the SEC's Office of the Whistleblower has posted notice of over 200 applicable enforcement judgments and orders issued from July 21, 2010 (when Dodd-Frank became law) through December 1, 2011. The expectation is that the first awards will be made early in fiscal year 2012.

This article discusses a few of the significant items included in the SEC's final rules implementing Section 21F, the anti-retaliation program included in Section 21F and some steps companies can take now to address these new whistleblower rules.

Section 21F Final Rules

On August 21, 2011, the SEC's final rules implementing Section 21F[1] (the Final Rules) became effective. The Final Rules contain a number of significant items, two of which are briefly discussed below.

Incentives, but No Requirement, to First Use Internal Compliance Process

The SEC's proposed rules requested public comment on whether a whistleblower would be required to report through the company's internal compliance processes as a prerequisite to award eligibility. Over some commentators' objections, the Final Rules do not include a requirement that whistleblowers report internally. Instead, the Final Rules include additional incentives for whistleblowers to utilize a company's internal compliance system. For example, with respect to the criteria for determining the amount of an award, the Final Rules expressly provide that a whistleblower's voluntary participation in an entity's internal compliance systems is a factor that can increase the amount of an award, and a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.

In addition, the Final Rules contain a provision under which a whistleblower can receive an award for reporting original information to a company's internal compliance system where the company later reports the information to the SEC. In this way, the whistleblower gets "credit" for an award if the whistleblower utilizes the internal compliance system. Finally, the Final Rules provide 120 days for a whistleblower to report to the SEC after first reporting internally and still be treated as if the whistleblower had reported to the SEC at the earlier reporting date.

Exclusions from Eligibility – Auditor Issues

Section 21F contains several exclusions that expressly exclude certain types of individuals from eligibility, including, among others, persons associated with certain regulatory and law enforcement authorities, persons convicted of criminal violations that are related to the SEC action or a related action, or "to any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to Section 10A of the Exchange Act."[2]

Similarly, the Final Rules provide that "original information" excludes information that is obtained (a) through an attorney-client privileged communication; (b) in connection with the legal representation of a client; (c) by an officer, director, trustee or partner of an entity, if such person learned the information from another person or in connection with the entity's processes for identifying, reporting and addressing possible violations of the law; (d) by an employee whose principal duties involve compliance or internal audit responsibilities or an employee of a firm retained to perform compliance, internal audit or internal investigation functions; (e) by an employee of a public accounting firm, if the information is obtained through the performance of an engagement required under the federal securities laws that relates to a possible violation by the audited entity or its directors, officers or employees; or (f) in a manner that is determined by a federal court to violate applicable federal or state criminal law. The SEC's rationale in adopting these prohibitions is to address the possibility that company personnel with compliance responsibilities could try to "front-run" internal investigations for their own benefit.

However, the Final Rules include exceptions to these exclusions for compliance personnel (but not for attorney-client privileged communications), including if the person has a "reasonable basis to believe that disclosure . . . is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors," or the person has a "reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct." Therefore, the SEC has effectively created a "back door" through which certain outside compliance personnel or auditors can blow the whistle on their engagement client without any obligation to first report through the company's internal compliance system and in potential violation of duties of confidentiality to the client. How effective or common this exclusion will be remains to be seen.

In addition, the Final Rules' adopting release states that an auditor is not prohibited from making a "specific and credible submission alleging that [the auditor's public accounting firm] violated the federal securities laws or professional standards" because such a submission is not contrary to Section 10A of the Exchange Act. Section 10A requires the auditor to take certain actions in response to becoming aware that illegal acts have or may have occurred. The SEC believes that this rule could help ensure that public accounting firm violations are timely reported, which is especially important given the SEC's view of the auditor's role as a gatekeeper.

Anti-Retaliation Program

Section 21F also includes an anti-retaliation program that prohibits employers from taking action to retaliate against whistleblowers by creating a new cause of action for whistleblowers who suffer employment retaliation after sharing information with the SEC. This cause of action allows whistleblowers to sue directly in federal court, without first exhausting the administrative procedures that were required by other statues, such as the Sarbanes-Oxley Act. In addition, the statute of limitations for these claims can be much longer – up to 10 years for some whistleblowers. Whistleblowers that prevail on their retaliation claims are entitled to reinstatement, attorneys' fees and double back pay with interest. Finally, employers may not require that employees waive their anti-retaliation rights under Section 21F pursuant to Section 29(a) of the Exchange Act, which voids any provision that binds a person to waive compliance with the Exchange Act.

The anti-retaliation rules apply irrespective of whether the whistleblower is ultimately entitled to an award. Recently, in *Egan v. TradingScreen, Inc.*,[3] the plaintiff sought relief against the company and its chief executive officer for, in part, retaliatory discharge under Section 21F. The federal district court ruled that an individual does not need to personally report to the SEC in order to qualify for anti-retaliation protection, provided that a report is made to the SEC by someone with whom the individual is "acting jointly." The plaintiff in *Egan* contended that, by initiating and participating in an investigation by outside counsel retained by the independent directors of the company as a result of his allegations, he acted jointly with outside counsel in providing information to the SEC. The court partially agreed, holding that the plaintiff had adequately alleged that he acted jointly with outside counsel. However, in order to prove the retaliation claim, the court granted leave to the plaintiff to amend his complaint in order to sufficiently allege that outside counsel had, in fact, reported the information to the SEC. In a subsequent decision, the court dismissed the plaintiff's amended complaint after it was shown that the outside counsel did not, in fact, report the information to the SEC.[4]

What Can Companies Do Now?

Generally, companies should reexamine and reevaluate their internal compliance procedures and policies to ensure consistency with the new whistleblower rules and to encourage compliance by making the company's internal compliance procedures as user-friendly as possible. Specifically, companies may want to take steps to increase the likelihood that employees will use the company's internal compliance system before reporting to the SEC. Companies also may want to develop a response plan that includes the formation of a compliance committee to handle serious allegations. Finally, companies that haven't done so already should consider adopting an anti-retaliation policy with respect to employees that report potential violations to the company or the SEC.

Increase Likelihood that Employees Use Internal Compliance System

Companies often want to maintain some control over the investigative process and the potential benefits of self-reporting violations if an issue arises. As noted above, however, there is no requirement under Section 21F that a whistleblower first utilize a company's internal compliance system. Indeed, a company is prohibited from requiring that an employee report any problem first to the company. Nevertheless, as discussed above, in the Final Rules the SEC did include certain incentives to encourage whistleblowers to do so.

Employees tend to use a company's internal compliance system if the employees are aware of the compliance system and they feel that it results in fair outcomes. In order to increase the likelihood that an employee will use a company's internal compliance system, a company should take steps to ensure that its compliance program is visible and available, such as utilizing internal company newsletters and training. Training, in particular, should teach supervisors how to be sensitive to employees who might lodge complaints and what steps are appropriate in response to complaints. In addition, it is important that the compliance program have the public support of management and the board so that it is viewed as credible by employees.

Establish a Compliance Committee

In some cases, companies may want to establish a compliance committee to investigate a whistleblower complaint. Generally, a compliance committee would be called into action only for credible complaints that allege substantial or widespread harm or misconduct. The members of a compliance committee could include senior members of the company's legal department, finance and/or audit divisions, investor relations and human resources. The goal is for the compliance committee to be able to evaluate the allegations raised, perform any triage to mitigate the damage and to address the proper reporting, if necessary, to the SEC or law enforcement.

Adopt Anti-Retaliation Policy

If a company hasn't done so already, these new whistleblower rules provide additional incentive for companies to adopt anti-retaliation policies. An anti-retaliation policy should reiterate the company's general commitment to complying with the law and include specific language to protect employees from unlawful retaliation. Whistleblower anti-retaliation policies often include, in every-day terms, what "retaliation" means so supervisors and employees are clear about what is considered retaliatory conduct and what is not. Employee training may also be helpful, especially for supervisors, since many types of conduct can be deemed "retaliation," not just an employee's termination or demotion.

A whistleblower anti-retaliation policy can also identify the company's procedures for investigating and responding to potential whistleblower complaints. Employees should be informed where to report concerns and companies need to explain what the individuals who receive complaints will do with the information. The company should make clear, however, that the anti-retaliation policy is not a license to disgruntled employees to steal confidential information or break contracts. Notwithstanding the anti-retaliation policy, employers are permitted to take appropriate action against whistleblowers that violate legitimate company policies. In order to help justify the company's actions, companies should carefully document their adverse employment actions and maintain such documents during the relevant statute of limitations period.

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Notes:

[1] 17 CFR §§ 240.21F-1—21F-17. [back]

[2] Section 21F(c)(2) of the Exchange Act. [back]

[3] 2011 U.S. Dist. LEXIS 47713 (S.D.N.Y. May 4, 2011). [back]

[4] 2011 U.S. Dist. LEXIS 103416, *9 – *14 (S.D.N.Y. Sept. 2, 2011). [back]

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