ALERTS AND UPDATES

U.S. Financial Reform: New Whistleblower Incentives and Protections, and More Enforcement Expected

August 24, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Expanded Bounty Hunter Provisions: A Sea Change for SEC and CFTC Enforcement Actions

The Act includes "bounty hunter" provisions to increase the voluntary reporting of securities and commodities violations. The U.S. Congress did so by significantly enhancing whistleblower rewards and protections. These provisions pose new and substantial challenges to publicly traded companies – including heightened Foreign Corrupt Practices Act (FCPA) risks and likely costly compliance burdens. The U.S. Securities and Exchange Commission (SEC) recently paid a whistleblower a reward of $1 million in the *Pequot* matter. Combined with the federal law that criminalizes retaliation against an employee who provides confidential information to the government, or who purloins corporate documents to turn them over to the government, companies must now take a careful look at how they conduct their business activities, measured by a focused risk metric.

These new whistleblower provisions appear in two main parts – section 922 (related to the SEC) and section 748 (related to the U.S. Commodity Futures Trading Commission, or the "CFTC"). Both offer a bounty of up to 30 percent of collected monetary sanctions over $1 million recovered by the SEC, the CFTC, the U.S. Department of Justice (DOJ), self-regulatory organizations and other regulators. Congress instructed that the necessary rules implementing these measures must be promulgated within 270 days of the statute's enactment.

Under the Act, a whistleblower who provides "original information" to the SEC or CFTC[1] leading to a successful enforcement action that imposes monetary sanctions over $1 million is eligible for a reward of between 10 percent and 30 percent of the funds collected as sanctions. These provisions are somewhat similar to the whistleblower provisions of the federal False Claims Act (FCA), which the DOJ reports has led to the recovery of $2.4 billion during 2009, and more than $24 billion since 1986.[2] Those FCA whistleblower actions have demonstrably increased the number of agency enforcement proceedings: In the healthcare industry, for example, more than three-fourths of the enforcement actions reported during 2009 relate to actions initiated by whistleblowers.[3]

A few categories of individuals are excluded by the Act from qualifying for the new bounty hunter provisions:

- individuals who work for the SEC or CFTC;
- auditors who conduct a required audit of the publicly traded company;
- and individuals who are convicted in a proceeding related to the judicial or administrative action for which the whistleblower otherwise could receive an award.

Clearly, potential whistleblowers are not limited to current or former employees. They can be independent contractors, consultants, joint venture partners, sales agents, accountants (if not conducting a required audit), as well as others whose dealings with a company puts them in a position where they can gather and provide original information to government officials in the hope of being financially rewarded.

The "plaintiffs' bar" now handling *qui tam* work under the FCA is anticipated to take advantage of these new whistleblower provisions. For one reason, the plaintiffs' bar may find it much easier for whistleblowers to seek bounties under the new provisions because, unlike the FCA's *qui tam* provisions, whistleblowers under the Act are not required to file and maintain lawsuits in federal court. Consequently, whistleblowers seeking bounties under the new provisions do not have to incur the significant financial burdens that *qui tam* relators and their counsel must shoulder under the FCA. They also do not have to meet the heightened pleading standards imposed by Federal Rule of Civil Procedure 9(b) for suits pleading fraud claims.

Recent FCPA Enforcement

The Act's whistleblower provisions take effect at a time when the DOJ and SEC have already increased resources devoted to FCPA matters. The SEC has added new FCPA enforcement units, while the DOJ has added prosecutors and FBI agents dedicated to FCPA cases – and is filling additional positions. The DOJ has also begun discussions with the IRS Criminal Investigation Division about partnering on FCPA cases around the United States. Moreover, the federal agencies have started to use extensive undercover techniques to uncover FCPA violations.

In a recently publicized FCPA investigation, the DOJ used undercover law-enforcement techniques to uncover allegedly widespread fraud and corruption – which resulted in 22 executives and employees of companies in the military and law-enforcement products industry being charged for their involvement in schemes to bribe foreign government officials. In 2010, the DOJ's Fraud Section has charged 46 individuals with FCPA or bribery-related offenses. And this year may surpass the record set in 2009, when more individuals were charged with FCPA violations than in any prior year (or in the past several years combined) – including CEOs, CFOs and other senior corporate, sales, marketing and finance executives. Assistant U.S. Attorney General Lanny Breuer, in charge of the DOJ's Criminal Division, has warned that "the prospect of significant prison sentences for individuals should make clear to every corporate executive, every board member, and every sales agent that we will seek to hold you *personally accountable* for FCPA violations." It is anticipated that the new whistleblower provisions will soon increase the number of FCPA matters – already at all-time-high levels – and will also increase other types of securities and commodities fraud investigations and prosecutions.

New Whistleblower Protections

While it is challenging for employers to determine how to best handle whistleblowing employees, the Act has added another layer of enhanced whistleblower protections. Under the Act, a whistleblower now can sue a retaliating employer directly in federal court without first having to exhaust administrative remedies. In addition, existing whistleblower protections under the Sarbanes-Oxley Act have been clarified to apply to *both* parent companies and affiliates whose financial information is included in consolidated financial statements.

New Requirements for the Natural-Resource Sector

A related provision, section 1504 – designated "Disclosure of Payments by Resource Extraction Issuers" – requires entities engaged in the commercial development of oil, natural gas, or minerals to provide additional information in annual reports filed with the SEC about any payments made by the issuer, a subsidiary or any entity under the issuer's control to a foreign government, department, agency or instrumentality of a foreign government, or a company owned by a foreign government for the purpose of commercial development of oil, natural gas, or minerals. In connection with section 922 of the Act, this provision may lead to more FCPA investigations and actions.

Section 1504 of the Act amends section 13 of the Exchange Act. Congress instructs the SEC to issue final rules that "require each resource extraction issuer to include in an annual report . . . information relating to any payment made by the resource extraction issuer, a subsidiary of the resource extraction issuer, or an entity under the control of the resource extraction issuer to a foreign government or the [U.S.] Federal Government for the purpose of the commercial development of oil, natural gas, or minerals, including: (i) the type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals; and (ii) the type and total amount of such payments made to each government."

The Act defines "commercial development of oil, natural gas, or minerals" to include "exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the [SEC]." "Payment" is any remuneration that is "made to further the commercial development of oil, natural gas, or minerals"; and is "not de minimis" and includes "taxes, royalties, fees (including license fees), production entitlements, bonuses, and other material benefits, that the Commission, consistent with the guidelines of the Extractive Industries Transparency Initiative (to the extent practicable) determines are part of the commonly recognized revenue stream for the commercial development of oil, natural gas, or minerals."

Aiding and Abetting Liability Authorized for SEC Enforcement Actions

The Act also includes provisions designed to make it easier for the SEC to bring and maintain enforcement actions based on expanded secondary liability. The following new provisions set out the newly expanded authority:

- Section 929M (Aiding and abetting authority under the Securities Act and the Investment Company Act);
- Section 929N (Authority to impose penalties for aiding and abetting violations of the Investment Advisers Act);
- Section 929O (Aiding and abetting standard of knowledge satisfied by recklessness).

Although the Private Securities Litigation Reform Act of 1995 authorized the SEC to charge aider and abettor violations of the Exchange Act in enforcement actions, Congress had required the SEC to demonstrate that defendant(s) knew about the misconduct, which courts interpreted as requiring proof of actual knowledge (and not just recklessness).

While a few senators had strongly supported extending to private litigants the authority to charge and prove secondary aiding and abetting liability in federal securities fraud cases, Congress did not do so in the Act, although it may in the future. Section 929Z of the Act instructs the U.S. Comptroller General to "conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws," and then report to Congress on its findings within a year.

Similarly, while Congress did not provide private litigants with the same authority as the SEC obtained in the Act (see below) regarding the extraterritorial reach of the federal securities laws in securities fraud actions (*i.e.*, legislatively repealing *Morrison v. National Australia Bank*), it also instructed that a study on this issue be conducted. Section 929Y of the Act instructs the SEC to solicit public comments, conduct the study, and then provide it to Congress, along with recommendations, within 18 months.

Extraterritorial Reach (Limited Repeal of *Morrison*) for SEC Enforcement Actions

Section 929P(b) of the Act effectively repeals *Morrison v. National Australia Bank*[4] for certain SEC enforcement actions. It authorizes extraterritorial jurisdiction if the SEC charges violations of the antifraud provisions of the federal securities laws that involve "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors" or "conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

What This Means for Companies

In light of the new and potentially sweeping consequences that may result if these new laws are violated – and since publicly traded companies may face many other issues, such as continued participation in government programs; collateral civil litigation; and obligations to shareholders, employees, customers and the public – companies may wish to thoroughly review their existing corporate governance and compliance policies.[5]

Companies may also want to take actions to encourage and enhance the general loyalty of their employees and agents, and to encourage informing the company of potential problems. This may discourage employees from quietly working with the government and plaintiffs' counsel in the hope of recovering huge bounties at the company's expense. Legal counsel may provide the necessary perspective and skills, including how to appropriately structure and handle internal investigations, if necessary.[6] It is likely to be more cost-effective to be proactive than reactive. Today, regulators and the public do not appear too willing to tolerate mistakes, honest or not.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact George D. Niespolo, Michael E. Clark, Marvin G. Pickholz, any member of the White-Collar Criminal Law Group or the attorney in the firm with whom you are most regularly in contact.

Notes

1. The legislation defines *original information* to mean "information that – "(A) is derived from the independent knowledge or analysis of a whistleblower; (B) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and (C) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information." See Dodd-Frank Act § 748 (amending the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*) and Dodd-Frank Act § 922 (amending the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*).
2. The new whistleblower provisions also are similar to the recently modified IRS whistleblower measures.
3. Government investigations frequently trigger collateral private litigation, which is likely to play a much more significant role in the overall enforcement framework. The government already works with whistleblowers' counsel to identify and prosecute FCA cases, for which there are frequently parallel criminal investigations. The state attorneys general are also allied with private litigants in their enforcement actions. In short, the government now uses the private plaintiffs' bar as an additional resource to leverage limited resources.
4. 561 U.S. __ , No. 08-1191 (June 24, 2010).
5. Federal enforcement agencies, state attorneys general, and the private plaintiffs' bar – primarily *qui tam* and class action counsel – all claim to be an integral part of the enforcement web. To handle an internal investigation involving a public company or one of its officers, employees, or directors against misconduct allegations typically entails negotiating a veritable minefield of legal challenges and business risks. As well as the applicable laws, regulations and policies, the perspectives, values and cultures of the enforcement agencies and any other involved parties often come into play.
6. Even if a company lacks a *legal obligation* to disclose an actual or potential violation, as is often the case, it still may be in its best interest to disclose the information. Many agencies, including the SEC, CFTC, and DOJ, have voluntary disclosure programs to encourage companies to provide such information in return for reduced penalties or non-prosecution agreements. But prosecution is by far *not* the government's only or most potent weapon. The collateral consequences of a prosecution action, such as suspension, debarment, and exclusion, often can be more harmful. Negative press associated with a formal enforcement investigation or prosecution may significantly affect the value of a company's publicly traded securities and lead to higher lending costs, strained shareholder relationships, and morale problems. A fact-specific analysis may need to be performed to assess, among other things, whether an event is so significant that it should be immediately disclosed in light of the history of events, the company's size, its overall profitability and the information already in the public realm.