Strategic Responses to the Whistleblower Provisions of the Dodd-Frank Act

DANIEL A. FEINSTEIN, RALPH W. NORTON, DAVID FISHER, AND JASON E. PRUZANSKY

The authors suggest steps employers can take to reduce the potential penalties resulting from a reported violation under Dodd-Frank, insulate themselves from some of these potential harms, and place themselves in better positions to deal with any future legal difficulties.

Many blame the recent economic struggles of the United States on an increase in white-collar crime and the greed of various members of the business community. In an effort to address such concerns, and appease voters, the federal government has taken numerous actions intended to improve the current economic difficulties and prevent future economic disasters.

One such action occurred on July 21, 2010, when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter, "Dodd-Frank" or the "Act") into law. While Dodd-Frank tackles a variety of subjects in an effort to address some of the root causes of the recent economic downturn commonly known as the "Great Recession," it is the whistleblower provisions found in the Act, and the Act's dramatic expansion of existing whistleblower protections under the Sar-

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Daniel A. Feinstein is a partner in the Labor & Employment Practice Group of Davis & Gilbert LLP. Ralph W. Norton is a partner in the firm's Corporate Practice Group. David Fisher and Jason E. Pruzansky are associates in the firm's Labor & Employment Group. The authors can be reached at dfeinstein@dglaw.com, rnorton@dglaw.com, dfisher@dglaw.com, and jpruzansky@dglaw.com, respectively.

banes-Oxley Act of 2002 (“SOX”), that arguably pose the greatest risks for businesses.[1] There are steps, however, that companies can begin taking immediately to mitigate these increased risks.

WHISTLEBLOWER BOUNTY PROVISIONS

Under Section 922 of Dodd-Frank, whistleblowers who provide the Securities and Exchange Commission (“SEC”) with “original information” that leads to an SEC enforcement action that results in monetary sanctions of more than $1 million — including amounts collected by certain other regulatory agencies in related actions — may be entitled to collect a bounty of between 10 and 30 percent of the sum recovered by the SEC and the other regulatory agencies. To qualify as “original information,” the information must be derived from the whistleblower’s independent knowledge or analysis and, with limited exceptions, cannot have already been received by the SEC from any other source. This “bounty” program is already in effect even though the SEC has — to date — issued only proposed rules implementing the program.[2] In fact, during the first two months following the Act’s passage, the SEC reportedly fielded, on average, at least one whistleblower tip per day.[3]

Whistleblowers are eligible to collect bounties even though they may have participated in the illegal activity unless they are actually criminally convicted of wrongdoing related to the SEC’s enforcement action.[4] Dodd-Frank also provides that whistleblowers may remain anonymous by acting through counsel until it comes time to collect the bounty. Under the Act, the bounties are to be paid out of a newly-created “Securities and Exchange Commission Investor Protection Fund,” which is to be funded with undistributed sanctions from other SEC cases.[5]

The Act provides that if monetary sanctions imposed by the SEC and by certain other regulatory agencies in related actions exceed $1 million, the amount of the whistleblower award must range from 10 percent to 30 percent of the aggregate amount collected, with the precise amount to be determined by the SEC in its sole discretion. In determining the amount of the award, the SEC is to consider factors such as the significance of the information to the success of the case, the degree of assistance provided by the whistleblower, and the interest of the SEC in deterring future violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In setting the award amount, the SEC is not permitted to take into account the balance of funds in the Investor Protection Fund. Determinations concerning the amount of a bounty award are not appealable so long as the amount meets the mandate of being between 10 percent and 30 percent of the recovery.

Significantly, the Act also prohibits employers from retaliating against whistleblowers who provide information to the SEC or otherwise assist the SEC in any investigation or judicial or administrative action. Moreover, Dodd-Frank provides whistleblowers who believe that they have been retaliated against with a private right of action that an employee may pursue directly in federal court. A prevailing plaintiff may be entitled to reinstatement with the same seniority status that the individual would have had but for the discrimination, two times back pay with interest, and attorneys' fees.

It is not just publicly-traded companies that need to concern themselves with Dodd-Frank. The Act applies to all companies, whether public or private, large or small. For example, an employee of small privately-held company may bring a retaliation claim under the Act if the employee believes he or she was wrongfully terminated after informing the SEC that certain individuals at the company were engaged in illegal insider trading.

AMENDMENTS TO THE SARBANES OXLEY ACT OF 2002

In addition to creating its own whistleblower bounty program and cause of action for retaliation, the Act also significantly expands the whistleblower protection previously available under SOX. For example, prior to the Act, Section 806 of SOX[6] arguably prohibited only publicly-traded companies from terminating, demoting, suspending, threatening, or harassing an employee because the employee reported, to the federal government or to a supervisor, fraud against shareholders or a violation of SEC rules. Prior to the Act, some judges dismissed whistleblower cases against publicly-traded companies under SOX when the whistleblower was an employee of a subsidiary of the publicly-traded parent company, even when the parent company had few, if any, direct employees, and employed most of its personnel through subsidiaries. Likewise, cases were dismissed against non-public subsidiaries of publicly-traded companies on the grounds that the employee was not employed by a publicly-traded company. Section 922(h) of the Act makes clear that no employer — whether it is publicly-traded or not — may take retaliatory action against an employee for reporting a violation under SOX Section 806. Moreover, the Act expands SOX whistleblower coverage to employees of nationally recognized statistical ratings organizations. Covered organizations include Moody's Investors Service Inc., A.M. Best Company Inc., and Standard & Poor's Financial Services LLC.

Under SOX, whistleblowers who believe they were retaliated against by their employers must first file a complaint with the Department of Labor and exhaust such administrative remedies before bringing an action in court. Prior to the Act, employees had 90 days to file complaints with the DOL. The Act doubles this period of time to 180 days. The Act also makes it clear that the 180-day statute of limitations period begins to toll when an employee becomes aware of a SOX violation, *not* on the date on which the violation occurred.

The Act also provides that an employee who brings a lawsuit against his former company for retaliating against him in violation of SOX's whistleblower provision is entitled to a trial by jury. In addition, the Act explicitly invalidates pre-dispute arbitration agreements concerning SOX whistleblower retaliation claims. Similarly, the Act prohibits the waiver of the rights and remedies afforded by SOX's whistleblower protection scheme "by any agreement, policy form, or condition of employment."

PROPOSED RULES FOR IMPLEMENTING DODD-FRANK WHISTLEBLOWER PROVISIONS

On November 3, 2010, the SEC issued proposed rules to implement Section 922 of Dodd-Frank. As mandated by the Act, the SEC will issue final regulations within 270 days of its passage, or by April 17, 2011. The proposed rules seek to, among other things, address criticism that the Act creates perverse incentives for employees to go directly to the SEC with information regarding potential securities violations, rather than initially raising the issue internally pursuant to a company's internal compliance program. With this goal in mind, Proposed Rule 21F-4(b)(7) provides that whistleblowers may — but are not required to — first report information to company compliance officers, in-house counsel and other appropriate personnel while preserving their status as a qualified whistleblower. When making an internal report first, a whistleblower seeking to collect a bounty would then have 90 days to submit the information to the SEC and remain eligible for an award even if the company self-reported the information to the SEC. If the company failed to report the information to the SEC within a reasonable amount of time or otherwise acted in bad faith, the 90-day limit would not apply.

Similarly, in a further effort not to undermine internal corporate compliance programs, Proposed Rule 21F-6 states that one of the criteria the SEC may take into account when determining a whistleblower's award may be "whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the Commission."[7] Although the SEC "will consider higher percentage awards for whistleblowers who first report violations through their [company's internal] compliance programs," this consideration is *not* a requirement for an award above the 10 percent statutory minimum and "whistleblowers will not be penalized if they do not avail themselves of this opportunity for fear of retaliation or other legitimate reasons."[8] This could be an effective way for the SEC to encourage participation in internal compliance programs, but only if, in practice, whistleblowers received substantially the same or a greater award if they reported the violation internally than if they went straight to the SEC. Companies could still reduce the overall penalties assessed against them if they responded to the internal "whistle" by immediately contacting the SEC, commencing an internal investigation and cooperating with the SEC's investigation. For this aspect of the program to have a chance to work, though, the SEC would have to demonstrate a clear and consistent connection between the relative size of the award and the whistleblower's use of the employer's internal compliance systems.

The proposed rules also expand on what is deemed "original information" for purposes of determining whether a whistleblower who provides information to the SEC is entitled to an award under the Act. The Act defines "original information" to include information that "is derived from the independent knowledge or analysis of a whistleblower."[9] The proposed rules make clear, however, that the whistleblower would not be required to have direct firsthand knowledge of the information, but rather could report information obtained through his or her experiences, observations, or communications as long as they do not violate other restrictions on independent knowledge. Thus, for example, under Proposed Rule 21F-4(b)(2), a whistleblower would be deemed to have "independent knowledge" of information even if that knowledge derives from facts or other information that has been conveyed to the whistleblower by third parties.

On the other hand, some of the individuals whom the proposed rules explicitly preclude from having the "independent knowledge" required in order to be eligible for a bounty include:

(1) Attorneys who obtained the information via communications that are subject to the attorney-client privilege;

(2) Attorneys who obtained information (not just privileged information) as a result of the legal representation of a client;

(3) Persons who obtained the information through the performance of an engagement required under the securities laws by an independent public accountant; and

(4) Persons who obtained the information through a company's internal compliance program or investigation or people with legal, compliance, supervisory, or governance responsibilities in the company who obtain such information in the expectation the company will take appropriate action.

However, an attorney, or person with the above responsibilities, or a person who learns information through a company investigation may properly become a whistleblower if the company does not disclose the information to the SEC within a reasonable time or otherwise proceeds in bad faith. Individuals who obtain information by a means or in a manner that violates applicable federal or state criminal law or who obtain information from anyone who is subject to any of the exclusions listed above are ineligible to receive a bounty.

The Proposing Release notes that an employee who learns about potential violations only because a compliance officer questions him or her about the conduct, and not from any other source, would not be considered to have "independent knowledge." It remains to be seen whether an employee with independent knowledge of the facts constituting the violation, but who becomes aware that those facts may constitute a violation only when he learns of an internal investigation, would be deemed to have independent knowledge of the violation for purposes of the rules. If the answer is yes, that could inhibit a full internal investigation for fear of alerting employees to a potential windfall. Further, the Proposing Release notes that a whistleblower would be credited with "voluntarily" providing information if the individual reports to the SEC after being questioned by an employer's internal compliance staff unless the information is within the scope of a request directed to the employer by the SEC or another designated governmental authority. If a company conducts an internal investigation in the absence of a governmental inquiry there will generally always be at least one employee who will be able to make a claim for an award, and the investigation may cause an employee to become aware of his or her opportunity for a windfall. This would seem to create the potential for a chilling effect on internal investigations in the absence of a subpoena.

The proposed rules provide broad anti-retaliation protections to whistleblowers. Proposed Rule 21F-2 extends the protections against retaliation by employers to any individual who provides information to the SEC about potential securities law violations irrespective of whether the whistleblower satisfies all of the requirements for award consideration set forth in the proposed rules. Thus, the protections against retaliation provided for by the Act will not depend on an ultimate adjudication that the conduct identified by the whistleblower constituted a securities law violation.

In Proposed Rule 21F-9, the SEC proposes a two-step process for the submission of whistleblower tips to the agency. The first step would entail the submission of information either on a standard form or through the SEC's online database. The second step would require the whistleblower to complete a separate form, signed under penalty of perjury, containing representations concerning the accuracy of the information provided and the whistleblower's eligibility to collect a bounty.

PERVERSE EMPLOYEE INCENTIVES

The potential for large cash awards created by Dodd-Frank and the concomitant amendments to SOX incentivize employees to bring information regarding potential violations of securities laws directly to the SEC rather than to the employer through internal channels. Moreover, the significant discussions of Dodd-Frank in the media increase the likelihood that employees are aware of this potential cash-grab. Why bother to notify one's employer of potential securities law violations when filling out a form with the SEC could lead to a $100,000 payday?

The requirement that the information given to the SEC be "original information" increases the incentive for employees to ignore internal reporting and complaint devices, as employees might naturally be concerned that co-workers may contact the SEC first, thereby eliminating the "original" nature of the information. This incentive to report immediately any potential violation to the government may — and likely will — deeply undercut today's ethics and compliance programs, which train employees to report wrongdoing internally first so that employers can assess and remedy any issue. Indeed, the incentives created by the Act and the proposed rules seem to fly in the face of the SEC's past efforts to reward companies that self-report violations. Dodd-Frank and the proposed rules instead seem to drive a wedge between employers and employees and reduce the ability of employers to discover, report and correct violations. The SEC may have to consider whether or not it can continue to reduce penalties for companies that self-report if it becomes clear that most companies will no longer have the opportunity to do so.

WHAT IS AN EMPLOYER TO DO?

The perverse incentives created by passage of Dodd-Frank cannot be eliminated entirely by any company. However, companies are not completely powerless, and there are certain steps and actions that can alleviate some of the concerns created by Dodd-Frank. They include:

- Do not violate securities laws
- Review and publicize internal reporting procedures
- Vigorously investigate and take prompt corrective action
- Train managers to deal with employee complaints
- Document performance issues

Do Not Violate Securities Laws

The advice "do not violate securities laws" seems simple — and perhaps it is — but it is critical that companies remain vigilant in their compliance with the securities laws. Companies must ensure that their accounting practices meet all legal and industry requirements. Rotating the accountants performing internal audits allows new eyes to review the company's accounting practices and, perhaps, to catch any inconsistencies and issues. Companies should verify the existence of proactive monitoring and tracking controls to identify any accounting and securities law issues and respond to them before noticed or reported by a whistleblower.

Additionally, rather than yielding to the temptation to employ creative accounting (e.g., creating costs so as to decrease reported profits for tax purposes), companies should stress a conservative accounting approach. Certainly, companies should not place their businesses in positions of economic difficulty, but taking fewer risks means that the SEC is (a) less likely to investigate and (b) less likely to find violations of the laws.

Review and Publicize Internal Reporting Procedures

The passage of Dodd-Frank re-emphasizes the importance of robust internal reporting and compliance procedures. This is particularly true for the subsidiaries and affiliates of parent companies whose employees are now subject to the whistleblower protections under SOX.

Employee handbooks should contain detailed information about how and to whom employees can report any potential accounting or securities laws issues. Employees should be encouraged, and perhaps even incentivized, to bring forward any information that may be helpful to their employers. If an employer creates a culture of compliance, in which employees feel as though their concerns will be addressed and that the company takes its ethical responsibilities seriously, employees may well be less likely to raise complaints with the government. If periodically reminded about their employers' reporting and complaint procedure — and if such procedures are easy to follow — employees may be more likely to make use of such procedures. For some companies it may be worthwhile to remind employees that even if they bring their complaint to the SEC they can, and should, still report it internally so that the employer can take prompt corrective action.

Vigorously Investigate and Take Prompt Corrective Action

Section 922 of Dodd-Frank may result in a dramatic increase in the number of violations reported to the SEC. But the SEC's resources are limited, so the SEC should have an even greater incentive to reward companies that quickly address and remediate violations on their own by imposing less onerous penalties. Employers consequently need to make sure that corporate compliance programs can quickly and fully address potential violations. Companies must investigate complaints and potential issues quickly to determine their legitimacy and what actions should be taken (e.g., self-reporting; changing internal controls, etc.). While it may not be possible to avoid paying a penalty entirely, self-correction and cooperation with the SEC can help significantly reduce the penalty assessed against a company.[10]

Train Managers to Deal with Employee Complaints

Often, the first person to whom an employee will speak about any concern is his or her direct supervisor. Employees assume that their supervisors can take complaints to the appropriate person. As such, it is imperative that all managers become intimately familiar with the employer's reporting procedures and the proper way to address employee complaints. Managers who fail to become familiar with these processes or who willfully ignore them should be corrected promptly.

Managers should be able to instruct employees how to report potential issues, and whom to contact (either internally or through an outside agency) to report their concerns. Additionally, managers should encourage their employees to use the employer's processes and allay any employee concerns about retaliation or being labeled a "troublemaker." Whistleblowers are able to remain anonymous under Dodd-Frank and SOX. As such, employers may want to institute internal reporting and complaint processes that offer the same degree of anonymity — and managers should inform employees of the ability to complain of perceived violations anonymously.[11]

In an effort to ensure managerial knowledge of and compliance with the employer's reporting and complaint procedures, employers should train their managers in the company's procedures on a regular basis and just as regularly remind them of the company's desire to address any and all concerns. This can create a "culture of compliance" and decrease the likelihood that employees (and managers) will pursue other avenues of redress.

Document Performance Issues

Dodd-Frank and the amendments to SOX create wholesale retaliation protections for employees who bring information to the government. As such, employers must be able to justify any adverse employment action taken against such an employee. So in addition to a "culture of compliance," there must be a "culture of documentation." Employers, and their managers, often speak to employees about performance issues but fail to place a record of the conversation in a file, or an email, because they do not want to place negative information in an employee's file. Other times, employers do not want to address a performance issue immediately because it isn't a good time (e.g., around the holiday season). Employers need to fight the urge to be "nice" and instead document any and all employee issues. The saying "nice guys finish last" is truer than many might think.

Employees often allege that the real reason for an adverse employment action is retaliation for engaging in a protected activity (such as reporting information to the SEC). And employers typically respond to any such claim by asserting that the adverse action was taken for legitimate reasons (e.g., performance problems) that were unrelated to the employee's protected activity. Of course, it is difficult for either party to prove the real reason for the action since that involves the "intent" of the decision-maker(s). Accordingly, it is critical for employers to be able to point to appropriate documentation showing that there were legitimate issues, those issues were communicated to the employee, and the employee was given sufficient opportunity to address the issues.

Indeed, in many instances an employer will assert that the issues that ultimately lead to the adverse employment action existed before the employee even complained about the alleged wrongdoing. However, if there is no documentation showing that the issues had, in fact, existed before the employee engaged in the protected activity, the employer may have difficulty establishing this fact and it may appear as though the employer only had issues with the employee after he or she had engaged in the protected activity. On the other hand, if an employer can point to documented performance issues that pre-date the protected activity, it will be better to demonstrate that the adverse action that was taken after the protected activity was not retaliatory but, rather, legitimate action taken based on long-standing issues.

In short, without appropriate and timely documentation of the performance and attitudinal or behavioral reasons for taking an employment action, an employer lacks the evidence to have the retaliation claims dismissed. And, even if an employer eventually succeeds at trial in proving that legitimate, non-discriminatory reasons motivated an employment decision, the employer will have already expended significant sums in defending against the claim. Proper documentation is key — and cannot be overstated.

CONCLUSION

No employer action can remove the possibility of an employee bringing his or her complaint to the SEC or from later claiming retaliation as the basis for an adverse employment action. However, by taking the steps outlined above, employers can reduce the potential penalties resulting from a reported violation, insulate themselves from some of these potential harms and place themselves in better positions to deal with any future legal difficulties.

NOTES

[1] Section 922 of Dodd-Frank has been codified as new Section 21F of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

[2] *See* Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 63,237 (Nov. 3, 2010) ("Proposing Release").

[3] J. Palazzolo, *After Dodd-Frank, SEC Getting at Least One FCPA Tip a Day*, Wall Street Journal Corruption Currents (Sept. 30, 2010), http://blogs.wsj.com/corruption-currents/2010/09/30/afterdodd-frank-sec-getting-at-least-one-fcpa-tip-a-day.

[4] Under the SEC's proposed rules, the sums awarded to whistleblowers may be reduced or eliminated to the extent that the whistleblower is required to pay penalties or directed, planned or initiated the conduct that resulted in an entity's fines. *See* proposed Rule 21F-15.

[5] Section 748 of Dodd-Frank, codified at Section 23 of the Commodity Exchange Act ("CEA"), establishes a parallel bounty system under the auspices of the Commodity Futures Trading Commission for persons who blow the whistle on violations of the CEA.

[6] Section 806 of SOX is codified at 18 U.S.C. § 1514A.

[7] Proposed Rule 21F-6; 17 C.F.R. § 240.21F-6.

[8] *Id.*

[9] Dodd-Frank § 922(a).

[10] On January 13, 2010, the SEC announced a series of measures "to further strengthen its enforcement program by encouraging greater cooperation from individuals and companies in the agency's investigations and enforcement actions." The Agency's "Enforcement Cooperation Initiative" describes incentives for individuals and companies "to fully and truthfully cooperate and assist with SEC investigations and enforcement actions." *Enforcement Cooperation Initiative*, http://www.sec.gov/spotlight/enfcoopinitiative.shtml. *See also*, SEC Sec. Ex. Act of 1934, Release No. 44969 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm#framework (the so-called "Seaboard Report," which sets forth some of the criteria the SEC would consider "in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation").

[11] Under Section 301(4) of SOX (codified at Section 10A(m)(4) of the Exchange Act), public companies whose securities are listed on a national securities exchange, including NASDAQ, are already required to provide a mechanism for anonymous submission of concerns about questionable accounting or auditing matters.