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Expert Analysis

Raising the Stakes: Effective 'Internal' Whistle-Blowing Programs are Essential In the Dodd-Frank Era

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Although the Dodd-Frank Wall Street Reform and Consumer Protection Act is universally recognized as an unprecedented overhaul of the U.S. financial regulatory landscape, employers are still parsing out what impact the reforms will have on their legal and regulatory compliance efforts.

One area of concern is already apparent: an unprecedented level of interest in the Dodd-Frank Act's new whistle-blower protections, which include substantial monetary incentives for whistle-blowers who report allegations of corporate misconduct directly to government authorities.

Employers beware — these new protections may result in generous rewards for employees who disregard the internal reporting programs that employers were required to adopt to comply with the Sarbanes-Oxley Act of 2002 and other federal regulations.

First, a little background.

The recent surge of interest in whistle-blower claims is fueled in part by the Dodd-Frank Act's expansion of existing whistle-blower protections provided under Sarbanes-Oxley. Although the expansion of Sarbanes-Oxley's whistle-blower protections is remarkable, the Sarbanes-Oxley amendments are dwarfed by the potential impact of new incentives for whistle-blowers who report securities fraud directly to the Securities and Exchange Commission.

Under the Dodd-Frank Act's so-called "bounty" provision, these whistle-blowers are now eligible for monetary rewards with the potential to be worth *millions* of dollars. Notably, the U.S. Department of Justice recently announced a record payout of $96 million to a GlaxoSmithKline whistle-blower (and former employee) as part of a $750 million fine to resolve a False Claims Act suit. Given the dollar amounts involved, it is not surprising that the Dodd-Frank Act is creating a flood of inquiries and tips directed not only at the SEC but also at the plaintiffs' lawyers who are eager to represent would-be whistle-blowers.

During 2008 and 2009, more than 150 SEC enforcement actions resulted in sanctions greater than $1 million.

Although employers are in the best position to address allegations of fraud or other misconduct, the Dodd-Frank framework has the potential to reward whistle-blowers who circumvent their employers' internal reporting mechanisms and instead pursue the large monetary rewards offered by the SEC.

In fact, even the SEC recently acknowledged in its official proposed whistle-blower rule that the new whistle-blower program is likely to discourage internal reporting and may even reduce the likelihood that employers will have opportunities to correct potential misconduct. *See* "Proposed Rules for Implementing the Whistle-blower Provisions of Section 21F of the Securities Exchange Act of 1934", *available at* http://www.sec.gov/rules/proposed/2010/34-63237.pdf.

Employers should take steps now to ensure that their internal reporting programs are an effective — and perhaps even attractive — option for employees.

DODD-FRANK ACT OVERVIEW: NEW MONETARY REWARDS FOR SEC WHISTLE-BLOWERS

Under Section 922 of the Dodd-Frank Act, the SEC is now required to pay monetary rewards to qualified whistle-blowers who provide original information directly to the SEC about a violation of federal securities law that results in a civil or criminal enforcement action with monetary sanctions of $1 million or more.

The program's coverage is broad. Violations of federal securities laws that can be reported include inaccurate disclosures, improper accounting practices, insider trading, and violations of the Investment Advisers Act of 1940 and the Investment Company Act of 1940.

Significant attention has been paid to the potential size of monetary awards for SEC whistle-blowers, which can range from 10 percent to 30 percent of the monetary sanction. Given that monetary sanctions in securities fraud actions can reach hundreds of millions of dollars, SEC whistle-blowers have the potential to receive monetary rewards worth millions of dollars.

Further, the whistle-blower program is likely to result in numerous rewards each year. By way of background, more than 150 SEC enforcement actions resulted in monetary sanctions greater than $1 million — the minimum threshold under the new whistle-blower program — during 2008 and 2009.

A lot of uncertainty still exists about how the whistle-blower program will work in practice. Although the SEC has until April 2011 to issue final regulations implementing the whistle-blower program, the SEC has already responded to a dramatic increase in tips and inquiries by setting up a website with information on the program and filing complaints.

In addition, the SEC recently issued proposed rules and forms to implement the whistle-blower provisions of the Dodd-Frank Act. *See* "Proposed Rules for Implementing the Whistle-blower Provisions of Section 21F of the Securities Exchange Act of 1934" (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. §§ 240 and 249), *available at* http://www.sec.gov/rules/proposed/2010/34-63237.pdf. The deadline for public comments to the proposed rules was Dec. 17.

Notably, the proposed rules provide that the SEC will consider higher rewards for whistle-blowers who first report alleged misconduct through their employers' internal reporting mechanisms, although it remains to be seen if this provision will be part of the final regulation.

Although compliance with the final regulations will be a prerequisite to receiving an award, the Dodd-Frank Act specifically states that information provided by a whistle-blower to the SEC in writing before the regulations' effective date will be included in the reward program.

In addition to the monetary rewards provided under the SEC whistle-blower program, Section 922 of the Dodd-Frank Act creates a new private right of action for retaliation against SEC whistle-blowers, who can avoid Sarbanes-Oxley's administrative procedure (discussed below) by asserting a retaliation claim directly in federal court.

SEC whistle-blowers are also eligible for more damages than are available to Sarbanes-Oxley whistle-blowers; in addition to reinstatement, litigation costs, expert witness fees and attorney fees, SEC whistle-blowers are entitled to double back pay (twice the amount provided by Sarbanes-Oxley) with interest.

The lengthy statute of limitations for filing a retaliation claim under Section 922 is also noteworthy. A retaliation claim can be brought six years after the date on which the retaliation occurred or three years after the date when facts material to the complaint are known or reasonably should have been known by the employee (whichever is later), but no more than 10 years after the date on which the retaliation occurred.

This generous time frame means that whistle-blowers will have another avenue available for a retaliation claim long after the statute of limitations for a Sarbanes-Oxley claim has expired.

DODD-FRANK ACT'S EXPANSION OF SARBANES-OXLEY WHISTLE-BLOWER COVERAGE, REMEDIES

Sections 922 and 929A of the Dodd-Frank Act include several significant amendments to Sarbanes-Oxley's whistle-blower protections. These amendments are likely to increase the number of Sarbanes-Oxley administrative claims, provide additional incentives for complainants to remove their claims to federal court and result in larger damages awards.

Perhaps most importantly, the Dodd-Frank Act greatly expands the number of companies that are covered by Sarbanes-Oxley. Prior to the amendments, Sarbanes-Oxley's whistle-blower protections were limited to employees of publicly traded companies that:

- Have securities registered under Section 12 of the Securities Exchange Act of 1934; or
- Are required to file reports under Section 15(d) of that act.

Due to uncertainty in this area, federal courts and administrative law judges were still wrestling with whether Sarbanes-Oxley's whistle-blower protections should also be extended to the employees of a nonpublic subsidiary or affiliate whose parent company is covered by Sarbanes-Oxley.

Perhaps most importantly, the Dodd-Frank Act expands the number of companies that are covered by Sarbanes-Oxley.

As amended by Section 929A of the Dodd-Frank Act, however, it is now settled that Sarbanes-Oxley's whistle-blower provisions apply to employees of subsidiaries or affiliates "whose financial information is included in the consolidated financial statements of [a publicly traded] company" — a group that includes many nonpublic companies.

In addition, Section 922 extends Sarbanes-Oxley's whistle-blower protections to employees of nationally recognized statistical ratings organizations (such as Standard & Poor's Ratings Services).

The Dodd-Frank Act also allows more time for a Sarbanes-Oxley complainant to file an administrative claim with the U.S. Department of Labor's Occupational Safety and Health Administration. Section 922 doubles the statute of limitations for filing a claim with OSHA from 90 days to 180 days.

Further, Sarbanes-Oxley now provides that the statute of limitations begins to run on the date when the employee became aware of the alleged violation rather than on the date when the alleged violation occurred.

Finally, the Dodd-Frank Act addresses two areas of Sarbanes-Oxley that were subject to debate and uncertainty: the availability of jury trials and mandatory arbitration.

It is still not clear whether the whistle-blower protections will extend to employees of a nonpublic subsidiary.

Previously, federal courts that had addressed a Sarbanes-Oxley complainant's right to a jury trial held that Sarbanes-Oxley's remedies were equitable and, therefore, did not create the right to a jury trial. As amended by Section 922, however, Sarbanes-Oxley expressly provides the right to a jury trial for a whistle-blower claim.

Similarly, Section 922 amends Sarbanes-Oxley to exempt whistle-blowers from mandatory arbitration by prohibiting any "agreement, policy form, or condition of employment, including … a pre-dispute arbitration agreement." These changes will likely result in more Sarbanes-Oxley claims being heard in federal court and in larger damages awards for complainants.

OTHER NEW, EXPANDED WHISTLE-BLOWER PROTECTIONS UNDER DODD-FRANK ACT

In addition to the SEC and Sarbanes-Oxley whistle-blower provisions discussed above, the Dodd-Frank Act includes other provisions designed to encourage and protect whistle-blowers.

First, Section 1057 creates a private right of action for retaliation against employees in the financial services industry who disclose information about fraudulent or unlawful conduct relating to consumer financial products or services. Notably, these protections will apply to employees of both public and *nonpublic* providers of consumer financial services.

Second, Section 1079A significantly broadens the conduct protected under the False Claims Act by extending its existing anti-retaliation provision to include "lawful acts done by the employee, contractor, or agent or associated others in furtherance of an action under this section or other efforts to stop one or more violations of [the False Claims Act]."

Finally, Section 748 amends the Commodity Exchange Act to create a whistle-blower incentive program and retaliation protections that are similar to those now provided to SEC whistle-blowers.

WHAT IS NEXT? EMPLOYERS RESPOND TO DODD-FRANK ACT

Although the Dodd-Frank Act is intended to encourage exposure and investigation of securities fraud and other corporate misconduct, an unintended consequence of the monetary incentives provided under the new SEC whistle-blower program may be to *discourage* employees from reporting potential misconduct directly to their employers. As a result, employers may have fewer opportunities to address legal and regulatory matters internally.

Employers should take steps now to ensure the effectiveness of both their legal and regulatory compliance efforts, and the internal reporting mechanisms available to employees.

A first step to ensuring an effective internal reporting program is to consider whether employees have sufficient options for reporting potential wrongdoing — including anonymous reporting mechanisms such as a telephone hotline or webform. Any potential roadblocks for internal reporting should be identified and addressed.

The employer should remind employees that their supervisor, manager and human resources department are resources for reporting any form of misconduct — and ensure that employees also have viable options for reporting misconduct that involves a direct supervisor or executive. Employees should be aware of their reporting options, *and* they should be able and willing to use them.

Employers also should ensure that managers and supervisors fully understand their obligations under the internal reporting program. No employer wants to discover that a manager received a report of potential misconduct but failed to act on it. Employers should take regular steps to ensure that management employees are trained to share any tips and complaints with the appropriate department or official.

On a related note, employers should revisit the effectiveness of their non-retaliation policies. A non-retaliation policy requires the full support of management employees in order to provide adequate protections for whistle-blowers.

Employers should also consider establishing a program that periodically requires employees to notify the employer of potential violations of company policy.

For example, in addition to signing policy acknowledgments, employees could be required to make disclosure statements to their employer on a regular basis in which they either certify that they are not aware of any violations of company policy or identify any known violations of company policy.

Although this framework may result in an increase in insignificant complaints that nonetheless must be addressed, it would also increase the likelihood that an employee would inform the employer of potential misconduct that does, in fact, warrant an investigation *before* reporting this information to a governmental authority.

Finally, many employers are considering whether they might try to "compete" with the Dodd-Frank Act on their own terms by providing incentives — including potential monetary or non-monetary rewards — for internal whistle-blowers.

Sarbanes-Oxley provides that the limitations period begins to run when the employee became aware of the alleged violation.

For example, an employer could establish a reward program for internal reports that uncover significant fraud, unethical behavior or other violations of company policy.

When appropriate, rewards could be publicized without revealing the source or the exact nature of the misconduct. An effective internal reward program could lessen the allure of the SEC whistle-blower program and persuade employees to take advantage of internal incentives. In the Dodd-Frank era, any opportunity for an employer to address misconduct internally could prove invaluable.

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