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Will the SEC's whistleblower bounty change employer/employee relationships?

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Under regulations that took effect on August 12, 2011, the Securities and Exchange Commission (SEC) has given itself a new weapon to combat corporate fraud. In essence, whistleblowing employees in many different corporate environments have an incentive to notify the SEC of compliance issues—even if those employees have not utilized internal reporting systems—and earn themselves a huge reward.

The scope of the regulations is breathtaking. For example, if a publicly traded pharmaceutical company is illegally practicing off-label promotion of its products, a whistleblower who advises the SEC of this activity can receive up to 30% of a subsequent settlement of the allegations. Similarly, a private entity providing illegal kickbacks might, if it seeks to raise capital under certain Securities Act provisions, find itself subject to rules that protect a whistleblower from retaliation.

With settlements in many fields—be it pharmaceuticals, health care, or even violations of good manufacturing practices in the food and drug industry—exceeding hundreds of millions of dollars, and often billions, the impact of the new SEC rules will be immediate.

And that, apparently, is the whole point of Wall Street reform. While companies are already conversant in statutes like the False Claims Act and the Anti-kickback Statute, which use back-end penalties as a disincentive to fraud, the SEC can now attack the issue of corporate fraud from the other end, and use the people most likely to know about it (e.g., corporate employees) to root out the problem.

A summary of the Whistleblower Rewards Rule

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform Act), adopted July 21, 2010, the SEC was empowered to adopt rules providing incentives for whistleblowers and also to provide them protection from retaliation.[1] The SEC rules were published on June 13, 2011, and became effective on August 12, 2011.[2]

Under the SEC rules, a whistleblower may be eligible to receive a bounty or reward, if he or she voluntarily provides original information that causes the SEC to commence an examination or open a successful investigation, or if the information significantly contributes to an ongoing investigation. The information cannot have been demanded by the SEC or known by the SEC from another source when reported. There are additional eligibility requirements. Among other things, the disclosures must lead to the recovery of more than $1 million (including "related actions" such as those brought by state attorneys general or by certain federal agencies).

The bounty is certain to raise a few eyebrows. For starters, eligible whistleblowers can get 10% to 30% of judgments that exceed $1 million, which should leave no doubt that the Wall Street Reform Act will encourage litigation against corporations. The actual value of a reward will depend on a variety of factors enumerated in the SEC rules (i.e., the reliability, completeness, and significance of the information provided, the degree to which it helped the enforcement action, and other assistance given by the whistleblower). Moreover, there is no requirement that a complaining employee first resort to available corporate compliance programs. Stated differently, internal reporting is not a pre-condition to award eligibility.

But, the SEC has provided some incentives for individuals to take advantage of internal corporate compliance programs: Voluntary participation in such programs increases the reward, and "full bounty credit" is given to persons whose internal efforts trigger a corporate disclosure to the SEC that results in a successful enforcement action.

The SEC rules are commonly viewed as applicable to public companies, but they go further. Also falling under the umbrella of the rules are broker-dealers and investment advisers as well as certain private companies seeking to raise capital under specified Securities Act provisions.

Fortunately, the SEC rules also contain some common sense exclusions, specifically that attorneys, directors, officers, compliance staff, and internal audit personnel are generally ineligible for rewards. There are, of course, exceptions to the exclusions, and those exceptions can reinvigorate what would otherwise be an ineligible event:

- 120 days have elapsed since the complaint was reported within the company, or
- the company is impeding an investigation, or
- action by the SEC is needed to prevent substantial injury to a company's or its investors' financial interest(s).

Finally, although not effective until August 12, 2011, the SEC rules are retroactive to tips received by the SEC after the July 21, 2010 adoption of the Wall Street Reform Act.

Are corporate compliance programs ready to be reformed?

Now that the dynamic has changed, it is time to refocus internal compliance programs, starting with those substantive areas where, statistically, fraud has been found more often:

- Financial statement manipulation;
- Practices made illegal by the Foreign Corrupt Practices Act, such as bribing another country's officials;
- Violations of the prohibition against illegal kickbacks, for example, payments by a hospital for illegal physician referrals; and
- Practices by a pharmaceutical manufacturer that influence decisions to prescribe a particular drug.

One study found that nearly one-quarter of fraud results in losses of more than a million dollars, that many instances of fraud are discovered by tips, and that anti-fraud controls do help reduce it.[3]

More important perhaps are the internal processes for rooting out fraud and other conduct likely to be the subject of a disclosure to the SEC. Internal compliance programs are not only designed to discover fraud, but they also *must* convince employees that any attempted fraud will be discovered, because the company is actually paying attention. Surprise audits and a program that encourages tips (e.g., a hotline that allows for anonymous disclosures) are important weapons in increasing vigilance and letting employees know that someone is always watching.

Equally important is a training program that teaches employees about common fraudulent activity and the ways to discover and report it. Such training should be frequently made a part of corporate newsletters or other employee

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outreach so that its principles are fresh in the minds of those individuals considering illegal activity. In short, a company must make it clear that fraud will not be tolerated and its employees are empowered to detect it; anything less only invites trouble.

To ensure a top-down commitment, some companies have already established new regulatory Compliance Committees to "quarterback" their internal program. Those reviewing information generated by an enhanced compliance program should also have the expertise necessary to evaluate that information and the resources to seek outside expert assistance when appropriate.

Whatever the process, assigning compliance staff with a skill set adequate to assess technical information or, even more troublesome, vague disclosures, may be key to avoiding SEC involvement. Otherwise, the 120-day prohibition on certain staff members making disclosures to the SEC may be triggered.

Because those people contacted by internal investigators about known problems may still be considered an eligible whistleblower under the SEC rules, some thought should also be given to the practice of conducting internal investigations to minimize the potential for suggesting claims.

Additionally, counsel must also play a role in improving corporate compliance programs. Standard operating procedures and corporate manuals should be revisited to ensure they are consistent with the SEC rules and, just as importantly, to allow a corporation to discover illegal action and address it before the SEC gets involved. After all, preventing fraud was the point of the Wall Street Reform Act.

Similarly, company Marketing departments should continue to vigilantly ensure that publicly distributed marketing materials are accurate to avoid whistleblowing claims about "burying" negative information. Likewise, company policies regarding the use of social media should be adequately policed to avoid the distribution of inaccurate information. Companies can also compare their own performance to prior years or to their competitors, to the extent such information is available, as an indicator of compliance. Outliers in the data set can be targeted for additional auditing. Finally, fraud that is discovered internally must be met with immediate and intelligent punishment. The intelligence part is crucial, given the SEC rules' anti-retaliation scheme.

Anti-retaliation made paramount

Because the statute and the SEC rules include the concept of anti-retaliation, companies need to think twice about adverse employment decisions, even if justified, against complaining employees.

Retaliation includes the discharge, demotion, suspension, harassment, or discrimination against a whistleblower because of his/her lawful act in providing information to the SEC. Of course, that definition promises to cause no small level of consternation for Human Resources personnel faced with situations where, for example, a demotion is in order notwithstanding a whistleblower's revelations.

The eligibility for anti-retaliation is determined differently from whether an individual is eligible to receive a bounty. Whereas a reward is earned for disclosures leading to the recovery of more than $1 million, there is a lesser standard with respect to retaliation. Specifically, those employees with a "reasonable belief" in the truth of their allegations are under the umbrella of the anti-retaliation protections. Moreover, employees who have been retaliated against have the right to sue in US district court and can recover their counsel fees and litigation costs *and* be reinstated with double back pay.

Final thoughts … and a warning

Perhaps the biggest impact of the SEC rules will result from the misunderstanding of human behavior and litigation. Litigation

is about leverage and maximizing pressure and thus, a financial recovery. Couple that with the normal behavior of disgruntled employees who see a dim future with a company, and these forces will combine themselves into a whistleblower claim that by its very nature is designed for maximum adverse financial impact.

Fortunately, if the SEC operates in the manner suggested by the rules, it will ask questions first and shoot later, and only if necessary. Assuming as much, corporate compliance programs should improve and complaints will be made—and kept—internally. This can increase the number of internal investigations and decrease corporate liability. After passing through an initial period of doubts and hand–wringing, many corporations will reach the other side and find the Wall Street Reform Act had a positive impact on their organization and on the financial markets as a whole, much as Congress intended.

There is, however, a larger cost to the above-referenced benefits. Without question, the costs for implementing new compliance programs, including a method to handle whistleblower disclosures, will rise. Moreover, the incentives will be difficult for a disgruntled employee to pass up, a fact that is sure to increase complaints—and the costs of investigation.

Finally, the concept of anti-retaliation may be a factor in negotiating a resolution to enforcement actions. It may, at a minimum, require some adjustment of policies relating to the termination of disgruntled employees. ■

1. Public Law No. 111-203 § 922(a) (to be codified at 15 U.S.C. § 78u-6 et seq.) and § 924.
2. 76 Fed. Reg. 34,300 (June 13, 2011) (to be codified at 17 C.F.R. Part 240).
3. Association of Certified Fraud Examiners: "2010 Report to the Nations on Occupational Fraud and Abuse" at 4. Available at http://www.acfe.com/rttn/2010-rttn.asp.