Bloomberg Law Reports® Securities Law

The Law of Unintended Regulatory Consequences: The Need for Corrective SEC Regulations for the Whistleblower Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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"[I]f there is any law more powerful than the ones constructed in a place like Washington, it is the law of unintended consequences."[1]

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Among other things, the Dodd-Frank Act authorizes the Securities and Exchange Commission (SEC) to pay monetary awards to whistleblowers who provide information to the SEC that relates to a violation of the securities laws and results in an SEC enforcement proceeding. Although intended to encourage compliance with the federal securities laws, the whistleblower provisions are drafted in a way that creates perverse incentives for both covered firms and employees that, ironically, could have the effect of undermining the very compliance efforts that the U.S. Government is hoping to encourage. Unless these concerns are addressed by SEC implementing regulations, the reform measures could work in ways that not only never were anticipated by the Act's drafters, but also undermine the goals of the Dodd-Frank Act's whistleblower provisions.

The Newly Granted Authority of the SEC to Grant Monetary Awards to Whistleblowers

Section 922 of the Dodd-Frank Act provides for the SEC to award whistleblowers between 10 percent and 30 percent of any monetary recovery (including penalties, disgorgement of profits, restitution, and interest) exceeding $1 million.[2] The whistleblower provisions call for the SEC to make monetary awards to individuals who submit "original information" leading to the successful prosecution of a "covered judicial or administrative action," defined broadly to include "any judicial or administrative action brought by the [SEC] under the securities laws that results in monetary sanctions exceeding $1,000,000."[3] Because the law provides for recovery based not only upon the SEC enforcement action, but also any "related" judicial or administrative action (such as actions brought by the Department of Justice, other regulatory authorities, state Attorneys General, and other state regulatory agencies),[4] the recovery is based upon the total collected from the broad range of related actions, therefore multiplying the amount of any potential recovery. The Dodd-Frank Act also provides enhanced protections for whistleblowers.[5]

The Dodd-Frank Act provides relatively few limits on the individuals who are eligible for awards. Whistleblowers who are convicted of related criminal violations will not be permitted to receive awards.[6] Certain government and Public Company Accounting Oversight Board officials also are not eligible to receive such awards.[7] Individuals who obtain information by auditing financial statements as required under the securities laws are not eligible for whistleblower awards if submission of the information would be contrary to Section 10A of the Exchange Act.[8] The SEC also cannot award individuals who provide information discovered from certain sources, such as allegations made in a judicial or administrative proceeding, from the news media, or from a government report, hearing, audit or investigation, or a judicial or administrative hearing.[9] The information also cannot have been known to the SEC from another source.[10]

The Dodd-Frank Act specifies several factors that the SEC must consider when determining the amount of the award. These factors include the degree of assistance provided by the whistleblower, the significance of the information provided to the SEC, and the SEC's interest in deterring violations of law.[11] The Dodd-Frank Act, however, does not specify that the SEC should consider the role that the whistleblower played at the company, even in situations where the whistleblower obtained the information in connection with a company's efforts to comply with the federal securities laws.

The Perverse Incentives Allowed by the Whistleblower Provisions

The Dodd-Frank Act is modeled after similar whistleblower procedures established in other contexts, such as the Internal Revenue Service (IRS) whistleblower statute (which provides for recoveries between 15 and 30 percent for tax whistleblowing). The purpose of the Dodd-Frank Act is to bring more violations of the securities laws to light, in the hope of encouraging greater compliance with them. Unfortunately, the Act is written in a very broad brush that leaves open a host of unintended and, at times, perverse incentives for both companies and potential whistleblowers. These perverse incentives occur for all covered security law violations that could be reported to the SEC, but are especially pronounced in areas like the Foreign Corrupt Practices Act (FCPA), where recent penalties have topped $100 million, thereby creating the greatest incentives for reporting. The potentially unintended consequences include the following:

- The Dodd-Frank Act gives employees potentially huge incentives to go to the U.S. Government, rather than to provide information to the company, which is in the best position to clean up the violations in accordance with the aims of the Dodd-Frank Act and to take steps to prevent their recurrence.
- The Dodd-Frank Act has a very narrow set of exclusions, such as for people who are hired to do external audits of a company. These exclusions do not exclude whistleblowing by compliance, internal audit, or supervisory personnel who learned of potential violations in the course of conducting their responsibilities. This means that the very same people who were entrusted with preventing or detecting a securities law violation, but who failed to execute their jobs properly,

can profit from their negligence or wrongdoing (except in those rare circumstances where their malfeasance was so great that they are convicted of a criminal violation).

- The Dodd-Frank Act prohibits whistleblowing by auditors, but not legal counsel. This means that the SEC could grant awards to attorneys who learned of the potential violation in the course of providing legal advice or services to the company, including with regard to the efforts by the company to seek legal advice to deal with the violation. If the SEC decided that it could not use the information because the attorney's submission of the information to the SEC breached his or her duty to the client, the SEC could deny the attorney's request for an award on the ground that the submitted information did not lead to the successful enforcement of the securities laws, but in other cases recovery still would be possible.
- The Dodd-Frank Act augments existing whistleblower protections[12] by prohibiting a company from taking employment action against a compliance, internal audit, legal, or supervisory employee for providing information to the SEC in accordance with the Dodd-Frank Act. This could effectively prevent a company from taking the normal actions of firing a compliance, internal audit, legal, or supervisory employee who is associated with a violation if he or she also is a whistleblower, especially if the company learned of the employee's involvement in the violation as a direct or indirect result of the employee having submitted information to the SEC.
- By basing the amount of the award on the recovery by the SEC (and in related actions), the Act could, in some circumstances, give a knowledgeable insider an incentive to delay reporting, in order to increase the amount of the likely fine and the informant's own recovery.
- By increasing the chances of disclosure, the Act could deter companies from conducting the increasingly common kinds of audits that are designed to detect past violations. This would be contrary to the goals of the recently amended Sentencing Guidelines,[13] which encourage audits as a means of discovering and correcting prior wrongdoing.
- Companies that discover wrongdoing often take actions to reprimand or fire the offending employees, a result that is encouraged by the Sentencing Guidelines. In the wake of the Dodd-Frank Act, however, companies will need to balance the risk of continuing to employ a person who has, for example, violated the FCPA by paying a bribe with the increased risk that the fired person will, in retaliation for a justified firing, turn to the SEC as a whistleblower.[14]

These incentives combine to threaten to undermine a company's efforts to establish effective compliance, internal audit, legal, and supervisory functions to detect violations of the federal securities laws. A company can reasonably fear that if it enhances its compliance, internal audit, legal, and supervisory functions for detecting violations of the federal securities laws, the compliance, internal audit, legal, or supervisory employee who detects the violations will – in an effort to be eligible for substantial monetary awards – promptly submit information to the SEC regarding the detected violation, rather than act within the company.

In situations where the conduct is not yet known, however, companies have the opposite incentive, which is to let sleeping dogs lie. In the wake of the Dodd-Frank Act whistleblower provisions, the discovery of a violation, rather than being a chance to rectify the procedures that led to the violation, instead becomes potential fodder for a whistleblower claim. Companies might respond to such fears by enhancing their compliance, internal audit, legal, and supervisory functions less than might otherwise have occurred, or even avoid taking such normally recommended actions as conducting compliance audits, than they would have in the absence of the Dodd-Frank Act.

These concerns appear to be more than theoretical, in that some of them actually have arisen under the IRS whistleblowing statute. As a result, the IRS promulgated new policies on June 18, 2010, designed to prevent some of the issues highlighted above. Most notably, the IRS guidelines contain the following relevant provisions:

- In situations where "the whistleblower 'planned and initiated' the actions that led" to the tax violation, the IRS Whistleblower Office "may reduce the award," even where the whistleblower was not convicted of any criminal conduct.[15]
- Information that is submitted by a whistleblower that is "subject to a valid claim of privilege" (which is referred to as "tainted" information) is to be returned to the whistleblower and is not to be used.[16]
- Under the IRS approach, "[u]nder no circumstances can a taxpayer representative who seeks to become a whistleblower continue to represent the taxpayer."[17]
- Any delay by the whistleblower in reporting, which "can allow the noncompliant activity to be repeated, increasing the magnitude of the noncompliance," is considered to be a "negative factor" that decreases the amount of the potential award.[18]
- The whistleblower's role in the violation, including his "active[] and knowing[]" participation in the activity, as well as any direct or indirect profit in it, is considered as a "negative factor."[19]
- The actions of the whistleblower in the planning and initiation of the actions, including his or her role in taking efforts to conceal the transaction, are to be taken into account when determining the amount of the award.[20]

As these provisions show, the concerns highlighted above also have arisen under the analogous IRS whistleblower provisions. None of these concerns, however, is addressed in the Dodd-Frank Act. With the U.S. Government imposing well over one billion dollars of penalties under just the FCPA over the last two years, the likelihood that the SEC will confront similar issues as those addressed by the IRS guidelines is virtually certain.

Recommendations

The goals of the Dodd-Frank Act are to encourage companies to increase their compliance efforts and to give them an incentive to self-report violations of the securities laws. But there is a tension between these two goals. By increasing the risks of not self-reporting, the Act ironically may have the opposite of the intended effect for compliance efforts, especially when it comes to compliance activity designed to unearth ongoing or already completed violations. This inherent tension is increased dramatically in the absence of protections like those set forth by the IRS guidelines. Accordingly, the SEC should take steps to ensure that companies continue to have a strong incentive to establish effective compliance, internal audit, legal, and supervisory functions to detect violations of the federal securities laws.

While it is true that the Dodd-Frank Act does not explicitly grant the authority for the SEC to do so, there are reasonable grounds for the SEC to so proceed. Although Section 21F(b)(1), as amended, contains language suggesting that the grant of a monetary award of 10–30 percent of monetary sanctions collected is mandatory (by stating that "the Commission . . . *shall* pay an award . . .") (emphasis added), other language suggests that determinations of whether and to whom to grant an award, are within "the discretion of the Commission," and that the Dodd-Frank Act merely provides that a decision to grant an award of between 10-30 percent is not appealable.[21] The overall Act provides for the SEC to issue regulations within 270 days, and the specific language of the whistleblower provisions does not preclude including regulations regarding the types of issues provided for in the IRS guidelines, which deal with some of the perverse incentives outlined above.[22]

Accordingly, the SEC should consider making it clear, by rule or otherwise, that compliance, internal audit, legal, and supervisory personnel are encouraged to work within the company and will be awarded for submitting information to the SEC only if it appears that the company is not responding appropriately to the identified violation. Any regulations also should include guidance regarding the situations when internal auditors, and inside and outside legal counsel, can use their work for the company as a basis for acting as whistleblowers, including with regard to the issue of using privileged information as a basis for a whistleblowing case.

This approach would be consistent not only with the IRS guidelines, but also with the approach that the SEC took in promulgating the SEC standards governing the professional conduct of attorneys appearing and practicing before the Commission. This approach also would be consistent with the approach that Congress took in the Dodd-Frank Act with respect to accountants who become aware of relevant information while auditing financial statements. If it is done, the SEC will move the Act a great deal closer to its goals of not only encouraging disclosure (by whistleblower and company alike), but also of encouraging greater, not decreased, compliance efforts.

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1 Freakonomics and Unintended Consequences: The Case of the Red-Cockaded Woodpecker, by Stephen J. Dubner and Steven D. Levitt (N.Y. Times, Jan. 20, 2008).

2 Pub. L. 111-203 (2010), Section 922, creating Section 21F(b) of the Securities Exchange Act of 1934 (Exchange Act).

3 *Id.* Section 922, creating Section 21F(a)(1) of the Exchange Act.

4 *Id.* Section 922, creating Section 21F(a)(5).

5 *Id.* Section 922, creating Section 21F(h).

6 *Id.* Section 922, creating Section 21F(c)(2)(B).

7 *Id.* Section 922, creating Section 21F(c)(2)(A).

[8] *Id.* Section 922, creating section 21F(c)(2)(C).
[9] *Id.* Section 922, creating Section 21F(a)(3)(2).
[10] *Id.* Section 922, creating Section 21F(a)(3)(2).
[11] *Id.* Section 922, creating Section 21F(c)(1).
[12] *See* 18 U.S.C. § 1514A (providing for a private right of action for employers who retaliate against whistleblowers who took actions to expose "any provisions of Federal law relating to fraud against shareholders"); 18 U.S.C. § 1513(e) (criminalizing "any action harmful to any person, including interference with ... lawful employment" for the provision of "truthful" information relating to the "commission or possible commission of any Federal offense").
[13] Section 8B2.1(b)(5) of the Federal Guidelines provide that an organization "shall take reasonable steps ... to ensure that the organization's compliance and ethics programs is followed, including monitoring and auditing to detect criminal conduct" and that the organization shall "evaluate periodically the effectiveness of the organization's compliance and ethics program."
[14] Curiously, although the Dodd-Frank Act expressly provides that no award shall be made to a whistleblower who is convicted of a criminal violation related to the enforcement action for which the whistleblower otherwise could receive an award, the Dodd-Frank Act does not have an exclusion for individuals who recklessly or negligently caused the violation that is being reported to the SEC. *See* Exchange Act Section 21F(b)(2)(B), as amended by Section 922 of the Dodd-Frank Act. Thus, the SEC could find itself in the anomalous position of making a multi-million award to the very individual who caused the violation at issue.
[15] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.2(4). The whistleblower guidelines are published as part of the IRS Internal Revenue Manual, and are available at http://www.irs.gov/irm/part25/irm_25-002-002.html#d0e844.
[16] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.6(9).
[17] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.6(12).
[18] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.9.2(11)(A).
[19] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.9.2(11)(B).
[20] *See* Internal Revenue Manual – 25.2.2 Whistleblower Awards at Section 25.2.2.9.2(14).
[21] Section 21F(f), as amended.
[22] The Dodd-Frank Act defines whistleblower to be any individual (or individuals acting jointly) who provide information relating to the violation of the securities laws to the Commission "in a manner established, by rule or regulation, by the Commission." Exchange Act Section 21F(a)(6), as created by Section 922 of the Dodd-Frank Act. Accordingly, the Dodd-Frank Act is open to the interpretation that the SEC is not authorized to grant monetary awards pursuant to Section 922 until the SEC has adopted rules or regulations establishing the manner in which a would-be whistleblower must provide the information. In addition, this provision arguably authorizes the SEC to require a person submitting information to the SEC in expectation of being eligible to receive a monetary award to make certain representations to the Commission as a condition of providing the information. Under this interpretation, the SEC could adopt rules and regulations designed to ensure that the submission of the information to the SEC is consistent with the public interest (e.g., the person submitting the information is not an attorney providing the information in breach of an ethical duty to keep the information confidential).