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Pitfalls Emerge in Dodd-Frank Bounty Provision

By Bruce Carton — September 8, 2010

In a span of just six weeks, the whistleblower provisions in the recently enacted Dodd-Frank Act have gone from a little-known sleeper section of the law to one of its most highly scrutinized provisions. Congress has been vocal that the whistleblower provisions are a smart way to uncover more fraud—at no cost to the taxpayers, they say, since the funds used for whistleblower bounties will come out of penalties companies pay to the Securities and Exchange Commission.

SEC Chairman Mary Schapiro has also identified whistleblower bounties as a key new tool that may help the SEC avoid missing the next Bernard Madoff. On the other hand, however, companies that will be squeezed by the legislation (and the lawyers, consultants, and other professionals who advise them) have anxiously pointed to the many pitfalls that may accompany the whistleblower provisions.

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To recap, Section 922 of Dodd-Frank provides significant new incentives for employees and others to "blow the whistle" to the SEC when they are aware of fraud within a company. A person who provides "original information" about a securities law violation to the SEC, which then leads to a successful enforcement action with penalties of $1 million or more, is now entitled to collect 10 to 30 percent of the total penalties imposed by the agency. As penalties in SEC cases routinely amount to tens or even hundreds of millions of dollars, whistleblowers under Section 922 have the potential to become instant multimillionaires (or deca-millionaires).

The pros of the whistleblower provisions are fairly obvious. There is little doubt that financial incentives will increase the number of tips and referrals the SEC receives about potential fraud. John Stark, former head of the SEC's Office of Internet Enforcement who is now at the law firm Stroz Friedberg, believes the avalanche of complaints that will result from the new provisions may end up being "the most dramatic thing to ever hit the SEC." That remains to be seen, but there have already been many reports—primarily coming from law firms representing whistleblowers—of complaints filed with the SEC pursuant to Section 922.

In addition, Dodd-Frank provides new protections from retaliation for whistleblowers. Foremost, Section 922 creates a private cause of action for employees who have suffered retaliation (that could be demotion, dismissal, suspension, threats, or other harassment) because the whistleblower was lawfully trying to: (a) provide information to the SEC in accordance with the new law; or (b) assist in any investigation based on tips the whistleblower might provide.

Still lurking below the surface, however, are a sizable number of potential cons that may flow from the new provisions. Most often heard is the complaint that the law provides a huge incentive for employees to race to the SEC's door, so they can be the first to provide the agency with "original information" leading to an enforcement action. The carrot for employees to go to the government immediately with information could deeply undercut today's ethics and compliance programs, which train and encourage employees to first report wrongdoing internally.

Jacob Frenkel, a former SEC enforcement attorney now with law firm Shulman, Rogers, Gandal, Pordy & Ecker, says that a more logical whistleblowing framework could be derived from Section 10A of the Securities Exchange Act. Section 10A requires auditors who believe they have discovered an illegal act at a company to first report it to company management and the audit committee. Only if the company fails to take remedial action is the auditor then required to report the illegal act to the SEC under that statute.

Section 10A only applies to auditors, but you can see how the logic could be applied to employees as well. Frenkel believes that absent egregious misconduct condoned (or even conducted) by senior

management, employees have a responsibility to attempt to correct errors and misconduct through existing corporate compliance systems. Anything else would undermine corporate compliance and ethics programs, he says, "and reverse a decade of effort promoting integrity, self-remediation, and corporate self-reporting."

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The millions that whistleblowers might potentially reap could also encourage a lottery mentality, where people file complaints on weak or wholly illegitimate claims "just in case." And the plaintiffs' bar is likely to run with Section 922 as far and fast as possible, seeing a lucrative new practice area. Section 922 specifically provides that any whistleblower who makes a claim may be represented by counsel, and must be represented by counsel if he or she wishes to submit the claim anonymously.

Contending with a barrage of borderline (or worse) claims will prove quite costly to the SEC, which will still be required to review each matter submitted to it. Indeed, Dodd-Frank requires the SEC to establish a new, separate office within the agency to administer and enforce the whistleblower provisions. This new office will report annually to House and Senate committees on its activities, whistleblower complaints, and the SEC's response to such complaints.

Section 922 will also be costly to the companies that may have to defend such complaints. Frenkel hopes that regulators will bring the same enthusiasm they have expressed for the whistleblower incentives to prosecuting "self-proclaimed whistleblowers who provide misinformation in order to pursue a bounty."

Jerome Tomas, a partner with Baker & McKenzie who was formerly in the SEC's Enforcement Division, warns that whistleblowers might also start lodging complaints with both the SEC and the company at the same time. Alternatively, the whistleblower may not have facts sufficient to warrant a complaint with the SEC, but may nevertheless lodge an initial vague complaint with the company. In either event, Tomas says, the company will then find itself in an undesirable race to investigate, take action, and reach out to the SEC (before the SEC reaches out to the company) if it wants to garner possible cooperation credit.

Other former SEC attorneys I surveyed pointed out still more pitfalls. Kenneth Winer, now a partner with Foley & Lardner, observed that the new protections from retaliation for whistleblowers set forth in Dodd-Frank create a situation where employees who take their complaint to the SEC have greater protection under the law than employees who simply raise their concerns within the company. That may provide even more incentive for employees to take complaints straight to the government rather than first going to their company's compliance department.

Richard Wallace, another partner with Foley & Lardner, stated that reacting to the expected crush of whistleblower tips may take away from the SEC's ability to set its own agenda. He notes that the Enforcement Division staff recently said that if the agency were faced with the same wave of stock option backdating conduct today, it might elect to bring select, "statement" cases rather than pursing hundreds of separate cases. Given the new whistleblower provisions, however, Wallace wonders whether "with 100 whistleblowers wanting a cut of the action, could the staff turn down such cases?"

With Dodd-Frank raising the stakes in so many ways, Pamela Parizek, a partner in KPMG's Advisory Services, says that it is more important than ever for companies to avoid opportunities for whistleblower claims in the first place. The best way to do that? As always, corporate culture. The right culture "fosters an attitude of doing the right thing in the right way, including setting a tone at the top that shows no tolerance for cutting corners or for the commission of a fraudulent act," she says.