

In This Issue:

July 2011

Legislation recently introduced in the House of Representatives takes aim at the whistleblower bounty program created by the Dodd-Frank Act. The Whistleblower Improvement Act would amend the program to avoid interference with a company's internal reporting system.

The Whistleblower Improvement Act: New Legislation Takes Aim at Dodd-Frank Whistleblower Bounty Provisions

By Ilyse Schuman and Gregory Keating

A year after the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") became law, its new whistleblower incentive and protection provisions are under scrutiny and challenge. Legislation recently introduced in the House of Representatives takes aim at the Act's creation of this whistleblower "bounty" program by seeking to preserve the primacy of a company's internal reporting system. As the Dodd-Frank whistleblower provisions garner more attention by Congress and corporations, employers are cautioned to re-examine and re-enforce their own policies for reporting and responding to employee allegations of misconduct.

Background

Under the whistleblower incentive and protection program established by the Dodd-Frank Act, employees who contribute original information that leads the Securities and Exchange Commission (SEC) to recover monetary sanctions of \$1,000,000 or more in criminal and civil proceedings are entitled to receive between 10% and 30% of any monetary sanctions that are imposed. The Act also provides a number of anti-retaliation protections for employees that act as whistleblowers.

In May of this year, the SEC issued a final rule governing these whistleblower protections.¹ Notably, the SEC's rule *does not* require employees to first report violations through their company's internal channels in order to qualify for the award, although it does create incentives for employees to do so. For example, whistleblowers are eligible for an award if they report internally and the company informs the SEC about the violations. Therefore, the information provided by the employer to the SEC is to be attributed to the whistleblower for award purposes. While internal reporting is not required for a whistleblower to receive an award, it is a factor in the amount of the award. A whistleblower's voluntary participation in the company's internal compliance and reporting system would constitute a factor that could increase the amount of the award. Conversely, the whistleblower's interference with the company's reporting process could decrease the amount of the award.

The Whistleblower Improvement Act of 2011

The Dodd-Frank whistleblower bounty provision and SEC regulations have been criticized as undermining the effectiveness of internal reporting systems by failing to require whistleblowers to first report their allegations internally. On May 11, 2011, the House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Entities held a hearing to explore legislative proposals to address the negative consequences of the Dodd-Frank whistleblower provisions.

Subcommittee Chairman Scott Garrett (R-NJ) stated that, "As with many of the provisions included in Dodd-Frank, the Committee did not spend enough time considering the whistleblower provisions before they were signed into law. Although well-intentioned, thousands of people and companies have commented to the SEC regarding the serious negative consequences of the proposed whistleblower rules." The Subcommittee examined a legislative proposal by Rep. Michael Grimm (R-NY) to improve the Dodd-Frank whistleblower provisions to preserve the viability of internal reporting regimes established by the Sarbanes-Oxley Act and to prevent employees who are responsible for wrongful acts from receiving an award from the program.

The Whistleblower Improvement Act of 2011 (H.R. 2483), which was introduced by Rep. Grimm on July 11, would amend the Dodd-Frank whistleblower incentive provisions by, among other things, requiring employees to first report potential misconduct through the company's internal reporting system. The bill seeks to preserve the integrity of a company's internal reporting system and prevent employees whose job it is to investigate misconduct from being considered whistleblowers. Upon introduction of the bill, Rep. Grimm announced:

"If we are serious about putting a stop to fraud and wrongdoing, we should continue encouraging companies to remain vigilant," said Rep. Grimm. "For decades, companies have maintained effective internal reporting mechanisms to help them stop criminal activity early with the help of tips from anonymous whistleblowers. The overreaching provisions in Dodd-Frank make these internal programs obsolete, open the floodgates of claims to an already overburdened SEC, and delay action on escalating crimes within a company. The Whistleblower Improvement Act corrects these provisions in Dodd-Frank that have the potential to cause more harm than good."

Specifically, the bill would deny any award granted under the whistleblower protection program to employees who fail to first report information constituting possible securities fraud to their employers before reporting such information to the SEC. In addition, the whistleblower would be required to report such information to the SEC no later than 180 days after providing the information to the employer. The bill would create an exception to the internal reporting requirement if: (1) the SEC determines that the employer lacks either a policy prohibiting retaliation for reporting potential misconduct or an internal reporting system allowing for anonymous reporting, or (2) the SEC determines in a preliminary investigation that an employer's internal reporting system would not have been a viable option based on evidence that the alleged misconduct was committed by or involved the complicity of the highest level of management, or other evidence of bad faith on the part of the employer.

An award under this program would also be denied to a whistleblower:

[W]ho has legal, compliance, or similar responsibilities for or on behalf of an entity and has a fiduciary or contractual obligation to investigate or respond to internal reports of misconduct or violations or to cause such entity to investigate or respond to the misconduct or violations, if the information learned by the whistleblower during the course of his or her duties was communicated to such a person with the reasonable expectation that such person would take appropriate steps to so respond.

This legislation also would eliminate the minimum award requirement, and instead give the SEC discretion in granting any award up to 30% of the sanctions imposed.

Finally, the bill would insert a new requirement that the SEC notify the employer of the whistleblower's allegations prior to commencing any enforcement action against the employer in order to give it time to investigate the alleged misconduct and take remedial action. In the event the employer responds in good faith and takes appropriate corrective action, the SEC would treat the employer as having self-reported the alleged violations. This option would not apply if, during its preliminary investigation, not to exceed 30 days, the SEC determines that notification would jeopardize its overall investigation into the securities law violation allegations, based on evidence that

the misconduct was committed by or involved complicity of the highest level of management or bad faith by the entity. This bill has been referred to the House Committees on Financial Services and Agriculture.

A day after introduction of the Whistleblower Improvement Act in the House, the Dodd-Frank whistleblower bounty provision was also criticized in a Senate Banking Committee hearing on *Enhanced Investor Protection After the Financial Crisis*. Harvey Pitt, former Chairman of the SEC under President George W. Bush, testified that: “this provision threatens to undermine corporate governance, internal compliance and the confidence of public investors in our heavily-regulated capital markets.” While the prospects for passage of the Whistleblower Improvement Act are uncertain, it is clear that the Dodd-Frank whistleblower bounty program is stirring controversy both inside and outside of Washington.

Practical Steps for Employers

Even in the absence of changes to the Dodd-Frank whistleblower bounty provisions called for by the Whistleblower Improvement Act, employers should prepare for the “new world” of whistleblower bounties and intensive enforcement efforts. It is more important than ever to encourage internal reporting of possible violations and to prevent retaliation against whistleblowers. Employers are well-advised to take the following steps to make sure they are prepared for this new world.

- Create a culture of ethics and compliance.
- Review internal compliance programs.
- Remind employees about reporting procedures.
- Take complaints seriously, promptly investigate, and take appropriate action.
- Prevent retaliation.
- Train managers in retaliation and whistleblower policies.
- Take a fresh look at retaliation and whistleblowing policies.
- Review severance agreements.

.....
 Ilyse Schuman is a Shareholder in Littler Mendelson’s Washington, D.C. office, and Gregory Keating is a Shareholder in the Boston office. If you would like further information, please contact your Littler attorney at 1.888.Littler or info@littler.com, Ms. Schuman at ischuman@littler.com, or Mr. Keating at gkeating@littler.com.

¹ See Littler’s Report *Dodd-Frank and The SEC Final Rule: From Protected Employee to Bounty Hunter* for a discussion of the final rule, <http://www.littler.com/files/press/pdf/LittlerReportDoddFrankAndTheSECFinalRule.pdf>.