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WHISTLEBLOWERS

Implementing a Whistleblower Awards Program Without Diminishing the Role of Internal Compliance

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The Dodd-Frank whistleblower awards program may have the unintended consequence of reducing the effectiveness of a company's internal compliance system. The SEC has sought recommendations on its implementation of Dodd-Frank. A recommendation advanced by business is that if a whistleblower bypasses a robust internal compliance system, the whistleblower would not be eligible to receive a monetary award for his reporting. In response, some have argued that Dodd-Frank prohibits the SEC from eliminating the entire award owed to a whistleblower.

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We favor the approach advanced by business, but if the elimination of the entire award is not deemed permissible by the SEC, we offer a compromise: reduce the award to a whistleblower, who bypasses the internal compliance system, to a statutorily permissible 10 percent of the total fine and rebate remainder of the potential whistleblower award to the company. Regardless of the final implementation of Dodd-Frank, companies should take certain actions now to integrate a whistleblower program into their existing internal compliance program with the steps proposed below.

In its request for comments to the proposed rules to implement the whistleblower program under Dodd-Frank, the SEC acknowledged that there are ''competing interests,'' including ''the potential for monetary incentives provided to whistleblowers . . . to reduce the effectiveness of a company's existing compliance, legal, audit and similar processes for investigating and responding to potential violations of the federal securities laws.''[1] Recognizing the challenge of the task at hand, the SEC sought ''recommendations on structures, processes, and incentives that [the SEC] should consider implementing in order to strike the right balance between the [SEC's] need for a strong and effective whistleblower awards program and the importance of preserving robust corporate structures for self-policing and self-reporting.''[2]

The comment letters and debate over the past months have underscored that many, if not all, commentators concur that implementing a whistleblower awards program and encouraging robust internal compliance systems are ''competing interests,'' but little attention has

[1] 17 CFR Parts 240 and 249, Supplementary Information.
[2] 17 CFR Parts 240 and 249, Description of Proposed Rules.

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been paid to ''striking the right balance'' between them. For the most part, the fundamental question of whether a potential whistleblower must first report through an internal compliance program has been presented as a zero-sum proposition—on the one hand, the existence of financial incentives will encourage whistleblowers not to report violations internally, which will eviscerate internal compliance programs (at least with respect to potential SEC violations), and, on the other hand, forcing potential whistleblowers to first report internally will have a chilling effect on the number of violations reported to the SEC and may be precluded by law.[3] Although commentators have suggested some modifications, like extending the time period for an internal investigation from 90 to 180 days,[4] and the SEC has indicated its willingness to ''consider higher percentage awards for whistleblowers who first report violations through their compliance programs,''[5] internal reporting has for the most part been presented as a Hobson's Choice.[6] The SEC can either require internal reporting (and chill whistle blowing) or not require internal reporting (and undermine the very compliance programs required by SOX and touted by the Justice Department).[7]

Reduce the Whistleblower Reward When Internal Reporting Is Bypassed

In approaching the decision as a Hobson's Choice, however, the SEC may miss an opportunity to ameliorate both fears (but not eliminate either fear). In order to ''strike the right balance between the [SEC's] need for a strong and effective whistleblower awards program and the importance of preserving robust corporate structures for self-policing and self-reporting,''[8] we propose that, instead of the vague commentary that the SEC may take into account ''whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the [SEC]''[9] that the SEC formalize the economic impact of not reporting internally, by borrowing a concept from shareholder derivative litigation. In this way, the justification for bypassing the internal compliance system can be made on a case by case basis and the Hobson's Choice between competing hopes and fears can be avoided at the macro level. Simply put, create an economic disincentive for employees to report a violation externally without first reporting the violation internally. If, in a particular set of facts and circumstances, reporting internally would have been pointless or chilling, the economic disincentive for not reporting internally is waived. If, however, a robust and trustworthy internal compliance program existed and the whistleblower chose to bypass it, that decision would have a direct and quantifiable negative economic impact on the award received.

Create an economic disincentive for employees to report a violation externally without first reporting the violation internally.

Under this proposed approach, assuming that all of the other requirements have been met for receiving an award, a whistleblower would only be entitled to the larger award of 20% to 30%[10] of the company's total monetary sanctions under two circumstances:

(A) The whistleblower first reported the violation internally, was unsatisfied with the response, and then subsequently reported the violation to the SEC within the required grace period; or

(B) The whistleblower can demonstrate that reporting internally would have been futile or dangerous because of the weaknesses of the internal compliance function at the relevant corporation. [11]

If, however, the whistleblower bypassed an internal compliance process that is later determined to have been sufficiently robust, the maximum award to the whistleblower would be 10% of the company's total

[3] Comment Letter from National Whistleblowers Center to Securities and Exchange Commission (Nov. 1, 2010).

[4] The proposed rule provides that a whistleblower who first reports internally has 90 days to submit the information to the SEC. If the whistleblower submits the same information it reported internally to the SEC within the 90-day grace period, the submission will be considered effective as of the date in which the information was reported internally. Proposed Rule 21F-4(b)(7).

[5] Proposed Rule 21F-6.

[6] Although the vast majority of pro-internal-compliance commentators present the question as stark choices, some corporations have suggested that there be an exception from the internal reporting requirement when ''(a) the employer does not have an effective internal corporate compliance program or (b) the employee can show that extraordinary circumstances should excuse such reporting.'' Comment Letter Submitted to the Securities and Exchange Commission on Behalf of Ten Corporations by Covington & Burling LLP (Dec. 17, 2010) at 3.

[7] The two positions are as follows: ''The [SEC]'s proposed rules disincent employees from looking for ways to improve or correct corporate behaviors, and incent them to find ways to profit from corporate wrongdoing. Fraudulent misconduct, the bane of good compliance systems, then becomes the gold mine, rather than an impetus for companies with effective compliance systems to address the underlying issues,'' Comment Letter from Association of Corporate Counsel to Securities and Exchange Commission (Dec. 15, 2010), and ''Any rule that would allow a corporation to make whistleblower protection contingent on compliance with an internal reporting scheme would illegally limit and chill the right of employees to anonymously disclose information to law enforcement agencies'' and ''would be contrary to the explicit language of both the Dodd-Frank and Sarbanes-Oxley Acts,'' Comment Letter from National Whistleblowers Center to Securities and Exchange Commission (Nov. 1, 2010).

[8] Proposed Rule 21F-4.

[9] Proposed Rule 21F-6.

[10] Under the proposed rule, the whistleblower must receive not less than 10% and not more than 30%, if certain criteria are met. Although, internal reporting is a consideration, the proposal makes it clear that internal reporting ''is not a requirement for an award above the 10 percent statutory minimum and whistleblowers will not be penalized if they do not avail themselves of this opportunity for fear of retaliation or other legitimate reasons.''

[11] This test would also apply if after having reported internally, the whistleblower later determined that to continue to wait for the outcome of the process was futile.

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monetary sanction.[12] As a corollary, the remainder of the award that was forfeited by the whistleblower because the whistleblower bypassed an adequate compliance system would go to offset the fine against the corporation. This corollary would have two positive effects. First, it would give a direct financial incentive for corporations to implement and promote a robust compliance program and would buttress the incentives of having such a program under the Revised Federal Sentencing Guidelines. Second, in those situations in which a whistleblower bypassed the internal compliance system and the corporation was fined, there would be a financial incentive for the affected corporation to prove that its compliance system was sufficiently robust and should not have been bypassed by the whistleblower. Over time, competing views of whether a program was robust or chilling may work to create more dialogue and insights into what constitutes a robust and open compliance program, the contours of which should evolve over time.

Rewarding companies for robust compliance systems, and the insights produced by a dialogue as to what is (and is not) a robust and open compliance system, would further the same goals as the recent Department of Justice initiative to publicize examples of when it has rewarded companies for vigorous compliance programs that existed at the time of an offense.[13] In other words, instead of eviscerating compliance programs by adopting a blanket rule, a whistleblower awards program that rewards robust compliance programs and includes an assessment of the adequacy and efficacy of the relevant compliance program could actually enhance internal compliance systems. Properly constructed incentives and dialogue could help regulators and corporate America learn and understand how an effective compliance program with a whistle blowing component should operate and the benefits of having such a system.[14]

Integrating the Whistleblower Requirement: Steps Companies Should Take Now

Many commentators believe that, despite the well-founded concerns of proponents of robust internal compliance programs, it is unlikely that the SEC will come down on the side of those who argue for required internal reporting. From our experience in working with compliance programs over the past fifteen years and our firm's experience working with government contract compliance programs, which have co-existed with the potential for qui tam law suits for 30 years, we offer two simple practical insights for addressing the most-likely outcome—the SEC adopting final rules that do not require internal reporting.

Whether or not the SEC adopts a policy that does not require potential whistleblowers to report internally first, there are two practical steps that corporations can take to harmonize whistle blowing and a strong compliance program:

1. Ensure a tone at the top that clearly articulates the importance of compliance and empowers employees to report any non-compliant behavior. Employees want to be part of an organization they can trust and embrace.

2. Modify the company's annual certification of code of conduct to include a certification that ''I am not aware of any behavior that is in contravention of the Code of Conduct, including any violation of federal securities law, that I have not reported to the corporation. (Note: If you are aware of a contravention and have reported it to the hotline, even if anonymously, you should certify yes to this question. If you are aware of a violation and have not reported such matter, you are strongly encourage to do so at [HOTLINE], which provides an anonymous option, and then complete this certification.).''

The ''tone at the top'' has long been cited as critically important to a robust compliance program. For example, the Revised Federal Sentencing Guidelines require high-level personnel to be actively involved in compliance efforts under the proposition that such action should (i) reduce the risk of criminal charges, (ii) improve the corporation's chances of demonstrating that it has an ''effective'' program, (iii) rebut any allegations that the board failed to participate in compliance initiatives and, most importantly, (iv) produce greater prevention and detection of wrongdoing within the corporation If the ''tone at the top'' is authentic and empowering, employees will trust and utilize the compliance system. From time to time, there will be actors that game the system, but overall if people trust their leaders to do the right thing, they will do the right thing. This reality has been borne out in the government contracts arena where the option of filing qui tam lawsuits has not prevented numerous employees from bringing legitimate concerns to the attention of internal compliance systems. Simply put, many employees will report internally if they believe that such a report will cause the behaviors to cease and that they will not be subject to retaliation. A strong and unequivocal tone at the top is necessary to create this reality.

The purpose of the modified certification is two-fold. First, the certification reminds certifiers of the obligation to report any violation internally and the opportunity of doing so anonymously. The annual nature of the certification should allow a corporation to learn about the potential violation within a reasonable period of time. Second, as a useful byproduct, the certification forces those with knowledge of a violation to choose among reporting internally, not signing the certification or certifying falsely. The choice made will give some insight into the integrity of the person, his or her belief in the efficacy of the internal compliance system or both.

While we think every corporation should implement the above two practical approaches, there is also a more radical approach that may be appropriate for some corporations—providing a monetary incentive to report

[12] If this approach were to be adopted, the statutory 10% threshold would ideally be reduced to a lower percentage or a set amount to underscore that an internal compliance program should only be bypassed in situations where internally reporting would be futile or dangerous.

[13] DOJ decided to publish these cases in the wake of recent criticism from commentators, such as the Ethics and Compliance Officer Association and the Society of Corporate Compliance and Ethics, who had observed that DOJ's policy of highlighting the merits of compliance systems imposed by deferred prosecution agreements and not highlighting those that warranted their companies more favorable treatment under the Revised Federal Sentencing Guidelines, was more rewarding to wrongdoers than to companies that had a strong compliance program in place.

[14] If over time, it becomes clear that the unintended consequences of a whistleblower awards program outweigh the benefits, then a repeal of the provision should be considered.

internally first. The details of any such program would need to be tailored to the particular corporation, but could be based on any or a combination of a set dollar amount, a percentage of the claim/money saved, or applying a multiple to the whistleblower's SEC award if the whistleblower first reported internally and gave the corporation a chance to respond during the grace period.

In short, compliance will change as a result of the implementation of Dodd-Frank. The goal is to have the change be supportive of compliance systems that are premised on doing the right thing. The SEC should implement the whistleblower awards program in a way that enhances internal compliance systems and ultimately Congress must act if it does not. Regardless, corporations should take steps now to create an alternative to external whistle blowing by empowering compliance programs with a strong tone at the top. A corollary step is to remind its employees of their obligation to ensure that violations of the corporation's code of conduct are reported internally in a timely manner.

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