Dodd-Frank and the FCPA: The Truth and Consequences

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On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") into law. Despite its title, Dodd-Frank's mandate goes beyond a comprehensive overhaul of existing financial services regulations. Several of the Act's core provisions, most notably the "Securities Whistleblower Incentives and Protection" provision, will significantly impact the day-to-day operations of multinational businesses outside of the financial sector. Such impact is especially pronounced in these companies' continuing efforts to comply with the Foreign Corrupt Practices Act ("FCPA").

Section 922 of Dodd-Frank guarantees whistleblowers a substantial monetary award for providing federal regulators with "original information" leading to a successful enforcement action. Unsurprisingly, violations of the FCPA are among those offenses that can net potential whistleblowers a sizable windfall under Dodd-Frank. The same section also provides whistleblowers with unprecedented protections against employer retaliation under federal law, including reinstatement, receipt of double back pay, and entitlement to litigation costs. While some may see this provision as an important tool in the fight against corporate crime, companies should be very concerned about the potential for abuse. Turning employees into "bounty hunters" is not going to help the government, and certainly it will not help promote business interests.

In light of Dodd-Frank's new whistleblower incentive provisions, prosecutors and law enforcement officers should be prepared to devote considerable assets to confront a deluge of frivolous claims. Likewise, corporations will be forced to launch costly internal investigations, face the potential for public criticism, and ultimately risk a loss of reputation. This certainly will benefit lawyers – defense attorneys likely will see a rise in business, while prosecutors may be courted aggressively by private law firms and corporations looking for experienced counsel. However, the damage to businesses will be significant. Internal corporate investigations will never be the same with a bevy of eager, lurking whistleblowers seeking to capitalize on increased disclosure awards. Since the new incentives condition whistleblowers' monetary rewards on the receipt of "original information," employees have a strong financial motive to bypass a company's internal reporting system and disclose suspected FCPA violations directly to the DOJ. The resulting government investigations can turn into a daunting minefield which must be traversed with great skill and care. Finally and perhaps most importantly, Dodd-Frank threatens the effectiveness of existing internal corporate compliance programs by depriving companies of critical intelligence sources necessary for

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implementing internal corrective measures and sustaining a viable compliance program.

This article challenges the wisdom behind Dodd-Frank's whistleblower provisions by highlighting the practical dangers in the provisions. It will then evaluate the marked impact that these provisions will have on how business is conducted and investigations are carried out. Finally, the article will expose the perverse incentive system created by the whistleblower provisions and the general increase in FCPA prosecutions. There is a "perfect storm" brewing on the economic horizon for all U.S. companies, especially those that conduct business abroad.

I. Dodd-Frank's Whistleblower Provisions: An Overview

Dodd-Frank has strengthened both the scope and vitality of the previously existing whistleblower program. Prior to Dodd-Frank, the only whistleblower award program existed in Section 21A(e) of the Securities Exchange Act of 1934, as amended by the Insider Trading and Securities Fraud Enforcement Act of 1988. These whistleblower incentives authorized the SEC to award no more than 10% of recovered penalties "to the person or persons who provide information leading to the imposition of such penalty."[1] Since the reward is completely discretionary and only whistleblowers in insider-trading cases stood to benefit from this program, this SEC program has been rarely used.[2] In fact, to date, the SEC has paid only approximately $1.6 million in awards pursuant to this bounty program, $1 million of which was authorized shortly before Dodd-Frank became law.[3]

The Dodd-Frank amendments have significantly expanded the existing bounty program, thereby providing greater incentives to potential whistleblowers. First, Dodd-Frank *guarantees* whistleblowers up to a 30% share of any monetary sanctions over one million dollars – defined to include penalties, disgorgement, and interest – that are made possible by the voluntary disclosure of "original information" that is "derived from the independent knowledge or analysis of a whistleblower."[4] As a result, both the amount and the likelihood of monetary rewards have increased. Payouts to whistleblowers most likely will be of staggeringly high sums. The sanctions often greatly exceed one million dollars and multiple persons may provide information and be eligible for a reward. Second, Dodd-Frank broadens the scope of a bounty program's coverage beyond insider-trading. The new revamped program awards whistleblowers that provide information in connection with enforcement actions brought under a wide array of "covered judicial or administrative action[s]" and "related actions," including enforcement actions pursuant to the FCPA.[5] Finally, it provides whistleblowers with unprecedented levels of enhanced protection against possible employer retaliation, including expanded private rights of action under federal law, as well as entitlement to reinstatement, double back pay, and litigation costs.[6]

The Dodd-Frank amendment also created the Securities and Exchange Commission's Investor Protection Fund. This Fund is the source for the whistleblower bounty payments and is built up through deposits of monetary sanctions obtained by the SEC and other federal regulatory and enforcement agencies, to the extent that those funds are not distributed to victims or used to fund the activities of the SEC's Inspector General.[7] The appropriate amount of a whistleblower's bounty is based on three explicitly enumerated factors: (1) "the significance of the information provided by the whistleblower," (2) "the degree of assistance provided by the whistleblower" in the relevant enforcement action, and (3) "the programmatic interest of the [Securities and Exchange] Commission in deterring violations of the securities laws by making awards to whistleblowers."[8] Dodd-Frank's expansion of the existing SEC whistleblower bounty program will be codified as the new Section 21F to the Securities and Exchange Act of 1934.

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Recent developments, including: a statement by Lanny Breuer, head of the DOJ's Criminal Division;[9] the conclusion of an extensive undercover DOJ sting operation;[10] and the successful extradition of foreign nationals to the United States to face FCPA charges,[11] signal a sharp increase in FCPA enforcement and heighten the potential industry impact of Dodd-Frank's new whistleblower program.

II. Dodd-Frank's "Original Information" Requirement

Dodd-Frank requires that, in order to collect a reward, whistleblowers must *directly* provide the government with "original information" not already known to the enforcement agency from another source.[12] Incidentally, if an employee voices her concerns through the company's internal compliance system or ethics hotline, management may decide to voluntarily report the matter to a government enforcement agency. If this occurs, the whistleblower's information becomes "unoriginal," since the government has already acquired knowledge of the information, and deprives the whistleblower of the chance to collect an immense bounty. Consequently, Dodd-Frank creates an irresistible financial incentive for employees with knowledge of wrongdoing to bypass their employers' internal reporting systems and report FCPA violations to the U.S. Department of Justice directly.

This new requirement – providing the government with "original information" – stands in stark contrast to the federal government's former legislative and public policy goals concerning corporate corruption. Regardless of their size, companies traditionally devote considerable resources to developing their own compliance systems, publicizing them internally, and encouraging employees to voice their concerns about questionable activities. These internal systems are designed to minimize compliance costs and lower the company's reputational risk. They also help cultivate an internal culture of legal and ethical compliance, enabling the company to quickly halt ongoing misconduct and promptly implement remedial measures internally. Dodd-Frank, however, threatens these long-standing corporate internal compliance efforts by luring employees to deliberately bypass their company's internal compliance mechanisms with the prospect of securing multi-million dollar bounties. As a result, companies may be deprived of critical sources of internal intelligence that they need to correct issues from within. This perverse incentive to involve federal regulators and law enforcement officers in the very first steps of the reporting process threatens to seriously undermine the continued viability of existing internal corporate compliance systems and ethics mechanisms.

One troubling consequence of these perverse incentives is that employees are no longer driven to help their company cooperate with regulatory authorities. In fact, the opposite is now true. Facilitating the company's cooperation with government investigators can actually lead to a decrease in the sanctions imposed, thereby diminishing the whistleblower's award in the process. Since whistleblower rewards are mechanically set as a percentage of a corporation's total monetary penalty, this is a self-defeating incentive. U.S. companies, especially those with an international presence, have implemented internal compliance programs at great effort and expense. The voluntary disclosure of information by corporate employees about potential misconduct to the company through confidential internal reporting systems sustains these internal compliance systems. Since companies can only remedy problems that are known to them, Dodd-Frank's whistleblower bounty program poses serious threats to the continued viability and effectiveness of companies' internal reporting systems.

Furthermore, the federal government has encouraged companies to develop and sustain self-governing corporate structures with minimal

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government interference. This policy is reflected in the U.S. Sentencing Guidelines and federal administrative agency regulations which encourage investment in internal corporate compliance programs and voluntary disclosure of suspected misconduct in exchange for mitigating or avoiding potentially harsh penalties for white collar crime.[13] Specifically, the current Sentencing Guidelines provide strong incentives for corporations to implement internal compliance programs and self-report suspected violations to appropriate government regulators. In the event that the corporations are prosecuted for such violations, they can receive credit for having an "effective compliance and ethics program," as well as for self-reporting a suspected violation and fully cooperating with government investigators.[14] A company that maintains an effective internal compliance program that promotes self-reporting can decrease its criminal culpability under the Sentencing Guidelines and receive more lenient sanctions. Ironically, and contrary to Dodd-Frank's inherent disincentives to report misconduct internally, one recent amendment to the Sentencing Guidelines defines a feature of an effective compliance program as "a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct . . . ."[15]

Consequently, Dodd-Frank's whistleblower provisions run counter to the government's longstanding policy to create a sustainable system of corporate self-governance, and to foster a positive culture of legal and ethical compliance from within a company's walls. By misaligning the monetary incentives for potential whistleblowers, Dodd-Frank paradoxically undermines the same internal compliance programs into which companies have made significant monetary investments, consistent with longstanding government mandates and expectations for proper conduct of corporate affairs.

III. The Lottery Mentality: Fostering a 'Sleeper Cell' of Informants

Dodd-Frank's whistleblower provisions can also give rise to a "lottery mentality" that transforms a company's own employees into bounty hunters. As a result, employees may now be tempted to file unsubstantiated claims in hopes of scoring big with one plausible complaint. Some employees consequently may now spend their time at work seeking information to score a potentially lucrative award. Additionally, corporations should be weary of disciplined or discharged employees looking to "get even" with the corporation. Either scenario can ignite a chain of events that benefits neither business nor government.

To counter this "lottery mentality," both the government and corporations will need to increase the time and resources spent on investigating these potentially frivolous claims. Prosecutors, law enforcement officers, and government regulators will now be wading through baseless claims to separate the good from the bad. Likewise, businesses will be forced to incur tremendous legal and operational costs to both restructure their corporate compliance programs and defend themselves against such claims, not to mention the far greater costs associated with damages to their reputation. In the current economic climate, devoting precious resources to combating these claims could be fatal to struggling companies. As an added incentive, Dodd-Frank's whistleblower amendments appear to afford *greater* legal protections to employees who make direct complaints to the government, as opposed to those who first bring their concerns to the company's compliance team.

To prevent whistleblower reports to the federal government, companies may now be compelled to win the "race to the government's door." Upon discovering corporate corruption, management may be forced to immediately report the suspected misconduct to government authorities, without the

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benefit of at least a cursory internal inquiry to better assess the relevant facts and circumstances.

IV. Proposed Solutions: The Time Is Now

Dodd-Frank has the unintended effect of depriving corporations of invaluable employee sources of information required to support robust and viable internal compliance programs. To protect the integrity of these programs, businesses can proactively respond to Dodd-Frank with detailed policy suggestions and internal corrective measures to address and mitigate the Act's most negative consequences. Corporations can soften the blow of Dodd-Frank by suggesting to Congress the implementation of requirements for simultaneous disclosure clauses in employment contracts and compliance policies. This will ensure that even if an errant whistleblower passes information along to the government, the company could continue to reap the benefits of employees using its own internal reporting systems. Moreover, at this critical juncture, government regulators are presented with an opportunity to mitigate the adverse consequences that Dodd-Frank's whistleblower bounty provisions have imposed on internal compliance policies. The SEC, for example, could design rules for administration of the whistleblower program that remain faithful to the enviable goals of Dodd-Frank, but preserve the essential components of internal corporate compliance programs that the federal government itself has long recognized as being an integral part of responsible and effective corporate self-governance.

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[1] 15 U.S.C. § 78u-1(e) (2006).

[2] *See id.*

[3] *See, e.g.*, U.S. Sec. & Exch. Comm'n, Litig. Release No. 21601, SEC Awards $1 Million for Information Provided in Insider Trading Case (Jul. 23, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21601.htm (last visited Nov. 11, 2010); *see also id.*, Office of Inspector General, Report No. 474, Assessment of the SEC's Bounty Program, at 4 (Mar. 29, 2010).

[4] Securities Exchange Act of 1934, *as amended by* Pub. L. No. 111-203 § 922(a) ("Dodd-Frank"), § 21F(a)(3)(A) (emphasis added).

[5] *See id.*, *as amended by* Dodd-Frank, at § 21F(a)(5).

[6] *Id.*, *as amended by* Dodd-Frank, at § 21F(h)(1)(C).

[7] *See id.*, *as amended by* Dodd-Frank, at § 21F(g), *et seq.*

[8] *Id.*, *as amended by* Dodd-Frank, at § 21F(c).

[9] "[T]he prospect of significant prison sentences should make clear to every corporate executive, every board member, and every sales agent that we will seek to hold you personally accountable for FCPA violations." Lanny Breuer, Speech to the 22nd National Forum on the Foreign Corrupt Practices Act, Nov. 17, 2009, *available at* http://online.wsj.com/public/resources/documents/111709breuerremarks.pdf (last visited Dec. 9, 2010).

[10] On January 18, 2010, federal agents arrested twenty-two executives and employees of companies in the law enforcement and military equipment industries for alleged FCPA violations, in the first-ever DOJ foreign bribery investigation using undercover federal agents. *See* "Twenty-Two Executives and Employees of Military and Law Enforcement Product Companies Charged in Foreign Bribery Scheme." Department of Justice, Office of Public Affairs. Jan. 19, 2010, *available at* http://www.justice.gov/opa/pr/2010/January/10-crm-048.html (last visited Dec. 9, 2010).

[11] *See* Howard W. Goldstein & Lisa H. Bebchick, *U.K. Extraditions Facilitate Corruption Prosecutions*, N.Y.L.J. 243:86, May 6, 2010.

[12] Securities Exchange Act of 1934, *as amended by* Dodd-Frank § 922(a), § 21F(a)(3)(A).

[13] *See, e.g.*, U.S. Sentencing Commission, *Federal Sentencing Guidelines Manual* ("Sentencing Guidelines"), § 8C2.5(f) (Nov. 2010).

[14] *Id.* §§ 8C2.5(g); 8B2.1(b)(5)(C).

[15] *Id.* § 8B2.1(b)(5)(C).

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