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Whistle-Blowers, Dodd-Frank and the FCPA: The Perfect 'Anti-Competitive' Storm for U.S. Businesses

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Through the new financial reform legislation, corporate whistle-blowers have been offered an enticing financial bounty designed to encourage them to directly report their employers' unlawful conduct to the federal government. Unsurprisingly, violations of the Foreign Corrupt Practices Act are among those offenses that can net potential whistle-blowers a sizable windfall. The reforms also provide whistle-blowers with unprecedented protections against employer retaliation under federal law, including reinstatement, receipt of double back pay and entitlement to litigation costs.

While some may view this brave new regime as a positive milestone in the government's ongoing efforts to combat white-collar crime, it is rife with potential for abuse.

This article challenges the wisdom behind the whistle-blower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act by

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identifying three key drawbacks that belie this ill-conceived legislation. First, by conditioning whistle-blowers' rewards upon the receipt of "original information," the Dodd-Frank gives employees a strong financial incentive to bypass their companies' internal reporting systems and directly report FCPA violations to federal law enforcement. This severely undermines the viability of existing corporate compliance programs and runs counter to long-established goals of federal enforcement policy, depriving companies of critical sources of internal intelligence that are necessary to implement corrective measures.

Second, the whistle-blower provisions unduly promote a "lottery mentality" where employees may be tempted to flood regulators with formal complaints based on weak or wholly inadequate grounds, all in the hopes of "striking it rich."

Finally, the provisions will rub salt into the wounds of companies that are already reeling from the effects of the "Great Recession," forcing them to incur inordinate legal and operational expenses to defend against a speculative onslaught of mostly frivolous, but serious accusations. There is a "perfect storm" brewing on the near-term economic horizon for all U.S. companies, especially those that conduct business abroad.

AN OVERVIEW OF DODD-FRANK'S WHISTLE-BLOWER PROVISIONS

Although government bounties for whistle-blowers are nothing new, Dodd-Frank has substantially altered the legal landscape by strengthening both the scope and vitality of the previously existing program. Prior to Dodd-Frank, a rarely used whistle-blower bounty program existed under Section 21A(e) of the Securities Exchange Act of 1934, as amended by the Insider Trading and Securities Fraud Enforcement Act of 1988. This program authorized the SEC to award no more than 10 percent of recovered penalties "to the person or persons who provide information leading to the imposition of such penalty."(1)

Yet, unlike under Dodd-Frank, the reward is completely discretionary and, only whistle-blowers in insider-trading cases stood to benefit from this program.(2) To date, the Securities and Exchange Commission has paid only $1.6 million in awards pursuant to this bounty program, and $1 million of that amount was authorized shortly before Dodd- Frank became law last July.(3)

Dodd-Frank retools this existing whistle-blower bounty program in three important ways. First, it increases both the amount and the likelihood of monetary rewards for whistle-blowers by *guaranteeing* them a 10 percent to 30 percent share of any monetary sanctions over $1 million, 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 whistle-blower."(4) These payouts are likely to be immense, given the astronomical sums that such sanctions normally demand, and multiple people may jointly provide information and be eligible for a reward.

Second, Dodd-Frank broadens the scope of a bounty program's coverage beyond insider trading, authorizing awards for those who 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)

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The Drawbacks of Dodd-Frank

- Whistle-blowers' rewards are conditioned upon the receipt of "original information," so employees have strong financial incentive to bypass their companies' internal reporting systems and directly report FCPA violations to federal law enforcement.

- It promotes a "lottery mentality" where employees may be tempted to flood regulators with formal complaints based on weak or wholly inadequate grounds, all in the hopes of "striking it rich."

- Companies will be forced to incur inordinate legal and operational expenses to defend against a speculative onslaught of mostly frivolous, but serious, accusations.

Finally, it provides whistle-blowers 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)

Dodd-Frank also created the Securities and Exchange Commission Investor Protection Fund, from which all bounty payments will be made. The fund 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 whistle-blower's bounty is determined with reference to three explicitly stated factors:

- "The significance of the information provided by the whistle-blower."
- "The degree of assistance provided by the whistle-blower" in the relevant enforcement action.
- "The programmatic interest of the commission in deterring violations of the securities laws by making awards to whistle-blowers."(8)

Dodd-Frank's expansion of the existing SEC whistle-blower bounty program will be codified as the new Section 21F to the Securities Exchange Act of 1934.

THE 'ORIGINAL INFORMATION' REQUIREMENT: A THREAT TO INTERNAL COMPLIANCE

Under Dodd-Frank, whistle-blowers cannot collect a reward unless they *directly* provide the government with "original information" not already known to the enforcement agency from another source.(9) Incidentally, voicing one's concerns through the company's internal compliance system or ethics hotline will run the risk that management may decide to voluntarily report the matter to a government enforcement agency. This makes the whistle-blower's information "unoriginal" and deprives her 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 directly report FCPA violations to the U.S. Department of Justice.

This perverse incentive to involve federal regulators and law enforcement in the first steps of the reporting process threatens to seriously undermine the continued viability of existing internal corporate compliance systems and ethics mechanisms. It also stands in stark contrast to the federal government's own long-established legislative and public policy goals in this arena.

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Companies large and small devote extensive money and manpower 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 misconduct and promptly implement remedial measures.

Dodd-Frank threatens these efforts by dangling the prospect of multimillion-dollar bounties that can be secured only by employees who deliberately bypass their company's internal compliance mechanisms. This deprives businesses of the critical sources of internal intelligence needed to institute corrective measures from within.

Moreover, through its own criminal sentencing guidelines and administrative agency regulations, the federal government has long urged corporations to implement their own internal compliance programs and voluntarily disclose suspected misconduct in exchange for mitigating or avoiding potentially harsh penalties for white-collar crime.(10) The enviable goal is to promote a sustainable structure of corporate self-governance that keeps government intrusion into internal corporate affairs at an acceptable minimum.

Violations of the Foreign Corrupt Practices Act are among those offenses that can net potential whistle-blowers a sizable windfall under Dodd-Frank.

Under the current federal sentencing guidelines, for example, the government has provided strong incentives for corporations to implement internal compliance programs and report suspected violations to appropriate government regulators. In the event that they are prosecuted for such violations, organizational defendants 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.(11) By having an effective internal compliance program that promotes self-reporting, a company can decrease its criminal culpability under the sentencing guidelines and receive more lenient sanctions.

The whistle-blower bounty program is rife with potential for abuse.

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."(12)

Furthermore, Dodd-Frank appears to affirmatively *remove* an employee's incentive to help her company cooperate with regulatory authorities. Because whistle-blower rewards are mechanically set as a percentage of a corporation's total monetary penalty, facilitating the company's cooperation with government investigators can actually lead to a decrease in the sanctions imposed, thereby diminishing the whistle-blower's award in the process. This is another self-defeating incentive.

U.S. companies, especially those that conduct business abroad, have implemented internal compliance programs at great effort and expense. These critical systems are sustained by their employees' voluntary disclosure of information about potential misconduct to the company through confidential internal reporting systems. Since companies can only remedy problems that they know about, Dodd-Frank's whistle-blower bounty program poses serious threats to the continued viability and effectiveness of their internal reporting systems.

Consequently, the law's whistle-blower provisions obviate the government's long-standing policy to create a sustainable system of corporate self-governance and to foster a positive culture of legal and ethical compliance

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from within a company's walls. By misaligning the monetary incentives for potential whistle-blowers, Dodd- Frank paradoxically undermines the same internal compliance programs in which companies have made significant monetary investments, consistent with long-standing government mandates and expectations for proper conduct of corporate affairs.

'LOTTERY MENTALITY': THE HIGH COST OF PERVERSE INCENTIVES

Dodd-Frank's whistle-blower provisions can also give rise to a "lottery mentality" that transforms a company's own employees into bounty hunters. It gives employees a reason to be constantly on the prowl for the potential of scoring an elusive but lucrative award. For example, certain invidious characters may be tempted to file a torrent of complaints based on flimsy or completely frivolous grounds, all in hopes of striking gold with one plausible complaint. Disgruntled employees who have been disciplined or discharged may also use the promise of a bounty in an effort to "get even" with the corporation. These undesirable possibilities can ignite a chain of events that benefits neither business nor government.

Prosecutors, law enforcement officers and government regulators will need to devote precious time and resources to investigating these potentially frivolous claims. Likewise, businesses will be forced to incur tremendous legal and operational costs to defend themselves against such claims, not to mention the far greater costs associated with reputational damage. While this will certainly benefit lawyers — defense attorneys will see a rise in business while prosecutors will be aggressively courted by the businesses they are now investigating — the damage, especially to businesses that are struggling in this harsh economic climate, will be significant, if not fatal.

Moreover, internal corporate investigations of FCPA violations will never be the same, with a bevy of eager, lurking whistle-blowers attempting to sponge information from the investigation and then recasting, packaging and selling it as "original information" to hungry government prosecutors and investigators in order to cash in their chips at the Justice Department's dealer table. To add more fuel to this vicious cycle, Dodd-Frank's whistle-blower 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.

As a result, companies may be compelled to win the "race to the government's door" to preemptively combat frivolous whistle-blower complaints. Upon discovering signs of internal wrongdoing, management may be forced to immediately report the suspected misconduct to government authorities, without the benefit of at least a cursory internal inquiry to better assess the relevant facts and circumstances. Consequently, the Dodd-Frank whistle-blower provisions drain the resources of corporate America, as well as those of government regulators who are bound by law to investigate and scrutinize each and every complaint.

PROPOSED SOLUTIONS

Our legislators should not have deprived corporations of invaluable employee sources of information that are needed 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 law's most negative consequences. These could include implementing

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The Dodd-Frank whistle-blower bounty program

- Guarantees whistle-blowers a 10 percent to 30 percent share of any monetary sanctions over $1 million.

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- Authorizes awards for people who provide information in connection with enforcement actions brought under a wide array of "covered judicial or administrative action[s]" and "related actions."
- Gives whistle-blowers enhanced protection against employer retaliation, entitling them to reinstatement, double back pay and litigation costs

requirements for simultaneous disclosure clauses in employment contracts and compliance policies so that even if an errant whistle-blower disseminates information to the government, the company could continue to reap the benefits of employees' using its own internal reporting system.

At this critical juncture, government regulators are presented with an opportunity to mitigate the adverse consequences on internal corporate compliance policies that Dodd-Frank's whistle-blower bounty provisions have imposed. The SEC, for example, could design rules for administration of the whistle-blower 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.

NOTES

1 15 U.S.C. § 78u-1(e) (2006).

2 *See id*.

3 *See, e.g.,* Litigation Release No. 21601, SEC, SEC Awards $1 Million for Information Provided in Insider Trading Case (July 23, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/ lr21601.htm; *see also id.*, SEC, Office of Inspector Gen., Report No. 474, Assessment of the SEC's Bounty Program4 (Mar. 29, 2010).

4 Securities Exchange Act of 1934, as amended by Dodd-Frank, Pub. L. No. 11-203 § 922(a), § 21F(a)(3)(A).

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

10 *See, e.g.*, U.S. Sentencing Comm'n, Federal Sentencing Guidelines Manual, § 8C2.5(f) (November 2010).

11 *Id.* at §§ 8C2.5(g), 8B2.1(b)(5)(C).

12 *Id.* at § 8B2.1(b)(5)(C).

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