

Client Alert

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Enhanced Whistleblower Incentives in Dodd-Frank Act Create Enhanced Risks for Public Companies

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 922 of the Dodd-Frank Act greatly increases incentives for whistleblowers to provide information to the U.S. Securities and Exchange Commission ("SEC"). These incentives, particularly when combined with recent SEC reorganization initiatives, significantly enhance public companies' risk of becoming a target of an SEC investigation, and justify fresh scrutiny of compliance programs.

In brief, the significant changes of which companies should be aware are as follows:

- Whistleblower bounties are now available for all securities law violations, including violations of the Foreign Corrupt Practices Act, with bounties increased to between 10-30% of the government's total recovery;
- Whistleblower protections have been significantly enhanced;
- These provisions coincide with SEC reforms to its processes for screening and tracking investigation of whistleblower tips to avoid another Madoff scandal; and
- The SEC will have a continuing duty to report to Congress on the effectiveness of the whistleblower program, which will in turn increase the incentive to follow through and show results.

Prior securities whistleblower incentives were limited

Previously, federal securities laws provided little financial incentive for whistleblowers to come forward to the SEC. Bounties for actionable information could be awarded only in insider trading cases (not any other securities violation, such as accounting misstatements or internal controls deficiencies); the bounty could not exceed 10% of the civil penalties recovered; and the SEC had sole, unreviewable discretion on whether and how much to award. As a result, very little use was made of these provisions. An SEC Inspector General report in early 2010 found that since 1989, only \$159,537 had been awarded under the SEC's whistleblower bounty program, to five people.

While the Sarbanes-Oxley Act of 2002 contained whistleblower provisions, these provisions only provided defensive protections to whistleblowers and did not contain any financial incentives for a person with information to come forward.

Related SEC Reforms

Enhancing whistleblower incentives for securities law violations, and improving the SEC's responsiveness to such whistleblowers were both strongly recommended in Congressional hearings and Inspector General reports following Bernard L. Madoff's multi-billion dollar Ponzi scheme. Although the SEC had been given detailed tips for years before the scheme imploded in December 2008, its failure to detect the wrongdoing was met with strong criticism by Congress. Consequently, the SEC has undergone a top-to-bottom reorganization aimed at increasing the speed and effectiveness of investigations and enforcement actions. As part of this reform, the SEC authorized a comprehensive outside review of its procedures for handling the hundreds of thousands of tips it receives every year, and created a new unit—the Office of Market Intelligence—to screen tips for investigation by other SEC units, and to ensure those units conduct appropriate investigation. This reorganization may help position the SEC to effectively take advantage of the whistleblower provisions of Section 922 of the Dodd-Frank Act.

The whistleblower provisions of the Dodd-Frank Act

Section 922 greatly expands the incentives for whistleblowers to report violations of federal securities laws, as well as providing other significant protections and reporting provisions.

Expansion of violations eligible for awards. The range of eligible violations has been expanded from insider trading cases to “any judicial or administrative action brought by the Commission under the securities laws,” so long as the resulting monetary sanctions exceed \$1,000,000. This broad scope includes everything from securities fraud cases to violations of the Foreign Corrupt Practices Act (“FCPA”), including violations of the FCPA's internal accounting controls and books and records provisions, which apply whether or not any improper payment was ever made or proven.

Increase in the size of the award. The amount of the potential whistleblower award has been increased from a maximum of 10% to a *minimum* of 10%, and a maximum of 30%, the exact percentage to be decided based on the value of the information, the cooperation of the whistleblower, and other relevant factors. Significantly, this enhanced percentage is now applied to all monetary sanctions collected, both in the SEC's action and in “related actions.” Related actions include actions brought by the Department of Justice, by self-regulatory organizations such as stock exchanges, and criminal actions brought by state attorneys general. Awards are payable out of the SEC Investor Protection Fund, which in general is funded by monetary sanctions collected by the SEC.

Judicial review of SEC decisions regarding awards. The Commission's decisions “on whether, to whom, or in what amount to make an award” may now be judicially reviewed, except that decisions as to amount may only be judicially reviewed if the award is outside the 10-30% range.

Anonymous reports. The Act permits reports to be made anonymously through an attorney and prohibits the SEC from disclosing the identity of the whistleblower

prior to payment of the award, unless and until required to be disclosed to a defendant or respondent in a public proceeding instituted by the SEC, another agency or governmental authority, an SRO or the PCAOB.

Whistleblower protection. The Dodd-Frank Act also strengthens anti-retaliation protections for whistleblowers, going beyond the Sarbanes-Oxley Act of 2002 in several ways, including a provision for a private retaliation remedy with double damages and federal jury trial rights that is unwaivable even in the case of a pre-dispute arbitration agreement.

Reports to Congress. The Act also requires the SEC to report annually to Congress on its administration of the whistleblower program, and requires the SEC's Inspector General to provide a report within 30 months on the effectiveness of the whistleblower program. This report must include such topics as the Commission's effective publicizing of the whistleblower program, its promptness in responding to whistleblower tips, whether the Act's reward levels are adequate or too high, and whether it would be useful to provide a private right of action to whistleblowers and others to pursue securities fraud claims on behalf of the U.S. Government in the event the SEC declines to pursue a case (similar to the False Claims Act).

Likely impact of these developments

The Dodd-Frank Act whistleblower incentives would likely have a significant impact standing alone. Within the past month, the government has reported several FCPA settlements with combined SEC and DOJ monetary sanctions of well over \$200 million. The Dodd-Frank Act would provide a *minimum* bounty of over \$20 million to a whistleblower who reported such a case—a powerful incentive to come forward.

The Act's large financial incentives will be particularly effective given the whistleblower protections in the Act, the ongoing reform at the SEC focused on improving responsiveness to whistleblowers, and the Act's annual whistleblower program reporting requirements, which will keep pressure on the SEC to effectively execute these provisions. There is therefore a strong likelihood that the SEC will see more tips from public company insiders, and that the staff will take at least some investigative action on those tips.

Incentivizing public company employees to come forward with tips will significantly aid the SEC's fraud and FCPA enforcement initiatives. Fraud and FCPA cases are notoriously difficult for the government to uncover absent tips from internal sources. For example, violations of the FCPA typically involve covert conduct in far-flung jurisdictions, with problematic transactions often immaterial for purposes of group audits and papered over with false justifications. Section 922 makes it more likely that whistleblowers who have information about potential violations of the FCPA will come forward, expanding the whistleblower class to include purely profit-seeking insiders, and therefore makes it more likely that the government will learn of and successfully investigate such violations.

Practical considerations

Given these developments and the corresponding risks, public companies should reassess certain key aspects of compliance, specifically, the following:

- Proactive compliance measures such as risk assessment and auditing;
- Internal whistleblower processes;
- Compliance incentives;
- Internal investigation procedures; and
- Self-reporting of violations.

Compliance systems should rely less heavily on passive information-gathering systems such as employee hotlines, and more heavily on proactive risk assessment, monitoring and auditing. Employees who might previously have filed an internal complaint now have a financial incentive (and greater whistleblower protections) if they instead go directly to the SEC.

Internal whistleblower programs should be staffed and supported to ensure that all complaints are properly reviewed by appropriate personnel. Although there is no one-size-fits-all approach to handling complaints, and indeed the privacy laws in certain jurisdictions require different approaches to employee hotlines, establishing a process to handle and reasonably investigate these complaints will demonstrate that a company's response was reasonable and in line with the requirements of the U.S. Attorney Manual, the Federal Sentencing Guidelines' definition of an "effective compliance person" and the SEC Enforcement Manual.

Companies should consider the incentives they offer employees to enhance their compliance culture. Numerous authoritative government sources list such employee incentives and disincentives to noncompliant behavior, as one of the main pillars of a corporate compliance system. Although anonymous complaints should still be permitted wherever possible, the abundance of government whistleblower incentive programs indicates that the government could hardly object to a company's decision to provide incentives for attributable internal reporting of potential securities law violations.

It is also recommended that companies review their internal investigation processes to ensure that best practices, from the retention of documents to the staffing of qualified independent investigators, are maintained as there is increased risk of government review of those processes.

Even if only a minor violation is detected, companies may wish to self-report to the government where previously they would not have. Although the incentives for self-reporting remain debatable, depending on the circumstances, there may be a significantly enhanced risk of the violation being reported by a whistleblower.

By enhancing whistleblower incentives and protections at the same time that the SEC is still recovering from its missteps from the Madoff scandal, the Dodd-Frank Act will likely result in enhanced SEC investigative activity, for which preparation is well-advised.

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