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The SEC's New Whistleblower Rules: Now What?

The changes made by the Securities and Exchange Commission to the whistleblower rules, as required by the Dodd-Frank Act, have garnered a great deal of attention from the corporate community. The pressing concern for companies and their audit committees is whether the new rules will undermine their internal compliance programs. How potential violations are reported, the availability and flow of crucial information and the ability to conduct efficient and timely internal investigations are all open questions as the new rules are put into practice.

A summary of the new rules is presented below along with key action steps that management and boards of directors should consider in response. At the board level, members of the audit committee should:

- Receive a detailed report from management on the action steps that will be taken to address the new rules and ensure that the internal compliance and reporting programs of the company are current and effective.
- Receive regular progress reports from management.
- Ensure that the audit committee's oversight of internal reporting of accounting and auditing issues mandated by the Sarbanes- Oxley Act is handled appropriately in the context of the broader Dodd-Frank whistleblower rules.

The Rule

Section 922 of the Dodd-Frank Act requires that the SEC adopt rules that encourage persons, through financial incentives, to report possible federal securities law violations to the SEC. After much back and forth with the business community, the plaintiffs' bar, the media and internally, the SEC adopted final rules on May 25th 2011.

In short, a whistleblower who voluntarily provides the SEC with original information that leads to a successful enforcement action that results in monetary sanctions of more than $1 million arising out of the same core facts is eligible for an award of 10% to 30% of the amounts recovered. The SEC's 300+ page adopting release goes into great detail regarding the many nuances of the rule. For example, the release defines "whistleblower," "voluntarily," "original information" and "action." It describes what is meant by information leading to a successful enforcement action, what kind of awards are included in the $1 million calculation and the persons excluded from eligibility to receive an award, such as compliance personnel, attorneys and outside accountants. The release also describes the enhanced employee anti-retaliation protections contained in the final rules.

A particularly contentious issue during the rulemaking process was the extent to which the new rules would discourage employees from utilizing a company's existing internal reporting procedures. Companies are understandably concerned that their employees will ignore internal reporting processes and go directly to the SEC with exaggerated claims or imagined

wrongdoing in hopes of tapping the whistleblower award vein. Most companies believe, and we agree, that utilizing an effective internal reporting process enables the company to minimize frivolous claims and discretely address claims with actual substance.

The SEC rejected calls to require that whistleblowers first use the internal process before reporting to the SEC. However, the rules attempt to mitigate this concern by providing that the amount of any award can be increased or decreased (within the 10% to 30% parameters) in the SEC's discretion depending on whether the whistleblower first participated in the company's internal reporting system and assisted with any internal investigation.

The Response

A natural first reaction to the rules would be to ignore them and hope that the whole thing blows over. After all, unlike many of the other Dodd-Frank provisions and related rulemaking, the whistleblower rules do not require affirmative action by public companies.

Unfortunately, that is exactly the wrong approach. Companies cannot simply assume that their employees either will not hear about the rules or, if they do, will be overwhelmed by their complexity or simply forget about them over time. The reality is that employees likely will be reminded of the award opportunities by plaintiffs' lawyers who earn fees by recruiting or encouraging whistleblower clients. Television commercials, other advertisements and websites from plaintiffs' lawyers are already touting their ability to navigate the SEC's reporting process and obtain large awards. Less sophisticated employees may see this as the equivalent of a lottery—the odds may be long, but the potential payoff is huge, particularly since there is anti-retaliation protection. In fact, the SEC, which expects to receive 30,000 tips per year, has formed an Office of the Whistleblower to handle the anticipated deluge of reports.

Proactive Communication. Companies should instead be proactive. They will be better served to get out in front of this development and manage the tone and content of information
that employees receive. This is also a perfect opportunity to reinforce a culture of compliance from top to bottom. Companies should communicate with their employees to encourage the use of internal reporting processes. In addition, creative communication is key. Companies should use newsletters, regular employee meetings, workplace posters or other techniques and communication channels that already exist and are proven to be effective.

Some companies may choose to include in their communication a reference to the new whistleblower rules and specific reasons why it is more advantageous to the employee to utilize internal reporting. This type of communication could be the most effective way to make a case for internal reporting and protect against the concerns described above. However, we believe that this level of communication, particularly initially, is somewhat aggressive and best used by companies that are particularly concerned about the prospects of SEC whistleblowing, perhaps due to prior wrongdoings within the company, a history of frequent internal reporting or the nature of their industry.

Update the Internal Reporting Process. Companies should have multiple reporting methods because the circumstances under which a report may be made are so varied. For example, many employees are uncomfortable leaving a message on a hotline or directly contacting a designated Ethics Officer. Companies should allow employees to report to a designated supervisor within their department or division and add an anonymous email or website as

alternatives. Companies with international operations should offer appropriate language alternatives and be cognizant of time zone differences. Foreign nationals are eligible to receive awards, and plaintiffs' firms have already started targeting this audience. The Code of Conduct should correctly describe the process and convey the desired tone.

Personnel Training. It is critical that managers be trained to be receptive to employee concerns, recognize an internal report and know how to react. Their initial reaction to the employee is critical to setting a positive tone and discouraging external reporting. Employees should not be made to feel that they are imposing on their superiors or being disloyal to the company by making a report. Managers also must understand not only the legal retaliation prohibitions, but also how to avoid even the hint of retaliatory conduct, and must be trained to promptly communicate the report up through proper channels.

Investigative Process. Once a report has been received and properly communicated, management must be prepared to evaluate whether the report warrants an investigation and, if so, the nature and scope of the investigation. There are many sensitive questions to be addressed at this stage regarding who should conduct the investigation, attorney/client privileges, whether the board of directors should be informed, whether public disclosures are required, and the like. Having an investigation plan or protocol in place is essential for the quick evaluation of these issues. The new rules state that if a whistleblower reports to the SEC no later than 120 days following his initial internal report to the company, then the date of his SEC report is deemed to be the date of that initial internal report. Therefore, it is critical to complete or at least significantly advance an investigation well within the 120-day period so that the employee is not compelled to report to the SEC to maintain "first in line" status.

Report Back to the Whistleblower. Finally, employees should receive a final report regarding the process that was followed to consider their report, the decision that was made and the reasoning behind the course of action chosen. The report need not be formal or written, although the nature and content of the communication should be documented. Many employees just want to be heard and taken seriously. They should not be left in the dark, wondering if their report disappeared into a corporate black hole.

Conclusion

To minimize any adverse impact from the new whistleblower rules, companies should assess and, in many cases, proactively and creatively expand compliance communication and training to encourage internal reporting. Boards of directors and audit committees can mitigate the risks associated with the new rules by actively monitoring current modifications to their internal reporting processes as well as critically evaluating their efficiency and efficacy going forward.