

## Reconsidering SOX whistleblower compliance programs in light of the Dodd-Frank bounty program

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Apr 19 2011 Fred Rivera

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The Dodd-Frank Act, known officially as the Wall Street Reform and Consumer Protection Act, includes a rich whistleblower bounty program that rewards individuals who provide information leading to a successful Securities and Exchange Commission enforcement action. While this may help the SEC achieve its goal of using whistleblower tips as an important tool in its enforcement program, the transparent financial incentives created by Dodd-Frank will without doubt disincentivize many employees from reporting their concerns through an *internal* reporting process that allows companies to promptly handle issues that may be very important for the company to know about. The SEC wants tips, is willing to pay for it and appears unconcerned about the bounty program's impact on corporate whistleblower compliance programs.

How quickly Congress forgot about the whistleblower and corporate compliance provisions included in the Sarbanes-Oxley Act of 2002 (SOX). Under SOX, Congress mandated that public companies design and implement robust whistleblower compliance programs aimed at promoting the internal reporting of complaints about fraud, accounting violations and similar conduct. Once reported, SOX requires prompt investigation and reporting to the board of directors, and (potentially) to outside auditors. SOX had a clear goal in mind: Companies must create an environment increasing the number of employee reports to an *internal* program able to promptly investigate and resolve matters, without resorting to government agencies for such resolution.

How are these two major compliance laws reconciled? And how should companies approach these competing interests -- one law trying to promote the external reporting of concerns to a government agency, the other encouraging internal reporting -- in connection with their corporate compliance and investigation programs? There are no easy answers to these questions; however, taking a "glass half full" view, the Dodd-Frank whistleblower provisions provide a new opportunity for companies to take a fresh look at their SOX whistleblower compliance program to ensure it is meeting a main objective -- encouraging the internal reporting of significant issues.

### **Overview of Dodd-Frank whistleblower provisions**

Dodd-Frank includes broad provisions aimed at increasing regulator enforcement and remedies. Subtitle B of the Act specifically provides additional powers and enforcement tools to the SEC, and Section 922, the whistleblower bounty program, requires the SEC to pay rewards to individuals who provide the agency with "original information" that leads to the successful enforcement of an SEC action resulting in monetary sanctions exceeding \$1m. Individuals providing such tips are eligible to receive a "bounty" of ten to 30 percent of the total penalties. Prior to Dodd-Frank, the SEC was only authorized to pay bounties on insider-trading cases, and only up to ten percent of the penalties collected in

the action. Without question, the Act dramatically expands the SEC's authority to compensate individuals who provide useful tips.

In February, the agency published proposed rules detailing the procedures whistleblowers must follow when providing information to the agency. The proposed rules include step-by-step information about how whistleblowers can qualify for and assert a claim for an award. The SEC has already funded its Investor Protection Fund, which will be used to pay bounties to eligible whistleblowers. And the Commission will soon finalize the specifics of its new Whistleblower Office, including the naming of a Whistleblower Coordinator to oversee the program.

The motivation of the Dodd-Frank whistleblower provision is clear: The SEC wants to be the first stop for the reporting of corporate malfeasance. Indeed, the program is closely aligned to SEC Chairman Mary Schapiro's strategy of using whistleblower tips as a key component of the agency's revamped enforcement following its failure to detect the Madoff scam despite the Commission's receipt of multiple, substantive tips from individuals familiar with Madoff's schemes.

### **SOX whistleblower provisions**

But let's flash back to 2002. In the wake of Enron and other corporate scandals, Congress passed the Sarbanes-Oxley Act. SOX included key provisions that, much like Dodd-Frank, sought to increase the number of whistleblower tips about improper corporate conduct. In addition to providing certain protections against retaliation for employees who cooperated in government investigations, section 806 of SOX includes significant protections for employees of public companies who make *internal* reports to their employer. Moreover, SOX requires that public companies create a complex infrastructure to handle whistleblower complaints, including the implementation of robust internal investigation and ethics functions. Hallmarks of the SOX whistleblower provisions include a requirement that companies provide a process that allows employees anonymously to communicate fraudulent or other inappropriate activity, and a procedure for boards of directors to receive, retain and treat complaints regarding accounting, internal accounting controls or auditing matters.

SOX spawned a cottage industry of compliance professionals retained to set up internal investigation, compliance and ethics programs aimed at complying with the letter and spirit of the new law, including procedures to handle internal complaints. These efforts were aimed at meeting three significant SOX whistleblower goals: creating a "safe place" for employees to raise complaints and concerns without fear of retribution, implementing a process to investigate those concerns promptly and effectively, and to hold boards of directors accountable for handling significant matters. Now ten years old, SOX has created an entrenched and important compliance structure in public companies.

### **The SEC's response**

Recognizing the inherent conflict between SOX and Dodd-Frank, the SEC recently proposed two rules in response to

corporate concerns. First, the SEC has proposed a 90-day reporting window. Under the rule, an employee who reports complaints to an internal compliance function remains eligible for the reward if the whistleblower believes that the company has failed to properly address the complaint within 90 days. This grace period may allow a company's internal compliance program to investigate and, if appropriate, resolve claims that have merit, while weeding out those that do not. Importantly, however, the proposed rule does not require that employees first report a complaint internally. Accordingly, the rule has no impact on those who intend to use the SEC bounty program as a lottery.

Second, the SEC proposes to consider as a factor when determining the amount of an award whether the whistleblower first reported the concern internally. The SEC will consider larger awards for whistleblowers who use internal reporting mechanisms before reporting to the agency. This proposal is an effort to incentivize internal reporting by increasing the potential award.

### **How should companies respond to the conflicting incentives?**

Nearly ten years after the passage of SOX, the whistleblower provisions included in Dodd-Frank create a new set of challenges that require public companies to review their internal compliance and ethics programs carefully. The SEC has become a competitor for the receipt of whistleblower tips. While SOX emphasizes the creation of a corporate infrastructure to handle and effectively resolve internal whistleblower tips, Dodd-Frank includes incentives for employees to ignore internal processes and go straight to the SEC.

Now, more than ever, is the time for companies to take a fresh look at their SOX whistleblower compliance programs.

1. **Increase efforts to ensure compliance.** With Dodd-Frank increasing the risks of government investigations, it is vitally important that companies make every effort to whistleblower claims in the first instance. Experience has proven that one of the most effective ways to achieve that goal is to create a corporate culture that promotes a "do the right thing" attitude. This includes ensuring that senior management creates a "tone at the top" that clearly articulates the company's zero tolerance policy for improper conduct of any kind. Similarly, companies should focus on the effectiveness of their legal and regulatory compliance programs relating to federal securities law matters to reduce the risk that employees will violate laws. Reducing the risk of violations, of course, is the best way to prevent legitimate whistleblower tips to government agencies.
2. **Ensure an effective and credible internal investigations program.** Even where a company's actions fully comply with the law, there remains risk that employees may develop concerns about potential misconduct, even if unjustified. Although employees may continue to raise these issues through an internal process, the Dodd-Frank bounty program will undoubtedly encourage some employees to report their concerns directly to the SEC in the first instance, while ignoring the internal process mandated by SOX. This could result in a costly, onerous and difficult investigation that may have been avoided and more promptly resolved if the employee had accessed the company's internal reporting and investigations processes.

In the post-Dodd-Frank environment, companies are wise to evaluate how they can encourage internal reporting of potentially improper conduct to compete with the SEC's bounty program. By having an effective internal reporting and investigation process, companies are more likely to be the first to learn of concerns about potential legal violations, rather than learning it for the first time through an SEC investigation notice. Simply put, if employees have confidence that the company will handle their concerns fairly, the more likely they are to first raise them internally, without resort to filing an external complaint.

3. **Supplement training for senior management.** Third, companies should consider supplementing management training programs to include information on recognizing corporate whistleblower complaints, identifying to whom complaints should be reported, and appropriately responding to any complaints received.
4. **Use internal audits to identify and promptly resolve potentially issues.** An effective internal audit function that finds problems before a whistleblower does is imperative. Moreover, once issues are identified, companies must then quickly and effectively address the problem.

The Dodd-Frank whistleblower program creates new challenges for companies. The handsome monetary awards available to SEC whistleblowers undoubtedly will have the intended effect of increasing external compliant reporting, while at the same time reducing the use of internal complaint processes mandated by SOX. This new dynamic requires that companies respond by reviewing their corporate compliance and SOX whistleblower programs to ensure it is effective in the face of the SEC's competing program.



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