

# New Whistleblower Rules Broaden

## Opportunities

The SEC has issued final rules to better encourage whistleblowers to report violations of securities laws. The rules also provide incentives for whistleblowers to first try using their organization's internal compliance system before involving the Commission.

When the Sarbanes-Oxley Act (SOX) was passed in 2002, it was expected that Section 806 of the Act, "Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud," would motivate employees to blow the whistle on employers who committed fraudulent activities. The thinking involved prohibiting discriminatory acts against an employee who provided information about fraudulent activities in connection with financial disclosures of a public company, thus making it safer for employees to come forward and report wrongdoing. Remedies under the law include reinstatement and back pay, but employers face no penalties.

Section 806 has been largely unsuccessful in protecting reporting employees from retaliatory acts. Because employees must meet a very high burden of proof in order to win their case, employers have successfully challenged in court virtually all claims filed. The

U.S. Department of Labor administers this portion of SOX, not the U.S. Securities & Exchange Commission (SEC). To remedy the shortcomings of SOX, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) passed in July 2010 enables cash motivations for whistleblowers who report violations of the securities laws. It also broadens the range of possible whistleblowers to include more than just employees.

After considering many public comments, the SEC just issued final rules effective August 2011 that enable it to pay substantial cash bounties to individuals who provide information about securities frauds. Awards to whistleblowers can range from 10% to 30% of the amount of monetary sanctions arising from SEC enforcement actions that result in more than \$1 million in penalties, interest, and disgorgement of ill-gotten gains. Information provided to the SEC must be a voluntary act, "original," and derived from the whistleblower's independent knowledge or analysis and not known to the SEC from any other source.

"For an agency with limited resources like the SEC, it is critical to be able to leverage the resources of people who may have first-

hand information about violations of the securities laws," SEC Chair Mary L. Schapiro said. "While the SEC has a history of receiving a high volume of tips and complaints, the quality of the tips we have received has been better since Dodd-Frank became law, and we expect this trend to continue."

One of the most troubling aspects of the whistleblower cash initiative in the Dodd-Frank Act was its perceived possible negative impact on public companies' internal compliance programs. Most large companies have instituted internal confidential reporting processes, or "hotlines," that comply with the mitigation provisions of the U.S. Sentencing Guidelines. People could choose to report wrongdoing to the SEC and obtain substantial cash rather than report internally and face possible reprisal. The final SEC rules don't include any explicit requirements that whistleblowers utilize internal reporting and compliance programs in order to be eligible for an award, but the rules do contain incentives to motivate whistleblowers to report to such systems when appropriate.

Incentives include providing for an increase in the amount awarded under the program when a



whistleblower voluntarily participates in an organization's internal compliance system and a decrease in such amount for any interference with the entity's system. Additionally, all of the information provided by an entity's investigation of an issue will be attributed to a whistleblower and thus possibly increase the amount of the resulting award if the entity fully reports information to the SEC that leads to a successful action. The adopting release notes that "internal compliance programs are not substitutes for rigorous law enforcement."

Of course, employees won't always have confidence that their employer will promptly self-report to the SEC any possibly incriminating information received via an internal hotline. Important to the success of internal ethics and compliance programs is sufficient oversight by a committee of independent directors and participation by the full board when necessary. A number of companies have assigned this responsibility to the audit committee.

Factors to be considered in determining the percentage of the total SEC sanctions that would be awarded to a whistleblower are (1) significance of the information provided by the whistleblower, (2) assistance provided by the whistleblower, (3) law enforcement interest in making a whistleblower award, and (4) participation by the whistleblower in internal compliance systems. Criteria that may decrease a whistleblower's award percentage are (1) culpability of the whistleblower, (2) unreasonable reporting delay by the whistleblower, and (3) interference with

internal compliance and reporting systems by the whistleblower.

For a whistleblower to be eligible for an award, the information provided must be sufficiently credible, specific, and timely to result in either an activation or reactivation of an SEC investigative process or "significantly contribute" to the success of an investigation already under way. Individuals already having a responsibility to report wrongdoing to the SEC are precluded from receiving monetary awards. Special provisions apply to reporting of information by either internal or external auditors.

Employees engaged in internal auditing or compliance processes and auditors engaged in an independent audit of the financial statements of a public company can be compensated as whistleblowers when:

- ◆ The whistleblower believes disclosure may prevent substantial injury to the financial interest or property of the entity or investors,
- ◆ The whistleblower believes that the entity is engaging in conduct that will impede an investigation, or
- ◆ At least 120 days have elapsed since the whistleblower reported the information to his or her supervisor or the entity's audit committee, chief legal officer, chief compliance officer—or at least 120 days have elapsed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people are already aware of the situation.

The SEC believes that these stated conditions are a high bar that

won't destroy the necessary open cooperation that every auditor requires in order to perform his or her job. The SEC's adopting release notes, "We believe it is in the public interest to accept whistleblower submissions and to reward whistleblowers—whether they are officers, directors, auditors, or similar responsible personnel—who give us information that allows us to take enforcement action to prevent substantial injury to the entity or to investors." For some time, independent auditors have had the duty to report illegal conduct encountered during an audit.

External auditors engaged in an independent audit may also receive an award for blowing the whistle on their firm, even if doing so would breach a duty of confidentiality to a client. Specifically, a footnote to the adopting release states that the SEC wasn't excluding any information that "is received in breach of state-law confidentiality requirements, such as those imposed on auditors, because to do so could inhibit important federal-law enforcement interests." Additional requirements deal with attorney-client privilege.

A whistleblower who provides information to the SEC is protected from employment retaliation if the person possesses a "reasonable belief" that the information he or she is providing relates to a "possible" securities law violation that has occurred, is ongoing, or is about to occur. It's unlawful for a company to interfere with a whistleblower's efforts to communicate with the SEC by, for example, threatening to enforce a confidentiality agreement.

The whistleblower protection

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## Ethics

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aspects are administered by the Occupational Safety & Health Administration (OSHA). A complaint of retaliation filed with OSHA must allege that the complainant engaged in protected activity, the respondent knew about that activity, the respondent subjected the complainant to an adverse action, and the protected activity motivated or contributed to the adverse action. Adverse action is generally defined as any action that would dissuade a reasonable employee from engaging in protected activity.

The SEC has established an Office of the Whistleblower and funded the Investor Protection Fund with \$451.9 million as of the end of the government's 2010 fiscal year. A Tips, Complaints, and Referrals (TCR) report can be accepted by the SEC. TCR information is made available throughout the agency using a new \$21 million TCR Database.

Tips and other inside information are the most important mechanism for detecting fraud. With all of the tools available, the SEC should be able to continue to bring significant cases of fraud to successful resolution. Ideally, their availability will act as a deterrent of additional fraud in the future. **SF**

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