



Legal Risk Management Tip September 2010

DEVELOPING INTERNAL REPORTING MECHANISMS IN THE WAKE OF THE WHISTLEBLOWER INCENTIVE PROGRAM

Most financial institutions today have developed some type of escalation process for internal reporting of inappropriate actions or potential securities law or ethical violations. Today, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act,¹ there are several provisions which provide for the creation of the SEC's own Whistleblower Incentives and Protection Program.² Substantial monetary rewards for employees, and others, are created by these provisions to incentivize reporting possible wrongdoing to outside regulators and law enforcement. Indeed, there already has been a surge of incoming tips to the SEC.³ This month, for example, a Connecticut hedge fund faces an FBI probe for allegedly committing fraud by overstating the value of some of its investments, which was brought to light because of a whistleblower's actions.⁴ Accordingly, it is important for firms to review and ensure their policies and procedures for internal reporting of possible wrongdoings are robust and encourage employees to come forward to address concerns at the company level.

This update will address the details of these bounty provisions and provide tips on how to establish channels of communication and compliance procedures to enable employees to report possible violations internally.

Overview of the "Bounty" Provisions

The whistleblower provisions are codified in Section 21F of the Securities Exchange Act of 1934.⁵ This section provides for the SEC to reward employees and others who voluntarily report "original information" that leads to a \$1 million or more recovery in any judicial or administrative action brought by the SEC under applicable securities laws.⁶ "Original information" is defined as information that is:

- Derived from the independent knowledge or analysis of the whistleblower,
- Is not known to the SEC from any other source, unless the whistleblower is the original source of the information; and

¹ Pub.L. 111-203, H.R. 4173 (hereinafter Dodd-Frank Act).

² See Dodd-Frank Act, §§748, 922 and 1057.

³ See Jessica Holzer and Fawn Johnson, Wall Street Journal, Larger Bounties Spur Surge in Fraud Tips, (Sept. 7, 2010), available at <http://online.wsj.com/article/SB10001424052748704855104575470080998966388.html>.

⁴ Katie Benner, Fortune, *Did Plainfield commit fraud? The FBI wants to know*, (Sept. 10, 2010), available at http://finance.fortune.cnn.com/2010/09/10/did-plainfield-commit-fraud-the-fbi-wants-to-know/?section=magazines_fortune.

⁵ The Dodd-Frank Act § 922(a), Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*

⁶ *Id.*

- Is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.⁷

If the information provided by the whistleblower results in “monetary sanctions” which exceed the \$1 million threshold, the whistleblower is entitled to “not less than 10 percent” and “not more than 30 percent” of the recovered amount.⁸ Monetary sanctions are defined broadly to include “any monies, including penalties, disgorgement, and interest.”⁹ The SEC has discretion over the amount of an award within the 10 to 30 percent range; however, the provision provides four guideposts for determining the percentage to which the whistleblower may be entitled:

1. The significance of the information provided by the whistleblower to the success of the covered judicial or administrative action;
2. The degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;
3. The programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that lead to the successful enforcement of such laws; and
4. Such additional relevant factors as the Commission may establish by rule or regulation.¹⁰

The provision also provides for the creation of a fund consisting of hundreds of millions of dollars to the pay bounties that whistleblowers may be entitled. It is also important to note that whistleblowers are defined as “any individual who provides, or two or more individuals acting jointly who provide, information relating to a violation of the securities laws to the SEC.”¹¹ Thus, whistleblowers may be employees *or* outsiders of the entity that they provide relevant information on.

If the whistleblower is an employee of the firm, the Dodd-Frank Act includes anti-retaliation provisions to protect these employees from the possibility of employer reprisals.¹² The anti-retaliation provision creates a private cause of action for employees wrongfully terminated, harassed, or disciplined because the whistleblower provided information to law enforcement or regulators. If the whistleblower is successful in their anti-retaliation suit against the employer, he or she may be reinstated to their position and be awarded twice the amount of back pay.¹³

While the general framework of the whistleblower program has been provided by the Dodd-Frank Act, the SEC is currently accepting comments on the regulations that will fill out the details of the program.¹⁴ The SEC’s regulations are due out no later than April 21, 2011.¹⁵

⁷ *Id.*

⁸ The Dodd-Frank Act § 922(b).

⁹ The Dodd-Frank Act § 922(a).

¹⁰ The Dodd-Frank Act § 922(c).

¹¹ The Securities Exchange Act of 1934, 15 U.S.C.A. 78a, §21F(a)(6).

¹² The Dodd-Frank Act §1057.

¹³ The Dodd-Frank Act § 922(a)(h)(1).

¹⁴ To submit comments on the SEC’s whistleblower regulations visit: <http://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml>

¹⁵ SEC Whistleblower Program *available at* <http://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml>

How Firms Can Avoid Running Afoul of New Whistleblower Rule

The following list provides some tips on how to build and maintain a robust compliance and reporting system to increase the likelihood that possible violations are reported early and internally.

- **Create an environment of compliance:** Through words and actions, make it plainly apparent that compliance with applicable securities laws is firmly embedded within firm culture. It should also be made clear that all reports of violations will be taken seriously and followed up on.
- **Continual training of employees on regulatory compliance:** Employees who conduct compliance should be continuously trained on the latest regulatory updates. Additionally, key employees who are responsible for assessing internally reported complaints should have the skills to calculate the merits of possible violations and how to resolve them.
- **Establish a reporting hotline:** A hotline for employees and outsiders to internally report any possible violations should be made available as an open line of communication for potential whistleblowers to make use of. Moreover, employees should be *encouraged*, not merely allowed to use the hotline to report possible violations. In light of the fact that whistleblowers can be either employees or outsiders, consider allowing third-parties to make use of a second hotline to report possible violations.
- **Maintain the confidence of those who report possible violations:** Given the anti-retaliation provisions, the source and content of internally received tips should be kept confidential. The anonymity of those providing tips should also be preserved if feasible.
- **Consult with counsel to determine the advisability of self-reporting discovered violations:** In the event that a material violation that cannot be remedied is discovered, an organization should consult with an attorney to determine the pros and cons of self-reporting the violation to the appropriate regulatory body. While self-reporting may not shield a firm completely, the SEC or other regulatory body looks favorably and may be more lenient on firms who self-report.

The firm's culture of compliance should encourage employees to come forward with concerns, which should be treated with the utmost of confidence. Through internal reviews, financial institutions will be able to detect if something is awry and address internal control gaps accordingly. Strong communications and training in this area is essential. Establishing the above internal control mechanisms may help to dispel fears of coming forward on sensitive compliance-related risks, which will allow the firm to address any potential issues and perhaps lessen the impact of potential whistleblowers.

For more information, or for assistance with the establishment of internal reporting mechanisms, please do not hesitate to contact us at (619) 298-2880 or e-mail info@jackolg.com.

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