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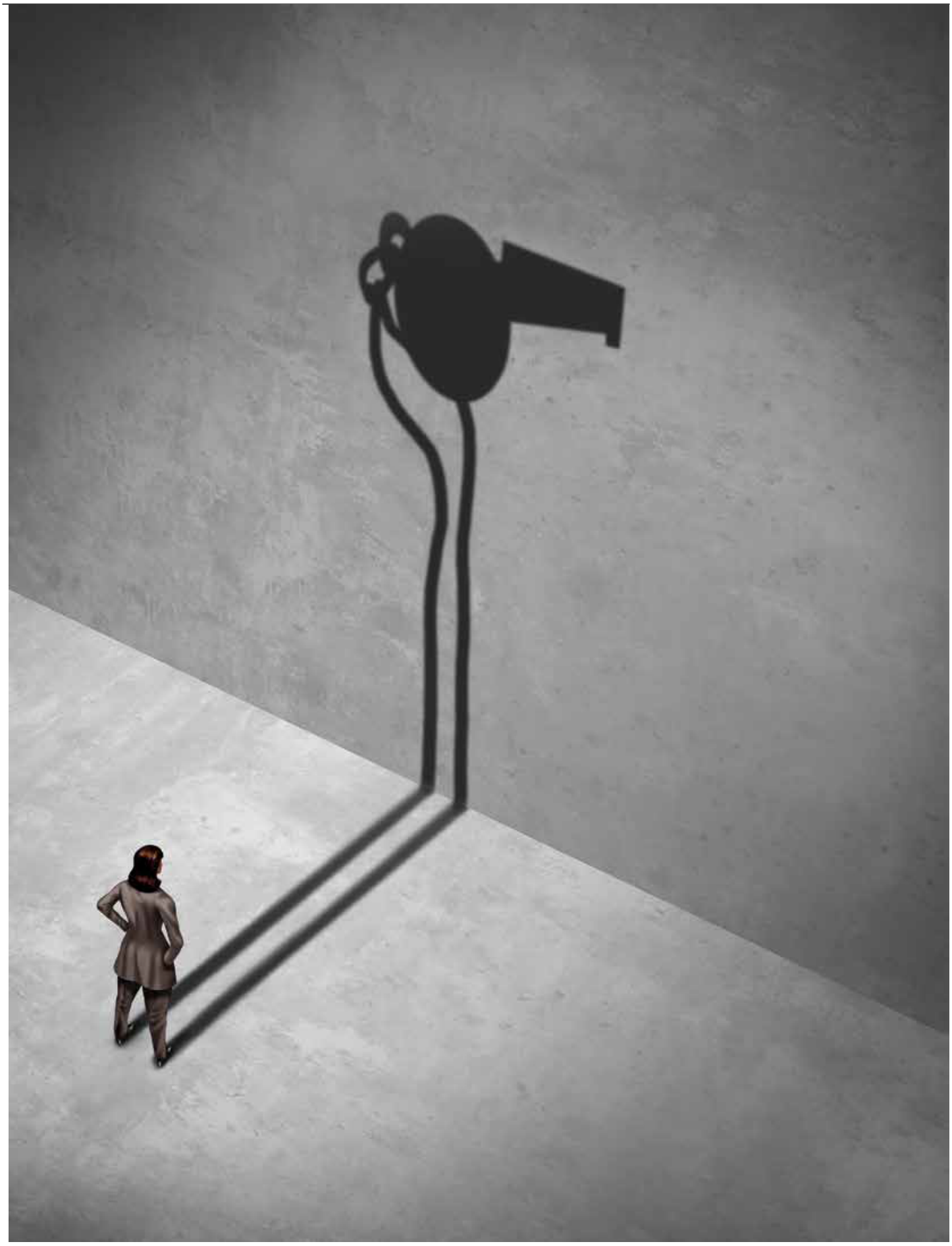
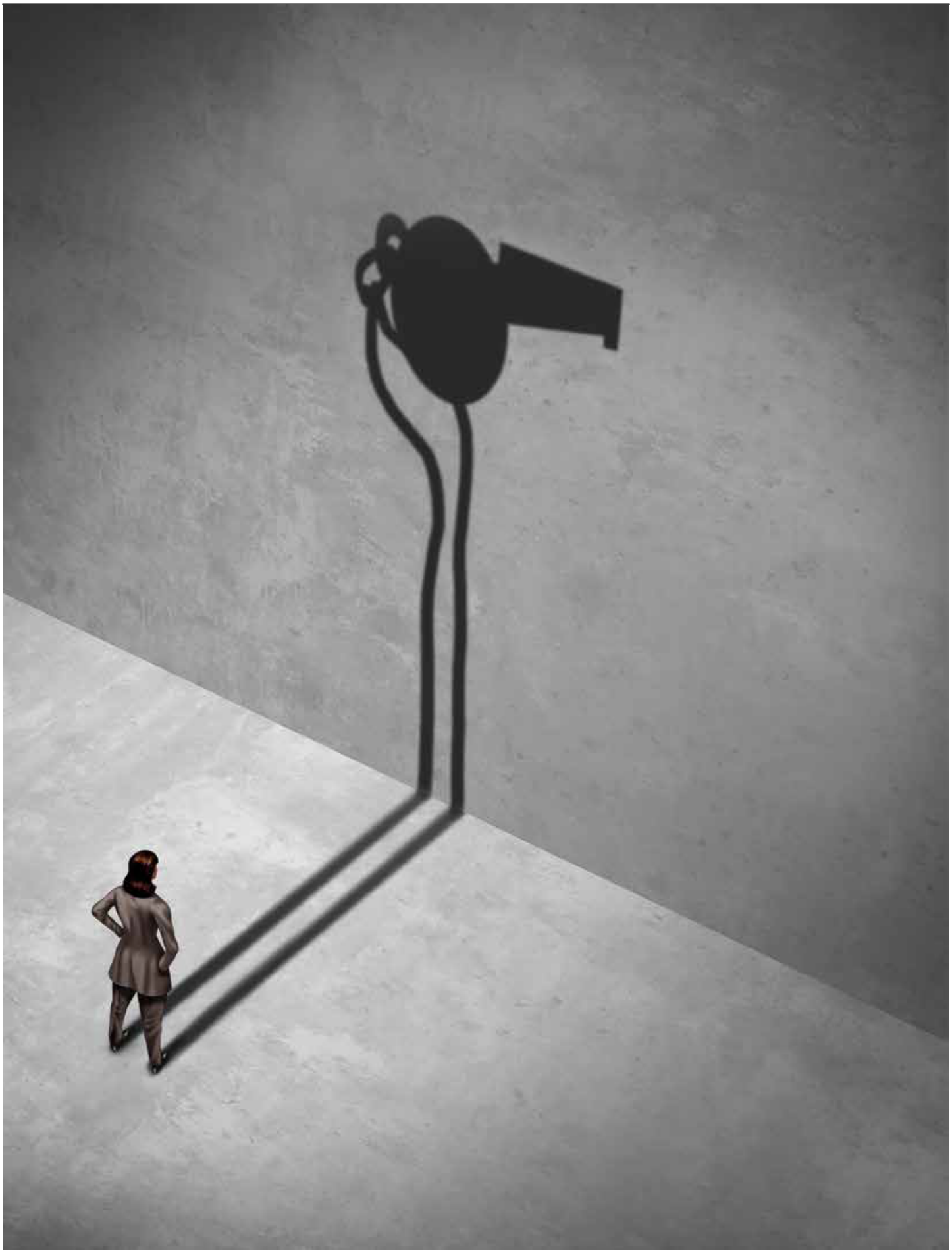
What Do the SEC's Proposed Whistleblower Rule Amendments Mean for Businesses?

Compliance and Ethics





CHEAT SHEET

- ***Supreme Court ruling.*** In *Digital Realty Trust, Inc v. Somers*, the US Supreme Court ruled that the term “whistleblower” in the Dodd-Frank Act only applies to individuals who report violations to the SEC, not internally.
- ***SEC amendment.*** The SEC proposed an amendment to define “whistleblower” as those who report possible securities laws violations in writing to the SEC.
- ***Ramifications.*** If company employees report violations directly to the SEC, their company compliance departments may not be able to investigate and address the problem before a potential lawsuit or fine.
- ***Red flag.*** A decline in internal reporting in response to the SEC amendments should be treated as a red flag.

In June of 2018, the US Securities and Exchange Commission (SEC) voted to propose amendments to the rules governing its whistleblower program. The proposed amendments are, at least in part, a response to the US Supreme Court’s 2018 holding in *Digital Realty Trust, Inc. v. Somers*, and its effect on the definition of “whistleblower.” In light of both the *Digital Realty Trust* decision and the proposed regulatory changes, in-house counsel and compliance leaders should examine their internal reporting policies, ensure that multiple avenues for internal reporting exist, and implement procedures for conducting efficient internal investigations.

> Under the Dodd-Frank Act, whistleblowers may initiate suit directly in federal court instead of first seeking a resolution by filing an administrative complaint with the federal agencies. Whistleblowers also generally receive higher awards under Dodd-Frank than under Sarbanes-Oxley.

History of whistleblower protections

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) first created significant and comprehensive protections for corporate whistleblowers. In addition to providing a legal remedy for wrongfully discharged employees, Sarbanes-Oxley also imposes four significant obligations on publicly traded corporations to protect whistleblowers. First, all publicly traded corporations must create internal and independent audit committees, which must include procedures for employees to confidentially file internal whistleblower complaints. Second, Sarbanes-Oxley and the SEC require attorneys to blow the whistle on their employer or client. Third, Sarbanes-Oxley criminalized retaliation against whistleblowers who provide truthful information to law enforcement. This Sarbanes-Oxley provision is not limited to publicly traded corporations. It potentially applies more broadly to discourage retaliation by all employers. Fourth, Sarbanes-Oxley grants jurisdiction to the SEC to enforce the statute, including its whistleblower provisions.

Following the 2007-2008 financial crisis and the Madoff investment scandal, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 922 of the Dodd-Frank Act added Section 21F to the Exchange Act of 1934 (the Exchange Act) and further

established the SEC's whistleblower program. The purpose of the program is to incentivize individuals to report tips to the SEC with a stated goal of assisting the commission in the detection of wrongdoing and the protection of investors and the marketplace. The Act authorizes the SEC to make monetary awards to whistleblowers who voluntarily provide original information that leads to successful enforcement actions resulting in monetary sanctions over US$1,000,000. The whistleblower may be entitled to receive an award between 10 and 30 percent of the monetary sanctions collected. The Act also contains anti-retaliation provisions, which protect whistleblowers from adverse employment actions in response to their tip or complaint.

The Dodd-Frank Act soon became the more common remedy for employees looking for relief from retaliation. The Dodd-Frank Act provides employees with more protection and does not contain an administrative exhaustion requirement like Sarbanes-Oxley. Under the Dodd-Frank Act, whistleblowers may initiate suit directly in federal court instead of first seeking a resolution by filing an administrative complaint with the federal agencies. Whistleblowers also generally receive higher awards under the Dodd-Frank Act than under Sarbanes-Oxley. Sarbanes-Oxley limits a whistleblower's recovery to back pay with interest, while the Dodd-Frank Act provides for an award equal to double back pay with interest, separate from potential awards for sanctions collected.

The Dodd-Frank Act defines "whistleblower" as "any individual who provides … information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." According to the SEC, "original information provided by whistleblowers has led to enforcement actions in which the commission has ordered over US$1.4 billion in financial remedies, including more than US$740 million in disgorgement of ill-gotten gains and interest."[1]

1 Press Release, SEC Proposes Whistleblower Rule Amendments, No. 2018-120 (June 28, 2018).

The additional rulemaking now proposed by the SEC draws from nearly seven years of experience administering the whistleblower program. The SEC believes that the proposed changes will continue to encourage individuals to come forward, permit the SEC to more efficiently process award applications, and address the definitional issues identified in Digital Realty Trust.

Digital Realty Trust, Inc. v. Somers

In recent years, whistleblowers have increasingly sued their formers employers under the Dodd-Frank Act, due in part to the ability given by the statute to sue a former employer in federal court and the availability of larger damage awards. Following this trend, Paul Somers sued Digital Realty Trust (Digital) in a California federal court after he was terminated from a senior management position. Somers claimed that he was terminated for internally reporting the alleged violations of federal securities laws by his former supervisor. Digital asserted that he was terminated for cause. At issue in the case was whether the definition of "whistleblower" in the anti-retaliation provision of the Dodd-Frank Act applies to individuals who report violations internally, rather than to the SEC. The Supreme Court determined that the definition is not ambiguous and that the statute requires whistleblowers to report violations to the SEC in order to receive the protection of the anti-retaliation provisions.

The Supreme Court's decision in *Digital Realty Trust* resolved a circuit split. Historically, the Fifth Circuit held that employees must report to the SEC, while the Second and Ninth Circuits concluded that an internal report was sufficient for employees to qualify for the Dodd-Frank Act's anti-retaliation protections. In reaching that conclusion, the Second and Ninth Circuits relied upon *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc*., 467 U.S. 837 (1984)[2] to grant deference to the SEC's interpretative rules. The Fifth Circuit, in contrast, found the terms of the Dodd-Frank Act unambiguous

and, accordingly, not entitled to the Chevron deference.

Digital argued before the district court and, subsequently, before the Ninth Circuit Court of Appeals that Somers did not qualify as a whistleblower under the Dodd-Frank Act because Somers did not report the alleged misconduct of his former supervisor to the SEC. Neither court found the argument convincing based on the "overall operation of the statute." Before the Supreme Court, Somers was joined by the Solicitor General[3] and contended that applying the whistleblower definition in the Act to the anti-retaliation provision would "create obvious incongruities" and "vitiate much of the [statute's] protection." The Supreme Court disagreed. The Court reasoned that if the SEC wanted to provide other means for whistleblowers to provide information rather than directly reporting the conduct to the SEC, it has the authority to do so.

2 The Supreme Court in Chevron established a test to determine whether to afford deference to a government agency's interpretation of a statute that it administers.

3 The Brief for the United States as Amicus Curiae stated, "Reading that provision to protect only whistleblowers who report to the commission would defeat Congress's purpose, weaken internal corporate-compliance programs, and potentially flood the commission with allegations that have not been vetted by the corporate insiders best situated to address them in the first instance."

Noteworthy awards

- The SEC's first whistleblower award was made on August 21, 2012. The whistleblower provided evidence relating to an ongoing multimillion-dollar fraud. The whistleblower received US$50,000.
- In 2014, the SEC awarded US$300,000 to an employee in an audit function who made a report to the commission after first reporting internally without response from the company.
- In 2015, the SEC awarded a whistleblower outside of the United States more than US$30 million, which is one of the largest awards in the program's history.
- Other precedential cases in 2015 included one to a former officer of a company and the first award to a whistleblower who suffered retaliation for reporting possible violations to the SEC.
- 2016 broke all prior records in SEC whistleblower awards, totaling more than US$57 million.
- In 2017, the SEC awarded more than US$16 million to two whistleblowers. One provided the initial tip and the other provided substantial ongoing assistance.

Summary of proposed amendments

In response to *Digital Realty Trust*, the SEC amendments propose a change to the definition of "whistleblower," which would modify the Exchange Act. The SEC's proposed amendment would define whistleblowers as those who report possible securities laws violations in writing to the SEC and would ensure that the revised definition applies uniformly to all aspects of the Exchange Act. More specifically, the SEC explained the proposed amendment as follows:

The amendments that we are proposing to this rule are in response to the Supreme Court's recent decision in *Digital Realty Trust, Inc. v. Somers.* In that decision, the Court held that Section 21F(a)(6) of the Exchange Act unambiguously requires that an individual report a possible securities law

violation to the commission in order to qualify for employment retaliation protection, and that the commission's rule interpreting the anti-retaliation protections in Section 21F(h)(1) more broadly was therefore not entitled to deference. We are proposing to modify Rule 21F-2 so that it comports with the Court's holding by, among other things, promulgating a uniform definition of "whistleblower" that would apply to all aspects of Exchange Act Section 21F. We are also proposing to provide certain related clarifications to Rule 21F-2 and to address certain other interpretive questions that have arisen in connection with the Court's holding.

In addition to the definitional change consistent with *Digital Realty Trust*, the SEC proposes other substantive amendments to its Rules, amendments intended to clarify and enhance SEC policies and procedures, and changes designed to increase efficiency in processing award applications. Lastly, the SEC included two additional items outside proposed amendments: (1) interpretive guidance; and (2) a request for public comment concerning a potential discretionary award mechanism.

Overall, the proposed amendments are modest but signal a maturing of the SEC's whistleblower program. According to SEC Chairman Jay Clayton, "the proposed rules are intended to help strengthen the whistleblower program by bolstering the commission's ability to more appropriately and expeditiously reward those who provide critical information that leads to successful enforcement actions."

Other proposed SEC rules amendments

SUBSTANTIVE RULE CHANGES

- Expressly allow awards based on deferred prosecution agreements and non-prosecution agreements entered into by the Department of Justice or state attorney general in a criminal case, or a settlement agreement entered into by the SEC to address violations of the securities laws. This amendment would expand the availability of awards to whistleblowers.
- Eliminate the potential for double recovery based upon the definition of "related action." This amendment would exclude matters brought by an entity for which there is a more directly applicable award program.
- Authorize the SEC to adjust the award percentage upward to more appropriately regard meritorious whistleblowers who might have otherwise been concerned about the low dollar amount of a potential award.
- Authorize the SEC to adjust the award percentage downward to an "amount that is reasonably necessary to reward the whistleblower and incentivize similarly situated whistleblowers."

AMENDMENTS INTENDED CLARIFY POLICIES, PRACTICES, AND PROCEDURES

- Clarify of the definition of "monetary sanctions."
- Provide the SEC with additional flexibility to modify forms used for tips, complaints, or referrals and other forms used in connection with the whistleblower program.
- Clarify the list of materials that the SEC may rely upon in making award determinations.
- Clarify the materials that may comprise the administration records for purposes of judicial review.

EFFICIENCY FOCUSED IMPROVEMENTS

- Clarify the SEC's ability to bar individuals from submitting whistleblower award applications where they are found to have submitted false information in violation of the Exchange Act or have repeatedly made frivolous award claims.
- Afford the SEC with a summary disposition procedure for certain types of common denials such as untimely award applications or incorrect form or content.

Public comments of note

Many comments on the proposed SEC amendments deal directly with *Digital Realty Trust* and the proposed modification of the "whistleblower" definition. Some commentators have supported these proposed changes. Others have requested that the commission eliminate all provisions of the rules that promote internal reporting at the expense of direct reports to the SEC.

Additional comments of interest to businesses include a request that the commission defines the meaning of a "corporate compliance program" in light of the *Digital Realty Trust* decision. The concern is that companies will re-brand a law department by naming one of the in-house lawyers or sub-offices a "compliance officer" or "compliance department." Commentators requested that the "compliance program" be defined as one independent from the legal department, not subject to attorney-client or work product privileges.

Law firms regularly engaged in the representation of whistleblowers have objected to the proposed 10 percent cap on large awards because of its potential to discourage the disclosure of fraudulent activity. The thought is that if the potential financial award is capped, employees will not risk their careers to expose corporate fraud.

Potential impact on businesses

The proposed amendments are limited and should not result in a need for dramatic response from businesses. However, the uniform application of the definition of "whistleblower" to all provisions of the Act could result in increased reports to the commission. Prior to *Digital Realty Trust*, whistleblowers may have only reported concerns internally because they did not believe it to be statutorily necessary to make concurrent reports to the SEC. Accordingly, employers may notice a decline in internal reporting. And that is not necessarily a good thing.

If employees report to the SEC first without making an internal report, compliance departments will not have an opportunity to investigate and address the problem before being faced with expensive lawsuits or fines. Accordingly, companies that experience such a decline should be wary. A decline in internal reporting in response to *Digital Realty Trust* or the SEC amendments could and should be treated by companies as a red flag that their ethical house may not be in order. Silence should not be construed as compliance.

Conversely, companies should not see a decline in internal reporting if they have robust compliance and ethics programs that provide for reporting mechanisms — such as anonymous tip lines — in which employees have confidence. In these environments, employees will continue to make reports when necessary due in large part to the culture of transparency established by the company's ethics program.

Essential components of an effective whistleblower program

- *Provide anonymity.* The ability to make anonymous reports provides an employee with assurances that they will not suffer workplace repercussions. This is perhaps the single most important component to encourage employees to report potential securities violations.
- *Establish easy reporting mechanisms.* The reporting procedures should fit with the organization and its employees. This may involve a toll-free hotline.
- *Establish consistent policies and procedures.* Every unit, from upper management down, should have the same access and obligations to report fraud.
- *Prepare to respond.* When fraud is reported, the organization should be prepared to evaluate the report and develop a plan for responding.
- *Make outside reports.* Internal policies and procedures should make clear when legal authorities should be notified and who is obligated to make the report.
- *Record and track processes.* Each report of fraud should trigger a report and filing system that retains the information received and documents the organization's response.

In all organizations, general counsel and senior executives should take these proposed amendments as an opportunity to assess extant ethics and compliance programs. A baseline risk assessment of these programs should be taken with a critical eye toward an internal audit mechanism that will identify potential misconduct and an appropriate remediation protocol. If not presently in place, policies and procedures should be created to provide for and incentivize confidential reporting. The result will be greater trust and confidence at all levels of the organization, which ultimately improves employee morale and client/customer satisfaction.

What's next?

The initial public comment period for the SEC regulatory amendments was closed on September 18, 2018. The amendments are subject to further revision by the SEC and a subsequent 60-day public comment period. For current details see www.sec.gov/rules/proposed.shtml.

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