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WHISTLE-BLOWERS

Reliability and the SEC's Whistle-Blower Program

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Passed in July 2010, Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the Securities and Exchange Commission to pay monetary awards to whistleblowers who provide original information that leads to a successful enforcement action with more than $1 million in monetary sanctions. Awards may range from 10 to 30 percent of the sanctions, and to date have proven to be quite lucrative. Several awards have exceeded the $1 million mark, with the largest to date surpassing $30 million. If the financial incentives were not enough, the statute and the rules passed by the SEC under it strongly favor unhindered reporting. They permit whistleblowers to bypass the internal reporting mechanisms of their own organization, submit initial reports anonymously to the SEC, and enjoy broad anti-retaliation protection if the reported information has a ''facially plausible'' relationship to a possible securities law violation. The whistleblower, it is true, has to have a reasonable belief that the information relates to a possible securities law violation; frivolous submissions are ineligible for awards. However, in the overwhelming majority of cases this threshold appears relatively easy to satisfy, absent evidence of bad faith or an obvious misunderstanding by the whistleblower.

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Other than the administrative cost of processing reports, submissions that lack merit appear to have rather limited impact on the SEC. Yet they pose a substantial threat to firms operating in the securities industry. Section 922 and the SEC rules under it require no relationship between the information reported and the whistleblower's job remit, responsibilities, or expertise. Employees may therefore report—indeed, are financially incentivized to investigate and report—information that might appear suspicious to them due to their lack of understanding or experience with the subject matter. The misunderstanding may not come to light until well into the throes of an SEC investigation, after the whistleblower's employer has spent substantial sums to face a probe by its regulator. Relatedly, the incentives of an award, the right to circumvent internal reporting, and the broad anti-retaliation protection provide a license to invoke the specter of whistle blowing to gain leverage in employment negotiations—most commonly, perhaps, when an employee is separating from her firm. Even a firm that is extremely confident in its controls and practices would likely think very carefully before ignoring a

veiled threat of whistle blowing and facing an SEC investigation.

To a degree, every whistleblower program has the potential to disrupt the sanctity of the principal-agent fiduciary relation between the employer and employee. The incentives created by the SEC's program, which might encourage an opportunistic employee to pry into her firm's activities with a view to obtaining a monetary award, could ultimately erode the trust between employers and employees. This erosion may undercut some of the broader goals of the SEC's regulatory program, by encouraging firms to adopt controls to limit access to information to employees when a freer flow of information might be beneficial to the firm and its clients.

The Risk of Unfounded Reports

A whistleblower submission consists of a voluntary provision of ''original information'' based on ''independent knowledge or analysis.'' The whistleblower's knowledge need not be first-hand, however. It may come from communications and observations in business or even from ''social interactions.'' This mandate is designed to encourage broad reporting by anyone with genuine concerns about a possible securities law violation, but this low bar on reporting suspected violations is not necessarily a positive. The lack of any required nexus between the violation and the reporter's role within the company, combined with the ability to report anonymously and the promise of a potentially lucrative award, means that employees not only are not encouraged to resolve concerns internally, but might be incentivized to snoop on their own organizations—in effect, becoming faithless agents.

Many employees of firms in the securities industry are aware that they need only hint at a potential violation of the law to enhance their position in severance negotiations. An SEC investigation instigated by a whistleblower could entail significant legal and reputational costs, regardless of whether the tip that prompted the investigation was meritorious. While the laws against extortion might provide some protection against a bad faith threat of whistle blowing, firms often prefer to avoid the publicity associated with taking action or the potential that the SEC would perceive such action as retaliatory. In practice, firms who wish to avoid reputational damage and preserve confidentiality, not to mention avert a costly investigation, are unlikely to pursue a complaint or litigation against an employee who presents herself as a whistleblower.

Reports arising out of a sincere but incorrect analysis also pose a risk, just like those driven by malign motives. An employee who misconstrues information picked up in ''social interactions'' may report it to the SEC without fully understanding what is at issue—and is encouraged to do so since monetary awards are available to all whistleblowers, not only those who report suspected violations falling within their job responsibilities or those who escalate concerns internally prior to filing a report. This approach in theory may be designed to enhance the volume of reports the SEC receives, but it also bolsters the potential for honest, but costly, mistakes.

The risks of inaccurate reporting present a particular challenge for firms given the limitations imposed by SEC rules on the use of confidentiality obligations. As part of the whistleblower program, the SEC adopted Rule 21F-17, which prohibits ''any action'' that ''impede[s] an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement.'' Last year, the SEC brought an action against KBR, Inc. under this rule because it had required employees interviewed in internal investigations not to discuss ''any particulars regarding [the] interview and the subject matter discussed during the interview, without the prior authorization of the Law Department.'' While there were ''no apparent instances in which KBR specifically prevented employees from communicating with the SEC about specific securities law violations,'' the SEC still determined that a ''blanket prohibition'' had a chilling effect on reporting. KBR settled for a $130,000 penalty and amended its agreements.

In the common imagination, the paradigm whistleblower is an employee who is asked or directed to engage in outright wrongdoing, or becomes aware of unlawful schemes within her organization that other employees happily carry on. But the SEC's bounty program also promotes another co-star: employees who wish to get rich quickly, snoop on their co-workers, and then raise purported concerns about suspected violations of the law with their firm to gain leverage in negotiations, or report their concerns in pursuit of an award. The upshot is meaningful erosion of the trust between employers and employees.

Existing Protections

The current framework includes provisions that target frivolous or malicious reporting. Rule 21F-9 conditions award eligibility on the whistleblower's sworn declaration that the submission is true and correct to the best of their knowledge and belief. Anonymous tipsters must submit through their attorney, using a Tip, Complaint or Referral form (Form TCR) signed under penalty of perjury. A submitting attorney is subject to additional obligations. She must certify that she (1) verified the identity of the submitter, (2) reviewed the executed Form TCR for completeness and accuracy and found the information correct to the best of her knowledge, (3) obtained the submitter's non-waivable consent to provide the SEC with the Form TCR if requested, and (4) consents to be legally obligated to provide the Form TCR within 7 days of receiving a request from the Commission. A whistleblower cannot collect an award without disclosing their identity to the SEC.

While these features may deter some false submissions or malicious reports, they are far from airtight. Employees can simulate a good faith rationale based on a vague concern about compliance with the law. Even if the concern turns out to lack any foundation, the whistleblower framework requires no nexus between the suspected violation and the employee's responsibilities, so a misleading report can easily be cast as a good faith misunderstanding. Where a maligned employee's report can be shown to have been frivolous, the affected organization may nevertheless sustain significant costs before this becomes apparent to the SEC. And the employer is often left without meaningful recourse: the identity of the whistleblower may never come to light, or she may not have the resources to compensate the firm for its expenses in responding to the SEC investigation that her frivolous or maligned tip initiated.

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To an extent, the SEC's whistleblower framework pits the promotion of a broad reporting regime against firms' concerns regarding confidentiality and the integrity of their fiduciary relationships with employees. The data the SEC has access to showing the reliability of the tips the agency receives does not reflect the universe of instances where employees threaten their organizations with the prospect of whistleblowing to their own ends. The approach implemented in Section 922 and the SEC rules strikes a strong balance in favor of broader reporting, but there are alternative approaches. For example, the SEC's program, while accepting tips from all kinds of whistleblowers, could have restricted monetary awards to whistleblowers who report suspected violations that fall within their job remit or area of responsibility. This approach would have perhaps mitigated the risk of uninformed submissions, while remaining consistent with the overall goals of the whistleblower regime. Dodd-Frank envisions a broad whistleblowing regime, but the sanctity of the employer-employee fiduciary relationship should not be sacrificed wholly on that altar.