CUG.COMments

A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 73 **March 2011**

WHISTLEBLOWING UNDER DODD-FRANK

In this issue … we look at whistleblowing, following its treatment under the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and in light of the Securities and Exchange Commission's (SEC) Proposed Rules for implementing the whistleblowing provisions of the Dodd-Frank Act.

A "whistleblower" is defined under Section 922 of Dodd-Frank as one or more individuals who provide information relating to a violation of the securities laws to the SEC, in a manner established by the SEC.

BACKGROUND

Sarbanes-Oxley

Under the federal Sarbanes-Oxley Act of 2002 ("SOX"), whistleblowers were afforded some protection from retaliation by their employers. If appropriate, various forms of relief were to be made available, such as getting their job back, receiving back pay and compensation for damages, and payment of incurred legal costs. SOX also required that companies falling within its scope (generally publicly-listed companies), must set up a complaint system to receive and address internal and external complaints. Internal complainants would generally receive anonymity, though non-employee complainants would typically not. SOX also imposed civil liability on companies that took retaliatory action.

These provisions resulted in a flurry of activity as corporations instituted complaint procedures to comply with the act—a task made harder by the need to maintain whistleblowers' anonymity.

While SOX provided safeguards and remedies for whistleblowers and allowed for punishment of guilty corporations, blowing the whistle on illegal corporate activities remained a largely altruistic exercise, and one which, notwithstanding the SOX protections, still had as much potential downside as upside for the whistleblower.

Dodd-Frank

The credit crisis which spawned the Dodd-Frank Act also laid bare the financial services industry, exposing—in the eyes of critics—corruption, greed and fraud. Dodd-Frank was introduced and supported as an attempt to address a long list of concerns.

At some time during the Dodd-Frank gestation period there emerged the belief that, while SOX was a good start towards encouraging effective whistleblowing, it did not go far enough. It was not sufficient to protect whistleblowers and censure the companies; knowledge of egregious corporate conduct had to be coaxed out with financial incentives. Corporate greed would be best revealed by appealing to whistleblower greed.

DODD-FRANK SECTION 922

This new, more aggressive approach was spelled out in Section 922 of Dodd-Frank. Subject to various conditions, the SEC would "pay an award or awards to 1 or more whistleblowers" whose information "led to the successful enforcement of the covered judicial or administrative action, or related action … equal to not less than 10 percent … and not more than 30 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions." Awards would only be considered if SEC monetary sanctions exceeded $1,000,000.

The rest of the section addresses such issues as determination of the final award, conditions leading to denial of an award, counsel for the whistleblower, and whistleblower protections (with a nod to SOX), but most readers would have stopped reading after seeing "30 percent." In 2010, Goldman Sachs settled with the SEC for $550 million. Under Dodd-Frank, this settlement could theoretically have produced a whistleblowers' windfall of $165,000,000.

IMPLEMENTATION

Having stated its intent, Dodd-Frank passes the ball to the SEC for execution and implementation. Section 924 describes how the SEC shall issue final regulations implementing the new requirements "no later than 270 days after enactment of this [Dodd-Frank] Act." That deadline falls on April 17, 2011.

While the Dodd-Frank whistleblowing provisions themselves total some dozen pages, the SEC produced 181 pages of Proposed Rules in carrying out its mandate.

The SEC released the Proposed Rules on November 3, 2010 and invited public comment until December 17, 2010. Following receipt of the comments, the SEC is evaluating them and will publish its final Rules in time for the April 17 deadline.

OPPOSING POSITIONS

A review of the public comments, published in full on the SEC web site, generally reveals two opposing factions.

On one side are the corporate lobby and its supporters, including the American Chamber of Commerce, the Institute of Internal Auditors, the National Association of Corporate Directors and the Association of Corporate Counsel. For this group, the Proposed Rules go too far.

Their position is generally consistent in trying to minimize what they see as Dodd-Frank's punitive provisions. For example, since the information provided by the whistleblower must be "original information" to qualify for an award, and since the Proposed Rules do not require a corporate employee to first report information to their company's internal compliance program, the whistleblower potentially increases the likelihood that the information is "original," and thus the likelihood of an award, by going directly to the SEC. While the commentaries differ in detail, they often share similar concerns and advocate similar solutions, including:

- Internal corporate compliance and investigative programs will be undermined; whistleblowers should not be encouraged to bypass internal reporting procedures.
- The SEC must inform the corporation of whistleblowers who have bypassed the internal reporting mechanisms.
- Reporting to the company should be made a condition of receiving an award.
- The Proposed Rules will hinder the ability of companies to adequately respond to claims.
- The Proposed Rules Proposed Rules do not sufficiently limit those eligible for an award.
- The Proposed Rules will release a flood of tips, which will strain the SEC resources.

Arrayed against these groups are those with an interest in whistleblower protections and benefits, for example the National Whistleblower Center and law firms specializing in whistleblower advocacy. These groups are supported by some of the posted comments of various individual investors who want corporate fraud rooted out and punished, and are suspicious and distrustful of corporations. Their opinions generally include:

- The pool of eligible whistleblowers is being limited.

- The proposals will create procedural hurdles, which will inhibit and discourage potential whistleblowers.

- The proposals are "more sympathetic to companies that violate the law than to employees who risk their careers, reputations and jobs to report wrongdoing." [National Whistleblowers Center]

The notion that whistleblowers should first take their case to the company is anathema to this group. Several individual respondents took the form of signing a petition, which states:

> *More whistleblowing about corporate crimes could have made the foreclosure crisis and economic meltdown less severe. Whistleblowers should never be forced or encouraged to take their concerns to their potentially corrupt bosses first: Those who go directly to the government deserve the strongest rewards and protections allowed by law.*

SUMMARY AND IMPACT ON THE D&O MARKET

There are thoughtful and detailed comments from both sides of the argument. For the SEC, satisfying both camps will likely be almost impossible, and finding even a measure of common ground will not be easy; upsetting both sides may be the most equitable outcome.

Pressure from opponents of the Proposed Rules may ultimately cause the SEC to make life a little harder for whistleblowers, but the SEC cannot really change the law: the award amounts are not negotiable even if the path to achieving them might be.

With such eye-popping bounties on offer, an increase in whistleblowing activity seems almost certain. In pages 96–98 of the Proposed Rules, the SEC estimates that each year it will receive around 30,000 tips, complaints or referrals and some 15,000 declarations concerning original information. The SEC forecasts that, from those submissions, the strangely precise number of around 117 applications for an award will be filed.

As applications for an award are intended to follow only successful SEC enforcements, there is a reasonable inference that private securities litigation will ride on the coattails of these 117 estimated actions. Legitimate or not, such lawsuits will likely cost D&O insurers money. The SEC will announce the final rules on or after April 17, and may help determine if insurers will be facing a deluge of money or a trickle. ❖

Past issues of CUGCOMments are available.

Chicago Underwriting Group, Inc.

Web: www.cug.com
Email: info@cug.com
Phone: (312) 750-8800
Fax: (312) 750-8965