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REPORT

CORPORATE GOVERNANCE

Whistleblowers and the Resurgence of Internal Investigations

BY RICHARD J. MORVILLO AND JEFFREY F. ROBERTSON

Many companies have come to doubt the value of cooperating with the Securities and Exchange Commission by self-reporting possible violations of the securities laws. As statistics show, while companies that self-report to the SEC arguably may receive some leniency in terms of sanctions, the vast majority are still rewarded with a black eye—they are named in SEC Enforcement actions.[1] The SEC's recent case charging Bank of America, which had self-reported the facts, with securities law violations in connection with

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[1] *Study Raises Questions on Cooperation and Enforcement*, COMPLIANCE WEEK (Aug. 10, 2010) (reporting on study by University of Texas professor Rebecca Files of 1,200 financial restatements between 1997 and 2005 finding that odds of an SEC Enforcement action *increased* for companies that conducted their own investigation and cooperated with the SEC, although they ultimately paid smaller fines for doing so).

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its alleged municipal bond practices is just the latest example.[2]

One consequence of the uncertainty about the potential benefit of self-reporting seems to have been a curtailment in the number of internal investigations companies have undertaken in areas outside of the Foreign Corrupt Practices Act and a few others. Although companies continue to bolster compliance efforts and self-police themselves, there is greater reluctance, particularly in this economy, to conduct the kind of comprehensive investigations that were more typical in the aftermath of Enron and other accounting scandals. And those that do conduct internal inquiries understandably are less apt to bring the results of the investigations to regulators absent some clear evidence that there is a tangible benefit in doing so.

Mindful that many entities do not feel adequately incentivized to self-report under these circumstances, the SEC has been trying to promote publicly the benefits of cooperation. For example, it turned to the Department of Justice's toolbox to borrow tools, such as non-prosecution and deferred prosecution agreements, to encourage individuals and companies to share information about potential violations of the law with the Enforcement Division.[3] It also re-iterated, in a slightly different formulation, the *Seaboard* factors regarding how and what credit the SEC will grant corporate cooperators.[4] How effective those measures will be remains to be seen.

Dodd-Frank Opens Floodgates

Now, however, Dodd-Frank's whistleblower provisions have entered the mix. That statute mandates that, in certain circumstances, the SEC rewards whistleblowers who provide substantial assistance to the SEC in unveiling and successfully prosecuting illegal conduct. The rewards can be very significant: up to 30 percent of the moneys paid in SEC and related proceedings by one who allegedly violated the law. The prospect of substantial rewards has already opened the floodgates at the SEC, which reportedly has been inundated with tips and complaints and scarcely has the resources to review them all in a careful and deliberate matter, despite efforts to improve the review process.[5] And yet, after the substantial criticism leveled at the SEC for ''missing'' Madoff and other scams, the SEC cannot risk being chastised for ignoring whistleblower reports or not pursuing those that appear to have merit. We can therefore expect the SEC to be very vigilant.

The SEC has already proposed a sweeping set of rules in the whistleblower area.[6] Recognizing that corporate compliance efforts can be undermined by creating a regime where whistleblowers bent on financial rewards are encouraged to end run internal compliance processes, the SEC has tried to strike a balance by making it possible for whistleblowers who go first to internal compliance to still get credit for being a whistleblower under the statute.[7] It has also suggested that it may consider whether a whistleblower first approached internal compliance in deciding the percentage reward to bestow on the whistleblower.[8]

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Companies Need to Move Quickly

The proposed rules are also designed to ensure that the company in receipt of a whistleblower complaint moves quickly. For instance, individuals who report complaints internally have a 90-day grace period after doing so to disclose the information to the SEC and have the SEC deem their disclosure effective as of the date of the internal report. That does not give the company much time to decide how to deal with the complaint, particularly those that touch on complex accounting matters or transactions over an extended period of time.

In the face of a complaint, a company has little choice but to determine whether the complaint has merit. How far it has to go is a fact-specific inquiry. But because a whistleblower will still be free to go to the SEC once the waiting period expires, the company should be prepared to explain what it did and why that was adequate under the circumstances. Whatever decision the com-

[2] *In re Bank of America Securities LLC*, Order Instituting Proceedings, SEC Rel. No. 34-63451 (Dec. 7, 2010), at ¶ 17. *But see* SEC Rel. No. 2010-252 (Dec. 20, 2010) (announcing SEC entered into non-prosecution agreement with Carter's, Inc. and would not charge company in connection with activities resulting in suit by SEC against former Executive Vice President of Carter's).

[3] ''SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations,'' SEC Press Release No. 2010-6 (Jan. 13, 2010); *see also Enforcement Division Announces Initiative Aimed at Greater Cooperation*, Client Alert: Schulte Roth & Zabel LLP (Jan. 15, 2010), available at: http://www.srz.com.

[4] *Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions*, SEC Release No. 34-61340 (Jan. 13, 2010); *see also* SEC Enforcement Manual, Section 6, *www.sec.gov/divisions/enforce/enforcementmanual.pdf*.

[5] ''SEC Delays Plans for Whistleblower Office,'' WALL ST. JNL. (Dec. 3, 2010) (citing ''budgetary uncertainty'' as the cause for delay in opening the SEC's whistleblower office required under Dodd-Frank).

[6] *Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC Rel. No. 34-63237 (Nov. 12, 2010).

[7] *SEC Proposes Whistleblower Program Rules*, Client Alert: Schulte Roth & Zabel LLP (Nov. 12, 2010), available at: http://www.srz.com.

[8] *Id.*

[9] The SEC's proposed rules also suggest that, after receiving a whistleblower complaint, the SEC may contact the employee's company and seek information about the alleged conduct. *Id.* Much of what we say here about instances where the whistleblower approaches the company first is also relevant to a company responding to an SEC request for information.

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pany makes on the merits of a whistleblower complaint, the statutory scheme now makes it critical that the company be able to defend its investigation and its conclusions.

Once it completes its investigation or (as noted below) time runs out, a company will have to decide whether to share its findings with the SEC, knowing that the whistleblower is likely to do so regardless of what the company decides. If the company concludes that a complaint has (or may have) merit, it may wish to bring the matter to the SEC's attention in an effort to obtain whatever benefits cooperation may hold. But, interestingly, even if the company concludes that a complaint is unfounded, there may still be advantages in discussing other than frivolous ones with the SEC. It is likely that, given the economic stakes, whistleblowers will choose to have the SEC, not an interested party like the company or its independent directors, be the arbiter of the complaint's merit. And, except in the most unusual cases, the SEC will be tempted to develop its own record and draw its own determinations. Thus, companies need to appreciate the fact that their review of the facts oftentimes will not be the only one.

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In addition, if the SEC takes an interest (which it probably will if a complaint has surface appeal and some factual corroboration), it will undoubtedly look into how the company dealt with the complaint and the whistleblower. Should the SEC believe that a violation of law took place and that the company ignored, minimized or, worse yet, covered up the problem, the SEC will not only focus on the conduct underlying the complaint but also on the disclosures the company made and the conduct it engaged in after becoming aware of the complaint. In other words, there is a palpable risk that whatever decision the company makes about a complaint the SEC accredits will be subject to second-guessing by the SEC.

In the pre-Dodd-Frank days, companies that self-reported after conducting internal investigations grew to expect that the SEC would either ''kick the tires'' to be satisfied with the investigation and its conclusions or conduct a more thorough investigation, often with the benefit of the facts developed during the company's investigation as a starting point. In providing those facts, the company sought to forestall a full-fledged investigation and/or to show the SEC that the company's investigative efforts and remedial actions—whether or not legal violations were found—were adequate and appropriate. Thus, part of the thinking going into a decision to share information often included the idea that, at a minimum, it might save the company time and money, earn it cooperation credit and, under the best of circumstances, lead to little or no SEC enforcement interest.

Changed Dynamics

Those dynamics are likely to change as whistleblowers are introduced into the equation. First, as noted, under the proposed SEC rules, a company will not have much time to investigate the facts fully. It may take more than 90 days in complicated matters to ascertain all the facts, draw thoughtful and supportable conclusions and initiate remedial actions. Consequently, a company may be forced to decide whether, in effect, to self-report (at the time or before the whistleblower approaches the SEC) before it is really ready on all fronts. Although one would expect the SEC to provide the company with more time to complete its internal investigation, a company may wind up reporting on a complaint that ultimately it deems to be without merit. While this kind of early reporting may not be avoidable, providing the Staff with premature and unwarranted conclusions that will not stand up at the conclusion of the fact gathering stage.

Second, and more significantly, the question whether the SEC will investigate once the company comes forward is more complicated when an internal investigation is prompted by a whistleblower. The SEC will evaluate the company's investigative efforts in light of the specific allegations the whistleblower makes. Particularly in view of the criticism it has received, even where a whistleblower's complaint may be off base, the SEC will be careful to make a record establishing that it looked into the complaint or tip where warranted. Although there are advantages in a company sharing its investigative findings with the Staff nonetheless, the Staff's interest in ensuring that it is fully informed in deciding whether to investigate or prosecute will naturally cause the Staff to be cautious about accepting a company's findings. As in the pre-Dodd-Frank days, where the Staff perceives that counsel for the reporting company carries the sword of an advocate, and has not proceeded as an independent investigator, the Staff will be reluctant to close a file without doing some investigation of its own. And anything the SEC uncovers that suggests that the company's efforts were incomplete or its factual findings were inaccurate will undermine the cooperative relationship the company strove to establish by self-reporting in the first place.

This kind of tension has existed for as long as self-reporting. The new twist, however, is that in the whistleblower context, the SEC now has an ''independent'' source, one whose economic interests can only be advanced if the SEC concludes that a violation has occurred. The SEC's institutional bias as a law enforcement agency lends itself to balancing competing assertions in favor of someone who comes forward ostensibly to reveal misconduct.

Seasoned criminal prosecutors, like those who now run the Division of Enforcement and its New York and other Regional Offices, are accustomed to relying on informants and cooperators. The criminal justice system encourages those who know of crimes to come forward, even where they have been involved in the underlying offenses. Early and substantial cooperation often spells the difference between jail time and no jail time for a cooperator.

There is a natural tendency by many prosecutors to find credible explanations offered by cooperators who profess to have ''come clean'' after being involved in illegal activities. Experienced criminal prosecutors must

have the discipline and the judgment to test and look for evidence to corroborate self-serving statements by one who is looking to avoid or survive prosecution. Such experience-based judgment is essential to preventing a prosecutor from bringing charges without real and substantial evidentiary support.

Where a whistleblower's claims, on or slightly below their surface, are plausible and are accompanied by some factual support, it is difficult to believe that the Staff will not want to conduct its own inquiry.

Though the SEC Staff has always had to exercise similar discretion in evaluating the statements of informants and witnesses in SEC investigations, the sheer number of whistleblower complaints the Staff will have to evaluate will be challenging. One can expect that the Staff will recognize those that are frivolous, but the more substance and plausibility they have and the more likely corroboration may exist, the harder it will be for the Staff, especially in the post-Madoff era, to conclude that no further inquiry is warranted. That is not to say that the SEC will always side with the whistleblower. Rather, where a whistleblower's claims, on or slightly below their surface, are plausible and are accompanied by some factual support, it is difficult to believe that the Staff will not want to conduct its own inquiry. Because in these circumstances the Staff is not likely to draw conclusions about a complaint without conducting meaningful due diligence or an investigation of its own, the existence of a whistleblower complaint likely portends more follow-up investigations by the Staff.

Benefits of Proper Investigation

A company that chooses to self-report may be able to affect the balancing the Staff has to do by planning and conducting an adequate internal investigation and sharing the facts developed in it with the Staff. While there may be little a company can do ultimately to prevent the Staff from taking a hard look, a careful and thorough internal investigation should help assuage whatever concerns the Staff may identify from a whistleblower complaint. An internal investigation that is well-designed and professionally executed under the auspices of persons not implicated in the complaint itself (*e.g.*, an independent committee of directors and/or counsel) will get traction with the Staff. Though the debate over whether counsel who conducts the internal investigation should be independent (*i.e.*, lacking an economic or other relationship with the company or its management) may be re-kindled, experience suggests that most regulators will be more intent on the investigating lawyer's reputation with the Staff for integrity and honesty and the objectivity counsel displays in conducting and reporting on the internal investigation.

If a company stands any chance of convincing the Staff that a colorable complaint is misguided, it will need to be prepared:

- to disclose in detail the investigative steps it planned and the reasons those were deemed to be sufficient;
- to identify the specific investigative steps that were taken, including the documents that were reviewed and the persons who were interviewed;
- to provide an objective recitation of the facts (good and bad) uncovered; and
- to furnish the Staff with the documentary or other evidence it may request to back up the company's assertions.

There is, of course, no guarantee that the Staff will accept a company's version of the facts even under these circumstances, and a company should understand that before approaching the Staff. At the same time, as companies and the SEC become more familiar with the emerging importance of whistleblowers, a company may find substantial value in having experienced and reputable counsel who are known to the Staff investigate, as necessary and appropriate, the whistleblower claims in anticipation of using the results of that inquiry (1) as a means to show the SEC Staff that a complaint is ultimately without merit or (2) as a measure of its cooperation, to identify and address the area(s) where a complaint may have some legitimacy.

Companies that have not already done so should seriously consider establishing protocols for dealing with whistleblower complaints. The financial incentives are significant enough that more whistleblowers and/or their attorneys will continue to come forward, and establishing a system of how to deal with them will help a company deal effectively with them in a timely manner. Indeed, some commentators on the SEC's proposed rules have advocated that the SEC should require whistleblowers to approach internal compliance *before* going to the SEC. Even if that proposal is rejected, companies should establish and publicize to its employees the existence of strong and objective procedures and a culture that encourages employees to report problems as they arise.

Note to Readers

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