FOCUS
Whistleblowers

Companies Concerned About New SEC Disclosure Rules Can Mitigate Risk That Insiders Will Blow Whistle, Experts Say

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The final SEC whistleblower rules (''final rules'')[1] allow compliance personnel, internal and external auditors, inside and outside investigators, officers, directors, trustees, and even business partners (collectively referred to as ''insiders'') to submit whistleblower claims directly to the SEC and be entitled to a reward of 10 percent to 30 percent of monetary sanctions for providing information about corporate wrongdoing.

Insiders are eligible if they have a ''reasonable basis to believe'' that (1) disclosure is necessary to prevent ''substantial injury to the financial interest or property of the entity or investors'' or (2) the organization is ''engaging in conduct that will impede an investigation of the misconduct.''[2] Insiders are also eligible if 120 days have passed since the potential whistleblower has informed the organization or if the entity was already aware of the information when the potential informant received the information.[3]

Whistleblowing by external auditors poses added risk. Not only can auditors blow the whistle on their client under the circumstances outlined above, but auditors can also blow the whistle on their own firms for failing to comply with Section 10A of the Exchange Act and other standards regarding the reporting of illegal acts.[4] Special care should be taken when communicating with external auditors about the scope and findings of internal investigations or engaging them on projects that might lead to discovery of misconduct.

Whistleblowing by external auditors poses added risk.

This article provides counsel with considerations on how they can assist companies to mitigate the heightened risk of insider whistleblowers and how they may help clients to seize the rules as an opportunity to reassess their anti-fraud and anti-corruption programs.

The final rules provide that the SEC will not consider information protected by the attorney-client privilege or obtained in connection with providing legal services.[5] The SEC commentary makes clear that this provision applies both to attorneys and non-attorneys.[6]

Counsel can assist the client to conduct a fraud, waste, and corruption assessment, if the entity has not already done so as required by the U.S. Sentencing Guidelines,[7] Sarbanes-Oxley,[8] and other laws, regulations, and professional frameworks.[9] Building upon the assessments, counsel can assist the entity to select internal audits and business reviews warranting protection under the attorney-client privilege.

Counsel should take the opportunity to supervise or otherwise participate in these reviews performed internally or with the assistance of outside forensic accountants to gain attorney-client privilege and protection from the insider whistleblower rules. The same, of course, applies to investigations of alleged misconduct by or against the entity.

If You Can't Beat 'Em . . .

Most, if not all, companies would prefer to have the opportunity to investigate before the government becomes aware of the alleged misconduct. How, then, can organizations compete with the financial incentives offered by the SEC bounty program?

Some companies might elect to establish their own reward programs. These programs can more than pay for themselves if they include potential wrongdoing against and not just by the organization. The

(continued on page 126)

[1] Securities and Exchange Commission. Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934. 17 CFR Parts 240 and 249. Release No. 34-64545, RIN 3235-AK78. Available at http://www.sec.gov/rules/final/2011/34-64545.pdf.

[2] See final rules, at 74-75. Rule 21F-4(b)(4)(iii).

[3] Id.

[4] See final rules, at 140-141. Rule 21F-8.

[5] See final rules, at 202, Rule 21F-4(b)(4)(iii).

[6] See final rules, at 59. Rule 21F-

[7] U.S.S.G. § 8B2.1 requires organizations to ''periodically assess the risk of criminal conduct.''

[8] Securities and Exchange Commission, Commission Guidance on Management's Report on Internal Control Over Financial Reporting Under Section 12(a) or 15(d) of the Securities Exchange Act of 1934.

[9] See, e.g., Institute of Internal Auditors, Internal Auditing and Fraud Practice Guide, page 16, 2009.

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(continued from page 128)

company thus would pay for information relating to revenue and expenditure leakage, asset misappropriation and theft of information, and other misconduct against the company. Corporate reward programs, however, are still relatively rare in the United States, although they are on the rise elsewhere.[10]

Incentivize Internal Reporting

Responding to criticism that the proposed rules undermine internal compliance programs, the final rules allow for whistleblowers to receive a higher reward for making use of internal company mechanisms. The commentary also notes that the potential whistleblower will receive the benefit of additional information discovered by the company during its internal investigation.[11] Counsel can assist organizations to walk the fine line of publicizing the benefits of employing the company hotline before going to the SEC.

The final rules provide for reducing the amount of the reward for interfering with the organization's internal compliance and reporting system.[12] Reduction likely requires some affirmative action and not just failing to make use of the hotline.[13] So just simply advertising the organization's hotline in the code of conduct or lunchroom wall will not be sufficient.

Counsel can assist companies to develop policies and contract provisions mandating the timely reporting of allegations or other indications of misconduct. Consideration can be given to requiring employees and possibly third party partners to confirm periodically in writing whether they have any knowledge or suspicion of corporate wrongdoing and including penalties for non-compliance with the company policy of reporting issues internally.

[10] ''Report to the Nations: On Occupational Fraud and Abuse.'' Association of Certified Fraud Examiners, Aug. 30, 2011, http://www.acfe.com/rttn/rttn-2010.pdf.

[11] See final rules, at 6. ''[T]he whistleblower will get credit—and potentially a greater award—for any additional information generated by the entity in its investigation.''

[12] See final rules, at 5.

[13] Examples cited by the final rules include interfering with procedures to prevent or delay detection, making false statements or providing false documents. See final rules, at 259.

The final rules now allow external auditors, consultants, joint business partners, and other third parties to qualify as whistleblowers. Counsel can assist companies to develop contractual and other legal protections to ensure that the third party reports wrongdoing to the company before going to the SEC.

Counsel can assist companies to develop policies and contract provisions mandating the timely reporting of allegations or other indications of misconduct.

The engagement with the independent auditor, for example, might require the audit firm to (1) commit to instruct its employees to report any alleged wrongdoing to the client's or audit firm's hotline and (2) indemnify the client if staff auditors circumvent policies and make direct government reports. Management, with the assistance of counsel, may also consider requiring the audit firm to disclose its internal policies on dealing with potential whistleblowing activities by its employees.

How's Your Triage Process?

It's not just about the hotline. Counsel should review the triage process to determine whether it adequately screens and assigns appropriate resources for allegations that may potentially give rise to an SEC whistleblower complaint.

Management must demonstrate and document that allegations of wrongdoing are treated seriously and investigated in a timely and thorough manner.

With the new rules in place, there is a strong possibility that the SEC will be informed of potential issues that companies and their audit committees previously may not have disclosed because of immateriality. Accordingly, counsel should advise audit committees that they must ensure internal investigations—whether or not they involve external assistance—are thorough, objective, and conducted properly in order to withstand reasonable outside scrutiny.

Audit committees and senior management should assume that any whistleblower allegations might be forwarded to the SEC. As a result, the parties involved should consider how any investigative findings will be assessed by external auditors and the SEC and the potential ramifications of any questionable tactics or shortcuts utilized in the investigation. In order to prepare for any potential future reviews of the issue at hand, management and the audit committee should also ensure that any accounting conclusions made are documented in a manner that will stand up to such a review.

It is possible that a company may not be informed by the SEC of the existence of, or any details concerning, a whistleblower report. Therefore, any investigation following a request for information from the SEC that appears as if it might be related to a whistleblower allegation should be treated very carefully. Additionally, an unfortunate consequence of trying to discern the fact pattern potentially at issue is that investigations may be more extensive than a targeted response to a specific allegation of irregularities.

Auditors Stand to Gain, Too

Understanding that external auditors (including individuals on the audit team) may have financial incentives to report allegations of wrongdoing directly to the SEC, companies should consider appropriate levels of involvement and communication with external auditors, especially during internal investigations. Careful and thorough communication regarding potential illegal matters may help auditors gain comfort with the investigative process and conclusions reached by management. However, counsel and companies may also now feel that they need to be more selective on how they utilize and communicate with auditors.

The final rules also allow auditors to receive monetary rewards if their submission alleges that the audit firm violated Section 10A of the Exchange Act or other professional standards. Under Section 10A, if auditors become aware of information indicating that any illegal act occurred at the company (whether or not perceived to have a material effect on the financial statements), the auditor must determine if it likely occurred, assess the possible effect on the financial statements, assess the company's remedial actions, and inform management of the issues as soon as practicable. If the auditors conclude that management or the audit committee has not taken timely and appropriate

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remedial action, then the auditors are required to report the failure to the board of directors and potentially the SEC.

The new rules will almost certainly result in increased scrutiny of potential illegal acts that occur at audit clients, as well as a need for increased review of the related auditors' judgments and conclusions on behalf of audit firms. In addition to investigating what happened, the company will need to conduct a financial statement and financial controls materiality analysis and demonstrate that it has taken appropriate remedial action.

History Offers Comfort

Previously, in the instance of disagreement as to conclusions related to investigations into allegations of illegal acts and the adequacy of management's remedial actions and conclusions, such differences were typically dealt with inside the respective audit firm's risk management group. However, as some may now find themselves enticed by the possibility of receiving substantial monetary rewards, it is not difficult to imagine a scenario where a lower-level auditor might choose to communicate disagreements to the SEC to the extent they don't feel satisfied their complaints regarding 10A conclusions have been addressed.

The final rules pose significant risk and deservedly have attracted substantial attention from lawyers and compliance officers. In addition to helping clients to take steps to mitigate these risks, counsel can also help clients to remain calm. The SEC, after all, is not the first federal agency to introduce a bounty program. Historically, only a small number of complaints have resulted in successful prosecutions.[14]

[14] See, e.g., Michael Hudson. ''Less than 2 percent of 'Sarbox' corporate whistleblowers win inside federal bureaucracy,'' Center for Public Integrity's iWatch News. July 1, 2011. http://www.iwatchnews.org/2011/07/01/5091/less-2-percent-sarbox-corporate-whistleblowers-win-inside-federal-bureaucracy.