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Addressing Employees' Perception That Internally Reporting Compliance Violations Is Futile

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This year is shaping up to be another bountiful one for SEC whistleblowers. As of the publication of this article, the SEC has already awarded $29.58 million to whistleblowers in 2016, including $17 million to one whistleblower (the second-largest award ever).[1] "We're seeing a significant uptick in whistleblower tips over prior years, and we believe that's attributable to increased public awareness of our program and the tens of millions of dollars we've paid to whistleblowers for information that helped us bring successful enforcement actions," said Sean X. McKessy, Chief of the Commission's Office of the Whistleblower, in a March 8, 2016 press release announcing the payment of nearly $2 million to three tipsters.[2]

Each year since the Whistleblower Program's inception in 2011, the number of whistleblower tips has risen.[3] According to the most recent Annual Report on the Whistleblower Program, the SEC received nearly 4,000 whistleblowers tips in 2015 – more than a 30 percent increase over the number of tips collected in 2012 (the first full year of SEC whistleblower data.[4] Notably, FCPA-related whistleblower allegations have increased by 62 percent over that same period.[5] Moreover, The Wall Street Journal reports that the DOJ, in addition to the SEC, is receiving a higher number of tips alleging violations of the FCPA, and that tips to both agencies are increasingly sophisticated as employees improve their understanding of the information needed by authorities to open investigations.[6]

The 2015 Annual Report also notes that almost half of the whistleblower award recipients last year were current or former employees of the company where the wrongdoing occurred, and 80 percent of those individuals raised their concerns internally to their supervisors or compliance personnel (or otherwise understood that the company knew of the violations) before reporting their tips to the Commission.[7]

Indeed, in the words of Andrew Ceresney, Director of the SEC's Enforcement Division: "Company insiders are uniquely positioned to protect investors and blow the whistle on a company's wrongdoing by providing key information to the SEC so we can investigate the full extent of the violations."[8]

See "*2015 Office of the Whistleblower Report Highlights a Banner Year for Whistleblowers*" (Dec. 16, 2015).

Given that Sarbanes-Oxley (SOX) and associated SEC regulations along with NYSE and NASDAQ listing requirements each mandate the maintenance of procedures to promote internal reporting, why do employees feel compelled to report violations outside of the company after they have reported internally? In this article, we attempt to answer that question and offer solutions on how companies can incentivize prompt internal reporting and decrease precipitous external disclosures without running afoul of SEC rules prohibiting a company or individual from impeding reports to the SEC.

Sarbanes-Oxley, NYSE, NASDAQ and DOJ/SEC Whistleblower Provisions

Sarbanes-Oxley

Section 301 of SOX directs corporate audit committees to establish procedures for employees to report confidentially and anonymously violations regarding accounting, internal control, or auditing matters.[9] Because of the variety of listed issuers in the U.S. capital markets, the SEC, in its implementing regulations, states that audit committees should be provided with flexibility to develop and utilize mechanisms appropriate for their circumstances.[10] Thus, the Commission has abstained from

mandating specific systems that audit committees must establish for receiving, retaining, and addressing whistleblower complaints. Companies often use telephone hotlines sometimes operated by third-party providers to satisfy SOX §301 requirements.[11]

NYSE

The NYSE requires that listed companies create charters for their audit committees that include procedures for their employees or employees of certain third parties with which the company does business to submit confidentially and anonymously concerns regarding questionable accounting or auditing matters.[12] Like the SEC, NYSE believes companies should encourage employees to report internally violations of law, rules, regulations or the code of business conduct.[13] To promote such reporting businesses must ensure that employees realize that their companies will not allow for retaliation against them for reports they have made in good faith.[14]

NASDAQ

NASDAQ, similar to SOX § 301 and the NYSE Listed Company Manual §§ 303A.00, .10, also mandates that audit committees of NASDAQ-listed companies establish systems for confidentially and anonymously reporting wrongdoing[15], and obligates company codes of conduct to contain "protection for persons reporting questionable behavior ... and a fair process by which to determine violations."[16] According to NASDAQ, the conduct codes are designed to demonstrate to investors that the boards and management of listed companies have a system to ensure that they become aware of and take prompt action against corporate misdeeds.[17]

DOJ and SEC Recommendations

Similar to NYSE and NASDAQ listing standards, the DOJ's and SEC's joint FCPA Resource Guide suggests that companies adopt mechanisms through which employees can submit confidentially allegations of misconduct without fear of retribution.[18] The Guide also recommends that companies implement a process for investigating such allegations and logging the company's responses so that they can take "'lessons learned' from any reported violations and the outcome of any resulting investigation to update their internal controls and compliance program and focus future training on such issues, as appropriate."[19]

The Futility Problem

While Dodd-Frank amended several aspects of SOX when it was passed and signed into law in 2010, Dodd-Frank did not revise SOX § 301's provisions regarding the establishment of procedures for reporting complaints. Instead, the statute (and its SEC implementing regulations) established a bounty program that pays whistleblowers – whether living domestically or abroad – a cash award of 10 to 30 percent of SEC-recovered sanctions when those individuals provide the Commission with "original information" about securities violations that ultimately produce a successful enforcement action.[20] The SEC may grant awards only when the enforcement action yields judgments over $1 million.[21] Even whistleblowers who choose never to report internally are eligible.[22]

Although Dodd-Frank clearly induces whistleblower employees to report externally to the SEC, that incentive alone may not explain why the vast majority of tipsters, as demonstrated by the 2015 Annual Report, disclose complaints to the Commission after submitting them internally.

A fuller explanation for why employees are reporting externally might involve the "futility problem," which is the idea that employees will submit information on potential violations to the Commission after presenting them to their companies' audit committees, or report only externally, because of the perception that management has or might ignore any concerns shared by the company's employees.

In the January-February 2016 issue of the Harvard Business Review, James R. Detert, a professor of management at Cornell University, and Ethan R. Burris, a professor of management at University of Texas at Austin, observed, "In many organizations we've studied, the biggest reason for withholding ideas and concerns wasn't fear, but, rather, the belief that managers wouldn't do anything about them anyway. At one Fortune 100 high-tech company, employees cited futility as a reason for reticence almost twice as often as fear."[23]

Mid-Level Managers Often Fail to Pass on Complaints

Detert and Burris provide several explanations for this observation. First, upon learning allegations of misconduct from lower-level employees, mid-level managers often fail to communicate those concerns to the more senior members of management. This discourages reporting within the company or incentivizes a whistleblower to report to the SEC after reporting internally when the employee discovers that management is not going to address his or her concerns.[24]

Senior Managers Often Discard Information They Do Receive

Even if mid-levels do pass on alleged violations to the higher-ups, such information is often discarded by senior managers. In many companies, because senior managers are so vested in their organizations and want to believe that they are doing the right thing, they are almost in denial about the possibility that something nefarious might be happening in the organization of which they are not aware.[25]

Moreover, corporate leaders often do not clearly communicate the type of feedback they are seeking, which leads them to discard much of the feedback they are given.[26] This sends employees the message that it is useless for them to raise concerns, leading employees to stop doing so or to take their concerns elsewhere, like to the SEC.[27] Finally, corporations often neglect to provide resources to follow up on alleged violations raised by employees, which suggests that employee input will change nothing.[28]

Overcoming the Futility Problem and Fostering Internal Reporting

Educate Senior Management

Despite the pervasiveness of the futility perception, there are solutions available to help corporations overcome it. Attorneys and compliance personnel may begin by advising senior management of the value of having individuals speak up and doing so frequently. Senior management should be taught to treat potential violations transpiring at the company in the same way they would raise an operational concern about, or a solution to, a business problem.

Spread the Message to Employees

Having developed an appreciation for internal reporting, senior management should then find a way to relay to employees, through mid-level managers, that they should feel comfortable raising concerns regarding accounting, internal control, or auditing matters. Employees should be aware of all the various ways they can make a report, including the submission of alleged misconduct to the company whistleblower hotline, on a climate/ethics survey, or through informal exchanges with their direct superiors.

Mid-levels should also provide employees with real-life examples of compliance concerns that were raised and addressed, in which voicing complaints led to the identification of systemic problems and the implementation of new corporate controls or programs to address those issues. By doing so employees will be able to visualize the real benefits of reporting and how that leads to change within the organization.

See "*How to Build a Compliant Culture and Stronger Company From the 'Middle' (Part One of Three)* (Apr. 1, 2015); *Part Two* (Apr. 15, 2015); *Part Three* (Apr. 29, 2015).

Address Issues That Arise and Publicize Resolutions Where Appropriate

Senior management and the audit committee should also devote resources to analyzing data collected through their company's internal reporting mechanisms and determine how to resolve violations that appear serious and credible. Senior management may then disseminate these solutions to mid-level managers who in turn may, in appropriate circumstances, communicate to employees within their units how that information is being absorbed, appreciated, and addressed at the more senior levels.

Communicating information about resolutions of particular complaints to relevant subsets of the company, such as specific business units, coupled with employees' realizations that their superiors take internal reporting seriously, increases the likelihood that employees will find internal reporting to be worthwhile. Employees might then be more likely to lodge complaints with their company's audit committee and forgo reporting alleged violations to the SEC or at least give the company an opportunity to address the issue before allegations are made to the government.

Avoiding Rule 21F-17 Enforcement

Use Caution With Confidentiality Agreements

In the April 15, 2015 issue of The FCPA Report we discussed the results and implications of the SEC's first enforcement action under Rule 21F-17 against KBR. The Rule protects whistleblowers from their companies' efforts to prevent employees from communicating with the Commission about securities law violations. The SEC's 21F-17 enforcement action against KBR resulted in the company paying a $130,000 penalty for violating the Rule by requiring employees interviewed for internal investigations to sign a confidentiality agreement that prohibited them from discussing the subject matter of interviews without obtaining prior approval from the company.

See "*Implications of the SEC's First-Ever Whistleblower Protection Enforcement Action*" (Apr. 15, 2015).

In penalizing KBR, the SEC signaled that even if the intent of a company in having employees sign a confidentiality agreement is to protect the legitimate privilege between the company and its attorney and the integrity of an internal investigation, the Commission might still consider such practices as violations of 21F-17. Accordingly, while companies must foster a culture that encourages internal reporting, in no way can they prohibit or even imply that employees will suffer adverse consequences for external reporting.

After taking a sweeping view of the reach of 21F-17 in KBR, the SEC has yet to issue further guidance on the Rule's scope. That said, the Commission's Office of the Whistleblower, according to its 2015 Annual Report, "continues to actively work with Enforcement staff to identify and investigate practices in the use of confidentiality and other kinds of agreements that may violate Rule 21F-17(a). We will continue to focus on agreements that have language that reasonably could have the effect of impeding whistleblowers from reporting securities violations to the Commission."[29]

Beware of Severance Agreements

Since publishing the Report the SEC has investigated several companies for potential violations of 21F-17. In one recent annual report, Sandridge Energy, Inc. reported an SEC investigation into the company's possible violation of 21F-17.[30] In the filing, Sandridge reviewed the Commission's inquiry into allegations submitted by a former employee that the company fired him after he protested against the levels of oil and gas reserves disclosed in Sandridge's previous public filings.[31] During its inquiry into the employee's allegations, the SEC issued a subpoena to Sandridge requesting documents relating to employment-related agreements between the company and certain employees.[32]

After discussions with the Commission, Sandridge sent "corrective letters to certain current and former employees who had entered into agreements containing language that may have been inconsistent with SEC rules prohibiting a company from impeding an individual from

communicating directly with the SEC about possible securities law violations."[33] While Sandridge's fillings do not specify which employee agreement caught the SEC's attention, one practitioner stated that a form Separation Agreement might have raised red flags.[34] The Agreement includes a provision requiring departing employees to agree that they "will not at any time in the future voluntarily contact or participate with any governmental agency in connection with any complaint or investigation pertaining to the Company, except to the extent required by applicable law."[35]

In sum, while fostering internal reporting is critical to effectively managing the compliance culture of an organization, it cannot be done in a way that risks violating Rule 21F-17. The Commission's recent statements and actions underscore the continuing need for companies to examine their practices with respect to maintaining the confidentiality of their business information to ensure that they do not violate 21F-17.

Conclusion

As the SEC receives a growing number of whistleblower tips each year, companies increasingly run the risk of exposure to enforcement investigations before they are able to address the behavior triggering such investigations. To mitigate this risk, it is imperative that companies incentivize employees to report internally before making a hasty and unconsidered disclosure outside the company without perhaps knowing all the facts. To achieve this goal, companies must address the perception that reporting complaints within the company is pointless. In doing so, companies can foster a reporting culture in which employees not only seek to share their observations on corporate misconduct, but also their suggestions on how to improve the business.

Hence, to promote reporting of FCPA issues within the company, organizations should review their internal reporting procedures, the resources they have allocated to address complaints of wrongdoing, and employee agreements. Through such an assessment, companies might also be able avoid the impression that they are impeding employees from providing information to the SEC.

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[1] Press Release, SEC Issues $17 Million Whistleblower Award (Jun. 9, 2016).
[2] Press Release, SEC Awarding Nearly $2 Million to Three Whistleblowers (Mar. 8, 2016).
[3] 2015 SEC Ann. Rep. Dodd-Frank Whistleblower Program at 21.
[4] Id.
[5] Id. at 28.
[6] Samuel Rubenfeld, SEC Reports Rise in Whistleblower Tips, The Wall Street Journal, Nov. 17, 2015.
[7] 2015 SEC Ann. Rep. Dodd-Frank Whistleblower Program at 16-17.
[8] Press Release, SEC Issues $17 Million Whistleblower Award (Jun. 9, 2016).
[9] 15 U.S.C. § 78j-1(m)(4).
[10] Standards Relating to Listed Company Audit Committees, Securities Act Rel. No. 8220 (Apr. 9, 2003), 17 C.F.R. pts. 228, 229, 240, 249, and 274, § II.C, https://www.sec.gov/rules/final/33-8220.htm#P268_78471.
[11] Michael Delikat, Renee Phillips, Corporate Whistleblowing in the Sarbanes-Oxley/ Dodd-Frank Era, 7-2 (2d ed. 2011).
[12] NYSE Listed Company Manual § 303A.00 (noting such third-parties are the investment adviser, the administrator, the principal underwriter, or any other provider of accounting related services for the management company).
[13] See id. § 303A.10.
[14] Id.
[15] See NASDAQ Manual IM-5605-5
[16] See id. Manual IM-5610.
[17] Id.
[18] Dep't of Justice & Sec. & Exch., A Resource Guide to the U.S. Foreign Corrupt Practices Act 61 (Nov. 2012).
[19] Id.
[20] 15 U.S.C. §§ 78u-6(a)(1), (a)(3), (a)(5), (b)(1).
[21] Id.§ 78u-6(a)(1)
[22] Donald C. Dowling, Jr., How to Launch and Operate A Legally-Compliant International Workplace Report Channel, 45 Int'l Law. 903, 916 (2011).
[23] James R. Detert and Ethan R. Burris, Can Your Employees Really Speak Freely?, Harvard Business Review, January-February 2016.
[24] Id.
[25] Ethisphere, Beyond the Hotline: Creating an Open Reporting Culture at Your Company, YouTube (Apr. 28, 2016), https://www.youtube.com/watch?v=kDyjeb-SAck&feature=youtu.be&list=PLbaF22DTAwE-kJQOPLwhZWdeg52pEKWMx.
[26] James R. Detert and Ethan R. Burris, Can Your Employees Really Speak Freely?, Harvard Business Review, January-February 2016.
[27] Id.
[28] Id.
[29] 2015 SEC Ann. Rep. Dodd-Frank Whistleblower Program at 7.
[30] Sandridge Energy, Inc., Form 10-K (Form 10K) (Mar. 30, 2016).
[31] Id.
[32] Id.
[33] Id.
[34] Adam Herzog, SEC Sets Sights on Employers Who Impede Employees from Reporting, SEC Whistleblower Blog, Apr. 21, 2016.
[35] Id.