Implementation of the Dodd-Frank Whistleblowing Provisions

Peer-to-Peer Roundtable Event
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Daniels College of Business

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In May, 2011, the SEC voted to adopt final rules implementing the new whistleblower program established by last year’s Dodd-Frank Wall Street Reform and Consumer Protection Act. The new rules became effective August 12, 2011. After a lengthy process that included over a thousand comments from companies, trade associations, academics, and whistleblower advocates, the new rules contain several provisions that will continue to be of concern to corporations.

Most noteworthy under the Act and regulations is the requirement that the SEC pay a cash “bounty” to whistleblowers who report potential violations. In general, a whistleblower can be any individual or individuals who provide the required type of information to the SEC. Subject to certain exclusions, whistleblowers can be employees, officers, directors, shareholders, consultants, outside vendors, or even customers, of a company.

Under the new rules, whistleblowers are not required to report information internally using existing compliance or other processes prior to reporting to the SEC. However, in the final rule the SEC created some incentives to report internally first:

- A whistleblower can get credit for reporting information internally if he or she, or the company, reports the potential violation to the SEC within 120 days of the date of the internal report;
- A whistleblower can also receive credit for any other information that the company discovers as a result of the initial tip and then self-reports to the SEC; and
- The SEC has discretion to increase the amount of the bounty to be paid if the whistleblower availed him- or herself of internal reporting processes prior to contacting the SEC.

THE ROUNDTABLE

On September 8, 2011 a group of over 30 business leaders, practitioners, service providers and academics gathered to discuss the challenges in implementing the recently released SEC regulations for the whistleblowing provisions of the Dodd-Frank legislation. The diversity of the group, including Ethics and Compliance Officers and General Counsels and Independent Directors of public and private companies, together with outside counsels, consultants and advisors to such companies and several members of the Business Ethics and Legal Studies Department of the Daniels College of Business provided a robust discussion and a rich variety of points of view. The event was sponsored by the Institute for Enterprise Ethics at the Daniels College of Business.

The Institute’s introductory view was that this implementation would be a significant challenge to companies as they had worked hard and successfully over the past decade to integrate the Sarbanes-Oxley provisions for internal whistleblowing into their business culture and operations. The Dodd-Frank legislation challenges this work by offering significant financial incentives (“bounties”) for employees to report perceived violations directly to the SEC. Potentially, these new regulations could nullify the efforts of many companies to build strong cultural loyalty and effective internal whistleblowing processes and practices within their organizations. This change could also deter companies from dealing effectively and quickly with violations as employees are attracted to the prospect of a rich payday from the SEC rather than a pat on the back from their company. These and other concerns provided the basis for a lively discussion.
Opening Remarks

Prof. Kevin O’Brien, chair of Daniels’ Department of Business Ethics and Legal Studies, opened the roundtable with an overview of the new whistleblower regulations. Prof. O’Brien outlined the requirements of the new regulations, and described the potential impact on companies of the new “bounty” that the SEC offers to employees who report potential violations directly to the SEC rather than using internal reporting mechanisms. The slides for Professor O’Brien’s opening presentation can be viewed on the institute for Enterprise Ethics website at: www.enterpriseethics.org.

Issues of Concern

Throughout the roundtable discussion the participants identified a number of areas of concern with the implementation of the Whistleblowing regulations:

Disruption. The very first comment came from a Chief Legal Counsel who said that these “bounties” could be very disruptive to the company’s culture of candor and openness supporting a pattern of internal reporting. Another participant noted that it appeared the SEC was trying to turn “…all our employees into bounty hunters”.

Outside Direct Reporting. By far the most attention was paid to the potential for bounties to encourage direct reporting to the SEC and the problems the bounties might cause in the management of existing compliance processes.

These problems relate especially to the likely long lead times between the actual reporting of the purported violation and any action by the SEC. During this time, no action would be taken by the company since its leadership has not been made aware of the infraction(s) and could not initiate their own remediation. Meanwhile, the bad behavior may continue to inflict harm on the company and other victims.

Other problems discussed included the inability for the company to determine whether or not its internal processes actually work. Since the whistleblower has gone directly to the SEC and has not attempted to utilize the existing company processes, the effectiveness of the compliance procedures remains unknown. Consequently there is no opportunity to make the internal processes more effective unless or until the SEC acts.

A final set of problems of direct reporting relates to the effects of responding to the SEC investigation. The company may feel it is put in a state of siege in responding to the aggressive and urgent demands of the Agency. The company and the accused malfeasant are denied the opportunity for a careful, deliberative and objective investigation. The result potentially damages the company’s established culture and practices of self-management of inappropriate behavior.

Finally, once a company is forced to submit to an SEC investigation, even if exonerated, their reputation is damaged, with little opportunity to recover from such an experience.

Plaintiffs’ Bar. Two more issues arose with respect to the activity of the plaintiffs’ bar. First, many of the participants were very aware that several firms have been advertising aggressively to attract potential whistleblowers. This invitation not only raises the probability that some employees will be attracted to the possibility of a big bounty payment with the representation of an impressive law firm, but it also raises the likelihood that the report to the SEC will be more powerful coming from an experienced and well resourced law firm. Such preparation takes time and therefore extends the period during which the company is unaware of the report and the alleged infractions continue. The other plaintiffs’ bar issue that came up is the possibility of derivative suits following the settlement of the SEC charges. Two independent directors of public companies
expressed this concern.

Communication of Incentives. One of the participants whose professional practice focuses on boards of directors and senior executive teams asked the Ethics and Compliance Officers at the table: “How have you decided to tell your employees about these external reporting bounties?” This question was followed by a very pregnant silence until one of the participants responded: “That is a very tough question and we have not determined a good answer yet.” Two of the independent directors offered similar observations indicating that they were not at all clear how they would include the external bounty issue in their discussions with management teams of their corporations.

The Question of Internal Bounties. Professor Spitz, as the moderator of the discussion posed the question of whether or not anyone had considered the possibility of offering internal bounties to whistleblowers as competition for the external reporting bounties from the SEC. Other participants, especially the practicing Ethics and Compliance Officers and General Counsels were not at all in favor of this approach. One participant described this ideas as “…sort of like paying your kid to get good grades. This is what they ought to be doing anyway as a good employee – bringing issues to the management team for their attention.” Professor Holcomb suggested that an alternative approach might be to offer to work with the potential whistleblowing employee internally to determine the validity of the complaint and then support the whistleblower as he or she takes the accusation to the SEC and collects the reward.

Retaliation. Professor Spitz noted that the Dodd-Frank legislation included some specific language prohibiting retaliation against whistleblowers and asked if anyone planned to do anything special as a consequence of these regulations. The participants unanimously responded that they all have had to address these kinds of prohibitions since the advent of the Sarbanes-Oxley legislation and consequently their processes and procedures were well established, robust and quite effective. They saw no reason to do anything more in response to this new prohibition of retaliation as they are well prepared already.

Implementation Approaches

Throughout the discussion, the participants offered a variety of suggestions and experiences with regard to what they were doing in their own organizations to implement the whistleblowing regulations. These approaches boiled down to four major issues: High quality management structure and processes; strong, positive corporate culture and “tone-at-the-top; excellent compliance processes; and capitalizing on empowered employees.

Management Structure and Processes. Participants agreed that by far the best approach to avoiding the difficult issues of dealing with whistleblowing to external entities, especially government agencies such as the SEC, is to run the company so as not to do anything that could be considered a reportable violation. That is, if a company has a high quality management team, structure and processes, the likelihood of any employee observing a violation of law, much less being eager to report it externally, should remain low.

Professor O’Toole observed that ethical and legal violations are a reflection of mismanagement and if there are no instances of mismanaged programs, there should be no ethical or legal violations. He noted further that highly respected high performing companies tend to have exemplary records and reputations with regard to their ethical and legal experiences.
The companies represented around the table expressed sufficient confidence in the strength of their companies’ culture, the prowess of their companies’ management and the effectiveness of their internal processes to feel that they are unlikely to be confronted with a reportable violation and if they are, their employees would continue to report perceived violations internally rather than going immediately to the SEC. The sense around the table was that the companies represented are well managed and that reportable violations of SEC regulations are unlikely. If violations were to occur the participants felt that “culture would trump greed” and the violation would be reported internally. Finally they felt that their employees have sufficient trust in the company’s processes that the report would be followed up effectively and the reporting employee would be protected.

Consequently, especially the Ethics and Compliance Officers and the Internal Counsels present expressed the view that these new SEC regulations are “just one more thing they have to deal with” in their jobs, and they are confident that they would be able to do so effectively. However, it was also clear that not all companies enjoy such a position; i.e. not all companies are well managed with a strong positive culture and effective compliance processes. The roundtable discussion turned to these companies’ challenges in implementing the new regulations.

Corporate Culture and Tone-at-the-Top. As professor O’Toole noted in the opening discussion, a culture of candor, transparency and openness will go far in encouraging employees to utilize internal reporting procedures. Employees who feel their views are respected -- and their positions protected -- are more likely to talk to their bosses about perceived violations and to utilize the companies’ internal reporting systems rather than blow the whistle directly to outside parties such as the press or the SEC.

The power of organizational culture is apparent not only in the macro context of the entire enterprise, but also, and possibly more importantly, in the dynamics of small groups and teams of employees in the organization. As one participant described it: The way “…the six people in the cubicles corner of the fourth floor of an office building in DesMoines” relate to and treat each other define the culture and behavioral expectations of that group. Such peer relationships are among the most powerful forces in any organization.

In addition, the roundtable participants agreed that the single most important factor in assuring good management practice, powerful cultural values and robust process execution is a positive and responsible tone set by the top executives of the organization. Leaders of the organization are expected to set positive expectations for the rest of the team and demonstrate that they embody the enterprise’s culture themselves. These officers and managers must not only “walk the talk,” that is, behave as they say everyone should, but also “talk the walk,” that is communicate enthusiastically when others in the organization do things that represent the highest values and principles of the organization’s culture. Thus, both walking the talk and talking the walk illustrate and reinforce the messages embodied in the company’s culture.

Compliance Management Processes. Similarly, if employees have faith in the effectiveness, fairness, seriousness and timeliness of the companies’ internal reporting process, they are more likely to utilize them. These processes should be both proactive and reactive. Proactive processes include a robust compliance audit protocol that effectively reviews key compliance activity, reports results to the accountable people and assures timely and comprehensive follow-up. Reactive processes designed to deal with reported violations should make the reporting employee feel:
- comfortable, safe and protected in their reporting;
- that their concerns are being heard and taken seriously;
- that the process is fair; and
- that the company will communicate in a timely manner back to the reporting employee regarding the result of the investigation.

Moreover, companies should deal with even minor reporting instances in a consistently protective and thorough manner in order to assure that employees will trust the established processes in the event of more substantial issues.

The question of exactly how the new whistleblowing regulations will be integrated into existing company internal reporting processes appears not to be fully determined yet. However, the roundtable participants felt that, if existing processes are robust and well established, new issues can be incorporated fairly easily. New regulations such as the Dodd-Frank whistleblowing legislation will be “…just one more issue to be managed well in the existing compliance management system.”

Empowered Employees. Professor O’Toole commented that a great deal of research has shown that the critical factors making for loyal and productive employees are the feeling that they are trusted and that they will be heard by their managers. Employees who are thus engaged and fully participating in the enterprise will support the enterprise with their own energy and honesty, providing a powerful force for openness and candor among their peers. Such an environment will encourage employees not only to report quickly any incidents that are harming the company but also to exert pressure on the offending associate to stop. One valuable side effect of such a culture of empowerment is that the behavior of the employees and of the entire organization tends to be both positive and ethical.

Professor O’Toole noted further that one of the more effective means to achieve such an empowered and engaged workforce is to provide for a substantial level of employee ownership in the enterprise. Employees who feel that they have an important share in the ownership of the business will also feel they have an important share of the responsibility for the behavior and performance of the business. The key to making this ownership culture work effectively is to ensure that the ownership perspective lasts over a long term and is not seen as merely another form of short term compensation.

Issues for the Board of Directors.

While most of the conversation in the roundtable discussion dealt with managing the challenges of implementing the whistleblowing regulations, two items were clearly seen as important topics for the board of directors:

The Board and Corporate Culture. Among the participants in the roundtable were four independent directors sitting on the boards of four publicly traded corporations. Throughout the discussion on corporate culture, these directors focused on how difficult an issue this is to address at the board level. They strongly supported the idea that the culture of the corporation exercises powerful influence on the behavior and performance of the organization, and this fact made their concerns even more bothersome. The question they all said they faced and was the source of much discomfort: “How do you as a director know, for sure, what real culture prevails in the organization three or four levels below the C-suite. In fact, how do you know for sure what the culture of the C-suite is when the board is not in session?”
Four suggestions were made to help relieve this anxiety:

- Field visits to remote operating facilities and informal conversations with employees at these facilities.
- Ethics and Compliance data regularly reported to and discussed at board meetings.
- Bottoms up compliance management processes.
- Having Ethics and Compliance executives as well as other functional executives in attendance for parts of the board meetings when matters of corporate culture are discussed.

While these four suggestions were respected and appreciated and in fact utilized in most cases, the concerns of the independent directors remained unresolved.

Effectiveness of Ethics and Compliance Processes. A similar concern was evidenced by the independent directors expressing their uncertainty regarding the untested effectiveness of the ethics and compliance processes. While these processes are audited and undergo some virtual testing procedures, the board often does not know for certain that they work as they are intended, at least until they are subjected to an actual reporting event. If the event is well managed and neutralized, confidence is restored in the processes. If the event turns into a crisis because the processes failed, it may be too late for remedial action. The Ethics and Compliance Officers around the table consequently argued for more frequent and more demanding compliance process audits. Again, the directors recognized the value of this suggestion, but their concerns remained unresolved.

Summary

The roundtable discussion once more reinforced certain basic principles for leading and managing ethical enterprises. Whether viewed from the seat of the Chief Ethics and Compliance office, the General Counsel’s office, the Independent Director’s chair, or the C-suite, the same four items are key:

- Excellent management structure and practices,
- A strong and positive culture coupled with a clear and consistent tone at the top,
- Robust and effective compliance processes,
- Employees empowered by a culture of candor and trust

All agreed that these principles will carry any organization along the path not only to avoiding compliance violations and dealing with them effectively should they occur, but also to embodying the character of the ethical enterprise.