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5 The new Dodd-Frank whistleblower provisions: A primer for private equity firms

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Introduction

One of the most hotly contested aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), as far as federal securities laws are concerned, is its expanded monetary rewards for whistleblowers who report violations of federal securities laws. The new whistleblower provisions have attracted significant attention and concern from the financial and legal communities, but the structure and business of private equity firms make them vulnerable to whistleblowing in ways that have been less fully explored. This chapter explains the whistleblower rules, the unique and wide-ranging risks they pose for private equity firms and the steps that private equity firms can take to protect themselves.

New whistleblower rules

Dodd-Frank requires the Securities and Exchange Commission (SEC) to provide substantial monetary rewards to encourage individuals to provide information about potential violations of federal securities laws. This mandate requires the SEC to significantly expand its existing whistleblower program, which had been limited to insider trading cases and capped the amount of any award at 10 percent of the penalties collected in the action.

In summary, the new rules[1] provide that a whistleblower who voluntarily provides the SEC with original information that leads to a successful enforcement action by the SEC resulting in monetary sanctions of $1 million or more is eligible for an award of 10 percent to 30 percent of any amount recovered. During the seven weeks between August 12 (when the new rules went into effect) and September 30, 2011 (the end of the SEC's fiscal year), the SEC received 334 whistleblower tips.[2]

Definition of a whistleblower

The rules define a whistleblower as someone who provides information to the SEC about 'a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing or is about to occur.' The whistleblower must be an individual person; companies and other entities are not eligible to be whistleblowers. Whistleblowers may report information anonymously, but only if they are represented by an attorney.

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[1] SEC Adopting Release No. 34-64545, 17 CFR Parts 240 and 249, available at http://sec.gov/rules/final/2011/34-64545.pdf; see also SEC Press Release, SEC Adopts Rules to Establish Whistleblower Program, May 25, 2011, available at http://www.sec.gov/news/press/2011/ 2011-116.htm.

[2] SEC 2011 Annual Report on the Dodd-Frank Whistleblower Program at V, available at http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.

Certain categories of individuals are expressly excluded from receiving monetary awards as a whistleblower. These include officers, directors, trustees or partners who receive information about a company's alleged violations from a company employee or from the company's internal compliance processes. Similarly, attorneys, compliance personnel, accountants, investigators and auditors are all excluded from receiving whistleblower awards if they receive their information in the context of a legal representation or in performing compliance or audit duties or a legal investigation. Despite these general exclusions, compliance personnel and internal auditors (but never lawyers) can become whistleblowers if they have a reasonable basis to believe that disclosure to the SEC is necessary to prevent the company from engaging in conduct that is likely to cause substantial financial injury to the company or to investors, have a reasonable basis to believe that the company is engaging in conduct that will impede an investigation into the misconduct, or if at least 120 days have passed since the whistleblower provided the information through the company's internal channels.

The whistleblower rules *do not* exclude foreigners from receiving awards. As a result, employees at a US entity's foreign subsidiaries or branch offices can become whistleblowers if they have information about potential misconduct that relates to the federal securities laws. There already are indications that plaintiffs' lawyers have been trying to benefit from this fact by soliciting potential whistleblowers in countries with a large multinational corporate presence, such as China. Such overseas whistleblowers may be well-situated to report possible violations of, among other things, the Foreign Corrupt Practices Act of 1977 (FCPA), which prohibits bribery of foreign officials for purposes of obtaining a business advantage.

Information must be provided voluntarily

To receive an award, a whistleblower's information must be supplied to the SEC voluntarily. This means that the information must be provided before the whistleblower or his or her representative receives a request from any authority of the federal government, a state attorney general or other securities regulatory authority. Nonetheless, a whistleblower may receive an award even if a request for information was made to the company where he or she works, and even if the whistleblower possesses documents responsive to the governmental request directed to his or her company.

Information must be original

To qualify for an award, the whistleblower's information must be based on the whistleblower's independent knowledge or independent analysis; the information cannot already be known to the SEC or derived from public sources. If the whistleblower provides the same information through internal channels, the whistleblower will have a 120-day period during which he or she can alert the SEC and still be considered to have provided original information as of the date the information was provided internally. Additionally, Dodd-Frank protects the whistleblower from employer retaliation if the whistleblower provides information to the SEC that he or she reasonably believes relates to a potential violation of the federal securities laws. For all of these reasons, a whistleblower has a significant incentive to provide information to the SEC at the same time or even before he or she goes through internal reporting channels, and thus many

commentators believe that the original information requirement will undermine internal compliance programs by encouraging a 'race to the regulators.'

Information must lead to a successful enforcement action

There generally are three situations in which the SEC will deem a whistleblower's information to have led to a successful enforcement of the securities laws. The first situation is where the information is sufficiently specific, credible and timely to cause the SEC to open a new investigation, reopen a closed investigation or 'open a new line of inquiry in an existing examination or investigation.' The second situation is where the information 'significantly contributed to the success' of an investigation already under way. The third situation is where the whistleblower reports original information through his or her employer's internal reporting procedures, the employer then reports the information to the SEC, and the employer's report satisfies the other requirements of either the first or second situations.

It is critical to note that in the third scenario, it is the value of the employer's overall report to the SEC that matters most, not the value of the whistleblower's specific information. As a result, the SEC may attribute all of the information provided by the company to the whistleblower, even if not all of this information came from the whistleblower. If that happens, a whistleblower may get credit for additional information generated by the company in its investigation. According to the SEC, this is intended to incentivize whistleblowers to report internally.

Successful enforcement actions must result in penalties of $1 million or more

To determine whether monetary sanctions exceed the requisite $1 million threshold, the rules permit the aggregation of multiple cases that arise out of the same nucleus of operative facts, as well as related actions brought by other government agencies such as criminal prosecutions by the US Department of Justice (DOJ). Since implementing the whistleblower program, the SEC has set up a website listing actions resulting in monetary sanctions exceeding $1 million, for which whistleblowers may seek to claim awards.[3]

Risks that private equity firms face

For a variety of reasons, private equity firms may be uniquely vulnerable to whistleblowing under the new rules. Dodd-Frank provides whistleblower rewards for information about *any* violation of the federal securities laws, regardless of whether those violations occur at a private equity firm itself or at one of the firm's portfolio companies. Similarly, whistleblowers may come from within the private equity firm or from any of the firm's portfolio companies, even if the private equity firm does not manage the day-to-day affairs of its portfolio companies. However, whistleblower risks are different at private equity firms than at their portfolio companies, and to protect themselves, private equity firms must understand the unique risks posed in each scenario.

[3] Claim an Award, SEC Office of the Whistleblower, available at http://www.sec.gov/about/offices/owb/owb-awards.shtml.

Whistleblower risks at portfolio companies

A private equity firm faces potential whistleblowers at each portfolio company in which the firm invests. All companies should be prepared to correctly handle whistleblower complaints, and most companies have only their own employees' complaints to worry about. A private equity firm, by contrast, may manage several funds, each of which invests in a portfolio of several companies. The number of employees at each portfolio company may vary considerably. Together, these factors may multiply the number of potential whistleblowers to which the private equity firm may be exposed.

Private equity firms face potential liability for wrongdoing at their portfolio companies, even if the wrongdoing occurred before the firm invested in the portfolio company. In an acquisition, the acquirer assumes and must be careful to understand the target's liabilities. FCPA violations at a portfolio company are an example of this principle at work. The SEC and DOJ have ratcheted up their investigation and prosecution of violations of the FCPA, a post-Watergate law that was rarely prosecuted before the mid-2000s. The FCPA makes it illegal for US-based entities, as well as non-US entities that issue securities in US markets, to pay foreign officials to secure a business advantage. Several companies have paid hundreds of millions of dollars to settle FCPA cases with the government; settlements in the tens of millions of dollars have become commonplace. These violations at a private equity firm's portfolio companies can trigger liability for the firm, even if the firm does not control the day-to-day operations of its portfolio companies, and even if the private equity firm has no knowledge of the violations. Although liability under the FCPA's anti-bribery provisions generally requires knowledge that a bribe was paid, a private equity firm may still be liable under the FCPA's accounting provisions because they do not contain a knowledge requirement. For that reason, anti-corruption due diligence should be a part of any private equity transaction, treated with as much importance as conducting due diligence into credit and other business risks.

Already, there have been public reports of at least one SEC investigation of a private equity firm for alleged corruption at one of its portfolio companies,[4] and in a November 8, 2011 speech, the Assistant Attorney General in charge of the DOJ's Criminal Division reiterated the appropriateness of imposing successor liability in the FCPA context.[5] In China – the location of more alleged FCPA violations than almost any other country – private equity firms have aggressively pursued pre-IPO investments in Chinese companies as traditional financing has dried up. The government's focus on FCPA violations at portfolio companies means that private equity firms must pay special attention and watch out for whistleblowers at portfolio companies where FCPA violations are most likely to occur – companies with overseas business, particularly in growth markets such as Africa, China, India, Latin America, the Middle East and Russia.

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[4] A. Viswanatha. US Targets European Insurer in Foreign Bribery Probe. *Just Anti-Corruption*. December 21, 2010, available at http://www.mainjustice.com/justanticorruption/2010/12/21/u-s-targets-european-insurer-in-foreign-bribery-probe/.

[5] Assistant Attorney General Lanny A. Breuer Speaks at the 26th National Conference on the Foreign Corrupt Practices Act, November 8, 2011, available at http://www.justice.gov/criminal/pr/speeches/2011/crm-speech-111108.html.

Whistleblower risks at the private equity firm

It also is important for a private equity firm to understand whistleblower risks closer to home. A private equity firm's first line of defense is to understand whistleblower risks originating from the firm itself. Many standalone private equity firms have fewer than 100 employees, but these employees (including but not limited to the firm's investment professionals) may have significant knowledge about companies across the private equity firm's investment portfolio. In contrast, the typical corporate whistleblower knows little beyond how his or her division or department operates within a larger company. With broader access to information about a range of companies, employees from within the private equity firm may pose greater risks if they tip authorities to possible misconduct either at the firm itself or at one of its portfolio companies, thereby causing potential harm to the private equity firm's investment. Additionally, because the Dodd-Frank whistleblower program is not limited to US citizens or US-based employees, private equity firms with global operations face increased potential risk.

Private equity firms must be prepared to address whistleblowers who report securities violations related to the firm's core investment business, including how the firm attracts investors and makes investments. For example, in one well-publicized case concerning a private equity firm's solicitation of investments, the SEC and New York's Attorney General accused a private equity firm and its head of paying kickbacks to win $100 million in investments from the New York state pension fund.[6] In another case, this time concerning a private equity firm's management of investor funds, the SEC charged a private equity firm with defrauding three Detroit-area public pension funds by illegally siphoning their money to a private equity firm's manager's personal accounts.[7] Although both of these cases occurred before the current whistleblower regime went into effect, both cases involved allegations of wrongdoing by multiple individuals inside and outside the private equity firm. This underscores the future potential for whistleblowers to alert the SEC and, perhaps more importantly, the potential risk to private equity firms that fail to adequately detect and address the misconduct of individual employees.

Whistleblowers can also report private equity firm violations of the FCPA. Invoking the FCPA, the SEC has turned its attention to investment firms' dealings with sovereign wealth funds, whose foreign employees may be considered 'foreign government officials' under the FCPA. Sovereign wealth funds around the globe collectively have assets under management in the trillions of dollars and close to 60 percent of these funds invest in some form of private equity. The SEC has sent letters of inquiry to banks and prominent private equity firms as well.[8] For this reason, private equity firms should ensure that in their dealings with such entities, the private equity firms' employees and

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[6] SEC Press Release, SEC Charges Private Equity Firm in Kickback Scheme Involving New York Pension Fund, April 15, 2010, available at http://www.sec.gov/news/press/2010/2010-58.htm.

[7] SEC Press Release, SEC Charges Private Equity Firm and Money Manager for Defrauding Detroit-Area Public Pension Funds, April 22, 2010, available at http://www.sec.gov/news/press/2010/2010-64.htm.

[8] A. Jones, SEC: Wall Street, Meet the FCPA, *Wall Street Journal*, January 14, 2011, available at http://blogs.wsj.com/law/2011/01/14/sec-wall-street-wed-like-to-introduce-you-to-a-little-law-called-the-fcpa/.

third-party agents – including investment placement agents and marketers – comply with the requirements of the FCPA. This is an area in which a private equity firm's employees and business partners, especially those working outside the US, may pose significant risks as potential whistleblowers.

Another potential risk area for private equity firms are its transactions with so-called 'Chinese reverse merger companies,' which involve Chinese private companies that accessed US equity markets by merging with an existing US-listed shell company. Until 2011, such transactions were especially popular among Chinese companies purportedly hoping to enter US markets without the burdens of a traditional initial public offering. The SEC has issued an investor bulletin cautioning about the risks of Chinese reverse merger companies, particularly in the areas of accounting and financial disclosure,[9] and has suspended trading in several of these companies' stocks. With the SEC's increased scrutiny of Chinese reverse merger companies, private equity firms should be alert for potential whistleblower activity connected with investments in such entities or activity connected with participation in the growing numbers of transactions designed to return Chinese reverse merger companies to private ownership.

Whistleblowers unaffiliated with the private equity firm or its portfolio companies

Whistleblowers may also be unaffiliated with the private equity firm or its portfolio companies. In the past, for example, competitors' employees have sometimes served as whistleblowers and there are indications that this trend may intensify. Even before the final implementation of the Dodd-Frank whistleblower program, commentators noted an increase in the number of private lawsuits against competitors who reached settlements with the SEC or DOJ concerning violations of the FCPA. This increase suggests that with the added incentive of the new whistleblower rules, competitors' employees may grow even more eager to tip off the government to their rivals' misconduct.

In addition to competitors, current or former family members can also become whistleblowers. In one well-publicized case under the SEC's old whistleblower regime, the SEC paid a $1 million bounty to the whistleblower ex-wife of a man who provided inside information to a hedge fund. Similarly, at least one plaintiffs' law firm utilizes its website to solicit whistleblowers by noting that Dodd-Frank potentially provides whistleblower awards for neighbors, spouses and ex-spouses who report violations of the securities law.

Suggested practices for private equity firms

Between the new whistleblower rules and Dodd-Frank's new registration requirements for private equity firms with over $150 million in assets under management, private equity firms' internal compliance programs will certainly come under greater scrutiny. The most important rule to remember is that one size will not fit all. Below are some

[9] SEC Investor Bulletin, Reverse Mergers, June 2011, available at http://www.sec.gov/investor/alerts/reversemergers.pdf.

themes that private equity firms should consider when crafting a compliance program that addresses Dodd-Frank's increased whistleblowing risks or when evaluating a current or prospective portfolio company's Dodd-Frank whistleblower exposure while, at the same time, taking into consideration the unique circumstances of the private equity firm and its portfolio companies.

Establish appropriate internal reporting channels

Private equity firms should implement, and require their portfolio companies to have, internal reporting channels that are appropriate to the size and nature of their businesses. Large global corporations sometimes have an entire department dedicated to fielding anonymous employee complaints from a variety of channels, including web-based reporting tools, 24-hour telephone hotlines with multiple language capability and e-mail. It may also be wise to allow and encourage other external stakeholders to use a firm's own reporting channels to share information about possible wrongdoing. For larger private equity firms and portfolio companies with global operations, such a setup may be necessary.

In smaller private equity firms, as well as in some smaller portfolio companies, it simply may not be feasible to dedicate an entire department to internal reporting. Here, private equity firms must think creatively and strategically about adapting their operations to the Dodd-Frank whistleblower program. Third-party vendors may be able to staff hotlines, maintain online reporting tools and log complaints as they come in. However, third-party vendors are not a complete solution. They cannot evaluate complaints and cannot investigate complaints that merit further attention. This work will always be the responsibility of the legal or compliance department within the private equity firm or portfolio company. Particular attention should be paid to establishing safeguards that can ensure anonymity and prevent retaliation even in the context of a smaller workplace.

Regardless of size, the legal and compliance departments within private equity firms and their portfolio companies must devise a systematic protocol for evaluating complaints, tracking investigations and handling remediation. In order to ensure that the attorney-client privilege attaches to an internal investigation's findings, attorneys should oversee and handle the investigation and a private equity firm may choose to bring in outside counsel for this purpose where necessary. However, outside counsel typically is ill-equipped to evaluate complaints at the initial stage or to see through remediation efforts. These tasks require intimate knowledge of the firm's business, and must therefore be completed by competent internal legal and compliance professionals. For these reasons, private equity firms should resist the temptation to understaff their legal and compliance departments.

Similarly, portfolio companies should implement procedures for handling complaints received by their boards of directors and/or audit committees. These procedures should define the means by which complaints can be submitted to the board or audit committee, as well as the people within the organization responsible for evaluating and investigating complaints. Often, this responsibility falls to the general counsel.

Additionally, the complaint policy should ensure that reports are treated confidentially to the extent permissible under the law. The policy should prioritize investigations of more serious complaints and should define the criteria for designating more serious complaints. Generally, serious complaints will include at least one of the following: inaccuracies in financial statements, misconduct of senior management, financial or other types of fraud, and potential criminal conduct. Companies should commit themselves to investigating serious complaints within a certain time frame, keep records of complaints and investigation progress, and should formalize how investigation results will be shared with the company's board and/or senior management. Anti-retaliation policies are also necessary, and companies should provide training to their managers about the anti-retaliation policy. To the extent that members of the private equity firm sit on a portfolio company's board of directors, they should encourage the portfolio company to adopt these types of policies.

Internal reporting channels must also be structured to give a private equity firm or portfolio company the ability immediately to investigate complaints as they come in. The whistleblower rules provide that a whistleblower may still qualify for an SEC award if he or she first files an internal company report, as long as the whistleblower informs the SEC within 120 days. The SEC has stated that this is not intended to impose a 120-day deadline on a company's investigation and remediation. Companies nonetheless have a strong incentive to encourage a whistleblower to seek only to resolve the matter internally by demonstrating that his or her complaint is being taken seriously and addressed promptly, and that the company intends to remedy any problem it discovers. Companies should thus have a procedure in place to keep whistleblowers informed about the general progress of investigations into their complaints. For this reason, private equity firms' legal and compliance departments should be sufficiently equipped to address complaints as soon as they are received.

Establish a culture and expectation of compliance

The consensus in compliance circles is that corporate culture is the key ingredient in the success of any compliance program. This begins with what is frequently described as the 'tone at the top,' meaning that the most senior members of the private equity firm must demonstrate a commitment to compliance and fair dealing.

Beyond establishing a strong culture, however, private equity firms and their portfolio companies should consider requiring, as a matter of company policy, that all employees must report (anonymously if necessary) potential wrongdoing or violations of the law. This helps demonstrate the firm's commitment to compliance and encourages employees to report internally, even if they also report to the SEC.

Finally, firms should consider recognizing the contributions of those individuals who report internally by, for example, internally publicizing instances in which an employee complaint enabled the firm to fix a problem. Firms can credit employee contributions anonymously, but the message must be clear that reporting achieves results and is never ignored or punished.

Include compliance in investment due diligence and treat compliance risk as an investment risk

More than ever before, compliance issues should appear on any investment due diligence checklist. As the SEC grows more interested in private equity firms' portfolio companies, it makes business sense to avoid problems at the outset by understanding whether a proposed investment may present future compliance problems. This is because the new whistleblowing regime amplifies the risks that a private equity firm will itself be subject to government investigation for its own actions or those of its agents, or that the firm will end up an investor in a company under the shadow of regulatory scrutiny.

Conclusion

Dodd-Frank's whistleblower program provides significant financial incentives for individuals who tip off the SEC to any potential violation of the securities laws. As the SEC increasingly turns its attention to private equity firms and the activities of their third-party agents and portfolio companies, private equity firms should understand how the new whistleblower program works and how to protect themselves. Private equity firms face potential whistleblowers from within the firm itself, and from their portfolio companies, competitors and third-party partners. It is impossible to devise a single program for dealing with whistleblowers that fits all private equity firms. Nonetheless, private equity firms can start by establishing appropriate internal reporting channels and systematic investigation procedures that leverage both outside resources and an adequately staffed and funded internal legal and compliance function, and requiring the same of its portfolio companies. Private equity firms also should establish expectations of compliance from their employees, agents and portfolio companies, with an eye to treating potential compliance problems as an investment risk at the due diligence stage. □

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