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The Problem With Compliance Whistleblowers

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The U.S. Securities and Exchange Commission's recent award of nearly $1.5 million to a whistleblowing compliance officer highlights a tension inherent in the federal government’s approach to combating corporate wrongdoing. The award continues a troubling trend that many argue risks undermining companies’ internal compliance function.

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This tension arises out of the differing enforcement approaches championed by legislation enacted after two of the more prominent financial scandals in recent U.S. history. The Sarbanes-Oxley Act, passed in 2002 in the wake of accounting scandals at companies such as Enron and WorldCom, emphasizes corporate self-policing. Through more stringent compliance controls and disclosure obligations, SOX directs and incentivizes corporate boards, their management, and compliance officers to identify and remediate problems internally.

By contrast, the Dodd-Frank legislation passed in 2010 after the financial crisis suggests a lack of confidence in corporate internal controls. It enacted a whistleblowing program under which employees (and others) who report wrongdoing to the SEC or the Commodity Futures Trading Commission may receive a reward if either agency recovers more than $1 million as a result of the whistleblower’s information. The program, which built on whistleblower actions in areas such as qui tam investigations, offers a bounty of between 10 percent and 30 percent of the government’s recovery, depending on factors such as the significance of the information provided, the assistance provided by the whistleblower, and the “programmatic interest” of the SEC in deterring violations of the securities law.

The inclusion of compliance employees in the whistleblowing program was controversial from the outset. Much of the commentary both prior to and following the enactment of the whistleblower provisions argued that allowing these employees to recover under the whistleblower program provides a perverse incentive for them not to do their job. As a result, those charged with ensuring corporate compliance, namely those working in internal audit or compliance positions, are presumed to be ineligible for an award. However, there are exceptions to this rule, which arguably negate it.

A compliance officer may be eligible for an award if the employee reports wrongdoing to the SEC after reporting it internally, and the company fails to take action. He or she must wait 120 days between reporting the issue internally and contacting the SEC. Alternatively, a compliance officer may be eligible for an award if the employee has “a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors.”

Adding Fuel to the Fire

Against this backdrop, the April 22, 2015, announcement of the SEC’s award of over $1 million to a compliance officer — the second such award it has made — adds fuel to the debate. Those in favor of permitting in-house legal counsel, compliance officers and internal auditors to participate in the whistleblower program argue that these employees are in a unique position to witness and provide evidence of corporate wrongdoing. The SEC has struck this theme aggressively.

In announcing the first whistleblower award to a compliance officer in August 2014, the chief of the SEC’s Office of the Whistleblower trumpeted the knowledge and access of employees in such roles: “individuals who perform audit, compliance and legal functions for companies are on the front lines in the battle against fraud and corruption. They often are privy to the very kinds of specific, timely, and credible information that can prevent an imminent fraud or stop an ongoing one.”

Conversely, critics of such expansive whistleblower eligibility note that disgruntled or reward-seeking employees may pursue self-aggrandizement over the zealous compliance duties that their positions require.

It is noteworthy that in the most recent award, the SEC waived the 120-day waiting period that presumptively applies to awards to compliance officers. The SEC specifically found that the conduct at issue was “likely to cause substantial injury to the financial interest or property of the entity or investors” in the near term, and thus 120 days was too long to wait.

Using the amorphous “substantial injury” exception to compliance officer whistleblower eligibility is problematic. This exception gives the SEC substantial leeway to investigate alleged impropriety, but more importantly, it short-circuits the internal investigation process that is key to safeguarding both the SEC's and a corporation’s limited resources.

The 120-day waiting period allows a company a modicum of time to verify alleged wrongdoing and attempt to remedy any identified issues. Thus, bypassing the 120-day requirement provides reason for concern. Many already believed that the 120-day investigation window was too short in a world where an investigation into improperly inflated footballs can last 100 days or longer. An investigation into serious accounting fraud or matters involving scores of foreign subsidiaries can take a considerable amount of time. Refusing to enforce the four-month safeguard gives further credence to suspicions that in-house lawyers and compliance officers are being improperly incentivized to seek compensation not from their jobs, but from the government.

A Troubling Trend

The trend of rewarding as whistleblowers employees tasked with ensuring corporate compliance is troubling. It may upset the delicately crafted balance between punishing corporate wrongs and ensuring that employees are properly motivated to self-police a company’s compliance with all applicable laws, rules and regulations. Particularly worrisome is the specter of misaligned incentives and a willingness to allow vital protections to be dismissed (namely, the 120-day internal investigation period).

In light of this trend, companies that have made the commitment and incurred the expense necessary for a robust internal audit and compliance effort will be left to wonder if doing so is truly in their interest. By contrast — and presumably contrary to the objectives of regulators — if whistleblowing by internal audit and compliance personnel continues to be encouraged and rewarded, companies that have chosen not to make that commitment will not only have secured a competitive advantage, they may find themselves the new model.

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