SIMPSON THACHER

Corporate Litigation:

Dodd-Frank and Whistleblower Protection: Who Qualifies?

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

AUGUST 8, 2013

Among the 2,319 pages of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the paragraph addressing the scope of the law's whistleblower protections has occasioned some of the sharpest disagreements. Is a corporate employee who reports an employer's possible violation of the securities laws to a supervisor or internal compliance officer—but not to the Securities and Exchange Commission—considered a "whistleblower" entitled to protection under Dodd-Frank? Last month, in the first federal circuit court decision on the subject, the U.S. Court of Appeals for the Fifth Circuit in *Asadi v. GE Energy (USA)*,[1] held that the anti-retaliation protection contained in the whistleblower provision of Dodd-Frank creates a private right of action only for individuals who provide information relating to a violation of the securities laws to the SEC.

Asadi rejected several district court decisions (including very recent Southern District of New York authority) and the view embodied in the SEC's implementing regulation extending Dodd-Frank's whistleblower protections to individuals who report internally and not to the SEC. The Fifth Circuit's decision limiting Dodd-Frank's anti-retaliation provision to employees who report potential securities law violations to the SEC certainly may narrow the universe of potential retaliation claimants. But it may have unintended consequences.

The existence of a robust and effective corporate internal compliance and reporting system provides a variety of benefits to companies, investors and regulators. *Asadi* may incentivize a would-be whistleblower concerned about potential retaliation to skip internal reporting systems and report directly to the SEC, or at least report simultaneously to the SEC and the company to lock in protected status and the

* ***Joseph M. McLaughlin*** *is a partner at Simpson Thacher & Bartlett LLP.*

enhanced potential benefits offered by Dodd-Frank. This column summarizes current law, and offers guidance on how companies can promote the important objective of encouraging employees to report internally.

Dodd-Frank Whistleblower Protections

Dodd-Frank enhanced and expanded preexisting protections and bounty incentives to encourage whistleblowing, including those contained in the Sarbanes-Oxley Act (SOX). Before Dodd-Frank, the award of a whistleblower bounty was left to the discretion of the SEC and applied only in insider trading cases. Section 922 of Dodd-Frank amended the Securities Exchange Act of 1934 by adding a new provision: section 21F, "Securities Whistleblower Incentives and Protection." This anti-retaliation provision of Dodd-Frank prohibits actions taken against "whistleblowers," a status the statute specifically defined as "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission…."

Section 922 also mandates that in any judicial or administrative action brought by the SEC resulting in sanctions exceeding $1 million, the SEC "shall pay an award" to any whistleblower "who voluntarily provided original information to the Commission that led to the successful enforcement of the…action, in an aggregate amount" of between 10 and 30 percent of the monetary sanctions imposed in the action. Dodd-Frank requires the SEC's Office of the Whistleblower (OWB) to report annually to Congress on OWB's activities. In fiscal year 2012, the first full year of OWB's operation, 3,001 whistleblower tips and complaints were received from 49 countries and all 50 states, mostly concerning corporate disclosures and financial statements, allegations of fraud in securities offerings and manipulation.

Dodd-Frank thus says that to qualify as a "whistleblower," an individual must provide information to the SEC. Controversy about the scope of anti-retaliation protection has arisen, however, because Dodd-Frank applies for anti-retaliation purposes to a "whistleblower" who makes disclosures protected under laws such as SOX, including disclosures not made to the SEC. To protect whistleblowers against retaliation, Dodd-Frank section 21F(h)(1)(A) prohibits employers from firing, demoting or discriminating in any other manner against a whistleblower "because of any lawful act done by the whistleblower" in (1) providing information to the SEC, (2) assisting in any SEC investigation or action relating to such information, or (3) "in making disclosures that are required or protected under" various securities laws. This third anti-retaliation category is at the center of the debate about the scope of the whistleblower provision.

Section 78u-6(h) of Dodd-Frank, titled "Protection of whistleblowers," also created a private right of action for individuals alleging a violation of the whistleblower anti-retaliation provision, providing for reinstatement, double back pay (twice the amount provided by SOX) and litigation costs and attorney fees. The Dodd-Frank private right of action for whistleblowers who believe they suffered retaliation for providing information to the SEC can allege a claim against their employer in federal court, bypassing the Occupational Safety and Health Administration (OSHA) administrative procedures required under SOX. The whistleblower statute of limitations under Dodd-Frank is much longer (within six years of the retaliation, or three years after the facts material to the claim are known), compared to the 180 days a whistleblower under SOX must file with OSHA. Unlike SOX, Dodd-Frank invalidates pre-dispute arbitration agreements concerning whistleblower retaliation claims.

'Asadi' Decision

Khaled Asadi was an employee of GE Energy (USA). After working out of the company's Jordan office, in 2010 he reported possible Foreign Corrupt Practices Act violations to his supervisor and GE's regional ombudsman. GE subsequently terminated Asadi's employment and Asadi sued GE in Texas federal court, alleging wrongful termination under Dodd-Frank's whistleblower protection provision.

GE Energy moved to dismiss, arguing that Asadi was not a "whistleblower," as Congress defined the term, because he did not allege that he reported any information to the SEC. The Southern District of Texas ruled that the Dodd-Frank Act's anti-retaliation provision does not extend to extraterritorial whistleblowing activity and dismissed Asadi's complaint. The district court did not reach whether Asadi qualified as a "whistleblower" under Dodd-Frank.

The Fifth Circuit agreed that Asadi had no whistleblower claim, "start[ing] and end[ing]" its analysis "with the text of the relevant statute," which defines the term "whistleblower" as "any individual who provides…information relating to a violation of the securities laws to the Commission."[2] The court held that "[t]his definition, standing alone, expressly and unambiguously requires that an individual provide information to the SEC to qualify as a 'whistleblower' for purposes of" the Dodd-Frank Act's anti-retaliation provision.

Conceding that he did not fall within the scope of the whistleblower definition because he did not provide information to the SEC, Asadi argued he was nevertheless entitled to damages under Dodd-Frank's anti-retaliation provision because it protects "whistleblowers" from adverse employment action based on, among other things: "making disclosures that are required or protected under" various federal laws.[3] Asadi contended that his internal reporting qualified him as a "whistleblower" and that his alleged internal reports were "required or protected" by Sarbanes-Oxley.

The Fifth Circuit allowed that Asadi had "some case law, as well as the SEC regulation on this issue, in his corner." Specifically, a number of district courts have concluded that Dodd-Frank's whistleblower protection cause of action extends to certain individuals who do not make disclosures to the SEC. These decisions, including a May 2013 decision from the Southern District of New York in *Murray v. UBS Sec.*,[4] denied motions to dismiss claims brought by individuals who did not report to the SEC, reasoning that a literal reading of Dodd-Frank's definition of the term "whistleblower" (requiring reporting to the SEC) would negate the statute's protection against retaliation for whistleblower disclosures "that are required or protected under" the securities laws and without reference to reporting to the SEC.[5]

Consequently, in an effort to harmonize the tension, these district courts generally have permitted a Dodd-Frank retaliation claim if the plaintiff alleges either that his or her information was reported to the SEC, or that the disclosures fell within the four categories of protected disclosures set forth in Dodd-Frank that do not require reporting to the SEC: those under (i) the Sarbanes-Oxley Act, (ii) the Securities Exchange Act, (iii) 18 U.S.C. §1513(e) [a federal witness protection law], or (iv) other laws and regulations subject to the jurisdiction of the SEC.

The district court decisions have also drawn support from the SEC's implementing Regulation 21F, which provides that "for purposes of the anti-retaliation protections [under Dodd-Frank], you are a whistleblower if…you provide that information in a manner described in any of [the Dodd-Frank categories which include information provided to an employer under SOX]."[6] In its comments to Final Regulation 21F, the SEC expressly stated that the "statutory anti-retaliation protections apply to three different categories of whistleblowers, and the third category includes individuals who report to persons or governmental authorities other than the [SEC]."[7]

The Fifth Circuit noted, however, that the SEC's implementing rule on whistleblower status and retaliation protection "expands the meaning of a 'whistleblower' beyond the statutory definition" by "providing that an individual qualifies as a whistleblower even though he never reports any information to the SEC, so long as he has undertaken the protected activity listed in 15 U.S.C. §78u-6(h)(1)(A)."[8] "[R]eject[ing] the SEC's expansive interpretation of the term 'whistleblower,'" the Fifth Circuit held that the "plain language and structure" of the Dodd-Frank Act establishes "only one category of whistleblowers: individuals who provide information relating to a securities law violation to the SEC."

The court took considerable care to explain that Dodd-Frank's definition of "whistleblower" and the third category of protected activity—"disclosures that are required or protected under" law—do not conflict. The statute's placement of the three categories of protected activity in subsection (h) (which includes "disclosures that are required or protected under" law) follows the phrase "[n]o employer may discharge…or in any other manner discriminate against, a whistleblower…because of any lawful act done by the whistleblower…." "The use of the term 'whistleblower,'" the court emphasized, "as compared with terms such as 'individual' or 'employee,' is significant."

If Congress had said "individual" or "employee," the court reasoned, "Asadi's construction of the whistleblower-protection statute would follow more naturally because the use of such broader terms would indicate that Congress intended any individual or employee—not just those individuals or employees who qualify as a 'whistleblower'—to be protected from retaliatory actions by their employers. Congress, however, used the term 'whistleblower' throughout subsection (h) and, therefore, we must give that language effect."

The court noted that Dodd-Frank's protection afforded to "disclosures that are required or protected under" law is not superfluous. It has effect even when the protection from retaliation under Dodd-Frank applies only to individuals who qualify as SEC-reporting "whistleblowers" under the statutory definition of that term. To illustrate how the two statutory provisions operate together in practice, the court offered the example of a mid-level manager who is fired by his company's CEO after reporting a securities law violation both to the CEO and to the SEC. Even if the CEO "was not aware of the report to the SEC at the time he terminated the mid-level manager, the mid-level manager [could] state a claim under the Dodd-Frank whistleblower-protection provision because he was a 'whistleblower' and suffered retaliation based on his disclosure to the CEO, which was protected under" SOX.

Practical Considerations

The Fifth Circuit's holding that Dodd-Frank limits anti-retaliation protection only to "whistleblowers," and that one must report to the SEC to be a whistleblower, rejects numerous district court rulings that individuals who report internally, and not to the SEC, can be protected by the statute's anti-retaliation provisions. Effective reporting requires the timely provision of information to an entity that can and will act on it. In addition to creating an important division of authority with both courts and SEC Regulation 21F, *Asadi* may incentivize would-be whistleblowers to skip any internal reporting they otherwise might have done.

Whenever internal reporting is bypassed, even a well-conceived and run compliance function cannot operate to identify and correct potential wrongdoing internally before an SEC investigation begins. In order to encourage corporate self-policing, companies should implement programs that strongly encourage employees to avail themselves of internal compliance processes.

The SEC in Regulation 21F reinforces the goal of encouraging internal reporting, providing that a whistleblower who reports internally then has a 120-day period to report to the SEC without sacrificing any provision-of-original-information status under Dodd-Frank. Moreover, in considering a bounty award to a whistleblower, the SEC will credit him or her with information derived from any internal investigation arising from the internal report.

The hallmarks of a strong internal compliance and reporting system include a clear, well-communicated written policy that allows for prompt identification and redress of potential wrongdoing. The policy should be reinforced with periodic training of both management and employees at all levels, available guidance and regular consideration of whether the system is adequate to reasonably foreseeable problems. Employees and the government will most likely perceive the policy as effective if employees see in writing and are reassured in practice that internal reports of potential wrongdoing will be taken seriously, appropriately investigated by persons with authority, and not result in employment-related retaliation.

The company should not overlook the importance of training any manager with employee evaluation or promotion responsibility to understand the nuances of these responsibilities when addressing an employee who has reported a potential issue. Whether made internally or to the SEC, the company's handling of a report may be scrutinized by the government and investors, and in litigation. Good records substantiating the policy and its operation will go far in enabling the company to defend its conduct to all its constituencies.

Endnotes:

1. 2013 WL 3742492 (5th Cir. July 17, 2013).

2. 15 U.S.C. §78u-6(a)(6).

3. 15 U.S.C. §78u-6(h)(1)(A).

4. 12 Civ. 5914 (JMF) (S.D.N.Y. May 21, 2013).

5. See *Murray*, 12 Civ. 5914 (JMF) (S.D.N.Y. May 21, 2013); *Genberg v. Porter*, 2013 WL 1222056, at *10 (D. Col. March 25, 2013); *Kramer v. Trans-Lux*, 2012 WL 4444820, at *3-5 (D. Conn. Sept. 25, 2012); *Nollner v. Southern Baptist Convention*, 852 F.Supp.2d 986 (M.D. Tenn. 2012); *Egan v. TradingScreen*, 2011 WL 1672066 (S.D.N.Y. May 4, 2011).

6. 17 C.F.R. §240.21F-2(b)(1).

7. SEC Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300-01, at *34304, 2011 WL 2293084 (2011).

8. 2013 WL 3742492, at *7 (citing 17 C.F.R. §240.21F-2(b)(1)).