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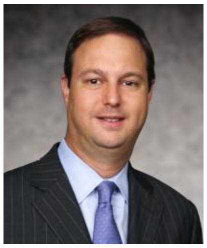
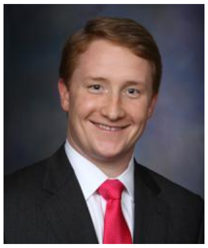
NY Financial Compliance Landscape May Get Treacherous

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Last month, New York Attorney General Eric Schneiderman proposed a New York “Financial Frauds Whistleblower Act,” which would provide compensation to whistleblowers who report fraud in the banking, securities, insurance and financial services industries. Modeled after the federal Dodd-Frank whistleblower provisions, Schneiderman’s proposal would give whistleblowers 10 to 30 percent of certain state fines that exceed $1 million. Because New York regulatory and enforcement agencies have brought enormous and far-reaching enforcement actions in recent years, Schneiderman’s proposal could create significant incentives for employees to provide information to the government rather than (or in addition to) reporting the information internally.

With employees facing such powerful incentives, it is more important than ever for companies to have sophisticated compliance programs, to act quickly to investigate allegations or evidence of misconduct, and — considering the U.S. Securities and Exchange Commission’s April 1, 2015, cease-and-desist order to KBR — to ensure that they are not potentially limiting employees’ ability to report possible violations of law to authorities.

The New York Proposal

Although Schneiderman has not yet released the proposed text of the Financial Frauds Whistleblower Act, he has presented the general terms of his proposal. If passed by the New York State Legislature, the proposal would provide monetary rewards to individuals who voluntarily provide original information, not previously known to the attorney general, regarding potentially illegal activity in the banking, securities, insurance or financial services industries.

Under the proposed legislation, whistleblowers would receive 10 to 30 percent of the money obtained in certain financial fraud cases if their information leads to a state enforcement action with sanctions of more than $1 million. The proposal also would protect employees against retaliation by strengthening existing labor protections to make it explicitly unlawful for employers to discharge, demote, suspend or otherwise harass employees who report suspicious or fraudulent activity to supervisory or internal compliance staff. Schneiderman thus promised the proposed law would be "the strongest, most comprehensive in the nation."

Whistleblower Incentives are Greater than Ever

This most recent announcement reflects a widespread trend toward strengthening the incentives for whistleblowers to come forward with information regarding possible fraud or misconduct. The potentially lucrative — and in some cases life-changing — rewards that are available under the federal Dodd-Frank Act have garnered much attention. But the less-noticed New York proposal could likewise have a significant impact, because New York regulators and enforcement agencies have been very active in bringing some of the largest investigations and enforcement actions in the financial sector.

For example, in the three years since it was created, the New York State Department of Financial Services has obtained more than $3 billion in fines from banks around the world, including $2.2 billion from BNP Paribas, $340 million from Standard Chartered, and $250 million from the Bank of Tokyo Mitsubishi. DFS has also imposed independent compliance monitors in many settlements.

On the federal level, the SEC has already pushed to bring more whistleblower cases since the 2010 passage of the Dodd-Frank financial reform bill, which created the agency's whistleblower program. The addition of §21F to the Securities Exchange Act of 1934, codified at 15 U.S.C. §78u, mandates a reward of 10 to 30 percent of any money the government collects from an enforcement action based on "original" information received from the whistleblower resulting in sanctions (including fines, disgorgement and interest) against the company in excess of $1 million. It appears that whistleblowers have been encouraged by the program, with the SEC fielding 3,620 tips on potential violations in 2014. This represents a 21 percent increase from two years before.

Importantly, government officials are aggressively looking for any signs of retaliation against whistleblowers or other efforts to silence whistleblowers. According to The Wall Street Journal, the SEC recently launched a probe into an undisclosed number of companies, asking them to turn over every nondisclosure, confidentiality, severance and settlement agreement they entered into with employees since Dodd-Frank went into effect. And on April 1, 2015, the SEC entered an administrative cease-and-desist order against KBR for asking employee witnesses to sign a boilerplate confidentiality agreement in connection with internal investigations.[1]

Under KBR's boilerplate confidentiality agreement, which was enclosed with KBR's code of ethics and in use prior to Rule 21F-17's enactment, employees interviewed during internal investigations agreed that they were "prohibited from discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law Department" and confirmed an understanding that "the unauthorized disclosure of information may be grounds for disciplinary action up to and including termination of employment."[2]

The SEC took the position that KBR's actions violated an SEC rule that protects whistleblowers and that implements part of the Dodd-Frank Act.[3] To resolve the matter, KBR paid $130,000 and modified its confidentiality agreement to include a provision stating that nothing in the agreement prohibited the employee from "reporting possible violations of federal law or regulation to any governmental agency or entity," including the U.S. Department of Justice, SEC, Congress and inspectors general, or from making any other disclosure protected by law.

The push to incentivize whistleblowing at the state level through stronger legislation is not limited to New York. Other states, including Maryland, Virginia and California, have proposed or already enacted laws similarly aimed at combating fraud through added incentives and stronger protection from retaliation. These laws are often modeled after federal legislation and incentivize whistleblowers to bring information to state enforcement authorities, particularly at a time when the SEC is fielding more and more tips regarding financial fraud.

The laws incentivize whistleblowing both by broadening the type of actionable frauds and by affording whistleblowers protection even before the information is disclosed. A recent legislative proposal in Maryland, for example, expands the type of actionable fraud to any fraudulent government contracting that occurs in the state, not just those related to the health care industry as was previously the case.[4] Last year, a California amendment enhanced protections against retaliation by protecting employees who report either internally or externally, and by making employers liable in cases of anticipatory retaliation, i.e., where the employer acts on a belief that the employee has or may disclose information.[5]

Implications for Your Company

If the New York attorney general is correct and the proposed law amounts to the “gold standard” in whistleblower regulation, then the legal and compliance landscape for companies will be more treacherous than ever. This makes it all the more important that companies have sophisticated compliance programs that are appropriately tailored to the companies’ risk profiles, that companies move quickly to investigate allegations and evidence of misconduct, and that companies take steps to ensure they are not restricting — even unwittingly — whistleblowers’ ability to report potential violations of law to authorities.

While even the most effective compliance program cannot prevent all potential wrongdoing, history has shown that enforcement agencies are particularly focused on the extent to which companies that are under investigation took steps to prevent misconduct and how those companies responded when evidence of misconduct came to light. Failure to act quickly and appropriately can cost your company greatly — and it can provide an enormous windfall to opportunistic employees who stumble upon evidence of wrongdoing.

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[1] Order Instituting Cease-and-Desist Proceeding, In the Matter of KBR, Inc., Admin. Proceeding No. 3-16466 (Apr. 1, 2015) (Exchange Act Rel. No. 74,619).

[2] Id. at ¶ 6.

[3] Exchange Act Rule 21F-17.

[4] Maryland False Claims Act, S. 374 (2015).

[5] Cal. Lab. Code § 1102.5(b).
