The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Vol. 11, No. 11 March 15, 2018

WHISTLEBLOWERS

Does the Digital Realty Decision Represent a Sea Change for Whistleblowers or Merely More of the Same?

Anne E. Beaumont and Alexander D. Levi, Friedman Kaplan Seiler & Adelman LLP

On February 21, 2018, the U.S. Supreme Court issued an opinion in Digital Realty Trust, Inc. v. Somers,[1] which addresses the scope of the whistleblower anti-retaliation provision of the Dodd-Frank Act. In a unanimous decision, the Court held that an individual can bring a claim under Dodd-Frank's anti-retaliation provision only if he or she has made a formal report to the SEC; internal reporting does not confer protection under the statute. Many commentators have predicted alarming consequences from the decision, but there are reasons to believe that many of those are unlikely to materialize.

This article reviews the statutory framework of whistleblower protections, lower court decisions in Digital Realty, the Supreme Court's decision in Digital Realty and the ruling's implications for private fund managers.

For a discussion of whistleblower protections in another jurisdiction, see "CIMA Regulator Discusses Key Issues for Advisers That Manage Cayman Funds: AIFMD Marketing Passport, Whistleblowers and Administrative Fines Regime (Part Two of Two)" (Sep. 21, 2017).

The Statutory Framework of Whistleblower Protections

Both the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)[2] and the Dodd-Frank Act[3] provide incentives and protections to individuals who report securities law violations and other forms of corporate misconduct, commonly referred to as "whistleblowers."

Protected Persons

Sarbanes-Oxley prohibits certain companies from discriminating – i.e., retaliating – against an "employee" because he or she reports information regarding conduct he or she "reasonably believes constitutes a violation" of, among other things, any SEC rule or regulation.[4] This provision protects an employee who furnishes such information to a federal regulatory or law enforcement agency (including the SEC), a member of Congress or a congressional committee or "a person with supervisory authority over the employee" (e.g., the employee's boss).[5] Therefore, an employee need not report to the SEC to invoke this provision.

In contrast, Dodd-Frank incentivizes and safeguards "whistleblowers," which are defined as "any individual who provides . . . information relating to a violation of the securities laws to the Commission [i.e., the SEC], in a manner established, by rule or regulation, by the Commission."[6] The statute protects not just employees, but any individual who reports to the SEC. Dodd-Frank protects whistleblowers from retaliation arising from (1) reporting to the SEC; (2) commencing, testifying in or assisting in an investigation or judicial or administrative matter of the SEC; or (3) "making disclosures that are required or protected under" Sarbanes-Oxley.[7]

The issue presented by Digital Realty arises out of SEC rulemaking under Dodd-Frank,[8] pursuant to which the SEC promulgated Rule 21F-2, which sets forth two definitions of "whistleblower,"[9] one of which arguably conflicts with the statutory language. With respect to Dodd-Frank's award program, to qualify as a whistleblower, an individual must "provide the Commission with information."[10] For purposes of the anti-retaliation provision, however, Rule 21F-2 states, "you are a whistleblower if," among other things, "[y]ou provide that information in a manner described in" clauses (i) through (iii) of Section 78u-6(h)(1)(A).[11] This means that, under the rule, an individual can claim anti-retaliation protections without any external disclosure, even though the statute's definition of "whistleblower" requires disclosure to the SEC.

Incentives and Private Causes of Action

The Dodd-Frank Act offers substantial financial incentives for a whistleblower who voluntarily provides "original information" to the SEC that leads to a successful enforcement action. A Dodd-Frank whistleblower may receive an award of 10-30 percent of the total monetary sanctions collected in such an action.[12] As of the end of fiscal year 2017, the SEC had awarded about $160 million to 46 whistleblowers since the beginning of the award program.[13] Sarbanes-Oxley offers no financial incentives.

See "Panel Analyzes SEC Use of Administrative Proceedings and Whistleblower Incentives, and Provides Guidance for Fund Managers Facing an Examination (Part Two of Two)" (Jan. 19, 2017).

Both statutes also protect whistleblowers by prohibiting retaliation (as discussed above) and providing, among other things, a private cause of action for retaliation. The procedures and remedies for private retaliation claims under the two statutes, however, differ significantly in the following ways:

1. Before bringing a retaliation claim under Sarbanes-Oxley, an employee must "exhaust" an administrative remedy through the U.S. Department of Labor.[14] Dodd-Frank contains no such exhaustion requirement.
2. Under Sarbanes-Oxley, the statute of limitations is only 180 days,[15] whereas a whistleblower has at least six years to bring a Dodd-Frank retaliation claim.[16]
3. An employee who brings a successful retaliation claim under Sarbanes-Oxley[17] can recover as damages actual back pay with interest, whereas Dodd-Frank allows for double back pay as damages.[18]
4. An employee who brings a successful retaliation claim under Sarbanes-Oxley "shall be entitled to all relief necessary to make the employee whole," such as "compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees."[19] While Dodd-Frank also permits a prevailing individual to recover "compensation for litigation costs, expert witness fees, and reasonable attorneys' fees,"[20] it does not provide for recovery of "special damages."

Thus, Dodd-Frank makes it relatively easier and more attractive to bring a retaliation claim, which explains in part the narrower definition of "whistleblower." The tension between the narrow statutory definition and the SEC's broader definition in Rule 21F-2 is at the core of the Digital Realty case.

Somers' Lawsuit, and the District Court and Court of Appeals' Opinions

The Digital Realty case arose from the termination of plaintiff Paul Somers' employment at Digital Realty. Somers filed a lawsuit in the U.S. District Court for the Northern District of California asserting claims for violation of the anti-retaliation provisions of Dodd-Frank and Sarbanes-Oxley, as well as for employment discrimination based on sexual orientation.

Somers alleged, among other things, that he was terminated because he reported to senior management that his boss had taken actions that "eliminated internal controls over certain corporate actions in violation of Sarbanes-Oxley."[21] Somers did not disclose such information to the SEC prior to his termination.

Digital Realty moved to dismiss Somers' Dodd-Frank claim, arguing he was not a "whistleblower" because he had not reported the alleged Sarbanes-Oxley violation to the SEC. Relying on SEC Rule 21F-2(b), the District Court held that reporting to the SEC is not a prerequisite to whistleblower status under Dodd-Frank's anti-retaliation provision, and denied Digital Realty's motion. The court held that the meaning of the term "whistleblower" in the statutory text was ambiguous, and thus accorded so-called Chevron deference[22] to the SEC's broader definition in Rule 21F-2(b).

On an interlocutory appeal, the Ninth Circuit Court of Appeals affirmed. The court reasoned that clause (iii) of Section 78u-6(h)(1)(A) "should be read to provide protections to those who report internally as well as to those who report to the SEC," and even if the meaning of "whistleblower" is ambiguous, the SEC's broader interpretation warranted Chevron deference.[23]

See "Securities Docket Webinar Analyzes 2017 SEC Enforcement Activities, Along With Disgorgement and Whistleblower Developments (Part One of Two)" (Feb. 22, 2018); "Proskauer Attorneys Evaluate the Dodd-Frank Whistleblower Program and Its Future Under the Trump Administration" (Jun. 1, 2017); and "Asset Managers Must Adapt to Increasing Protections for Internal Whistleblowing Under Dodd-Frank" (May 18, 2017).

The Supreme Court's Opinion

The Ninth Circuit's decision was consistent with the Second Circuit's view that SEC disclosure is not required, although inconsistent with the Fifth Circuit's conclusion that it is.[24] The Supreme Court granted certiorari to resolve this circuit split and unanimously reversed the Ninth Circuit's decision. "To sue under Dodd-Frank's anti-retaliation provision," the Court held, "a person must first 'provid[e] . . . information relating to a violation of the securities laws to the Commission.'"[25]

The Court simply applied the statutory definition under which only individuals who report to the SEC qualify as whistleblowers.[26] The Court also found corroboration in the "purpose and design" of Dodd-Frank, as reflected in the legislative history.[27] Having found the statutory definition of "whistleblower" to be "clear and conclusive," rather than ambiguous, the Court concluded that Chevron deference to the SEC's broader interpretation was inappropriate.[28]

The Court rejected a number of arguments and concerns raised by both Somers and various amici curiae.

The Court dispatched the contention that its interpretation would "gut" clause (iii) of Section 78u-6(h)(1)(a), which forbids retaliation against a whistleblower for "making disclosures that are required or protected under" Sarbanes-Oxley.[29] Because clause (i) already protects individuals who are retaliated against because of reporting to the SEC, Somers and the U.S. argued that the Court's interpretation would leave clause (iii) with extremely limited independent force; only protecting those who report both to the SEC and internally, and who face retaliation solely because of the latter disclosure.[30] Yet, the Court noted that such a situation could readily occur if a retaliating employer is unaware that an internally reporting employee has also reported to the SEC – a potentially common scenario because the SEC is required to safeguard a whistleblower's identity.[31]

Along a similar vein, the Court denied that its holding would "jettison protection" for lawyers, auditors and other professionals who, under Sarbanes-Oxley, must report internally before they can approach the SEC. The Court noted that those professionals remain protected by Sarbanes-Oxley and, as soon as they report to the SEC, are also protected by Dodd-Frank.[32]

The Court was also not troubled by the possibility that the consequences of an employer's "identical misconduct" would depend on whether an employee reported to the SEC. Because the "core objective" of Dodd-Frank is to encourage reporting to the SEC, the Court reasoned, "it is understandable that the statute's retaliation protections, like its financial rewards, would be reserved for employees who have done what Dodd-Frank seeks to achieve."[33]

The Court was also unconcerned about the impact of its decision on a hypothetical situation posited in the Government's amicus brief, in which an employee reports to the SEC at one job and then sues a subsequent employer for whistleblower retaliation under Dodd-Frank after internally reporting an unrelated matter. That situation, the Court noted, "veers far from the case before us."[34]

Finally, the Court addressed the concern that its holding could undermine clause (ii) of Section 78u-6(h)(1)(a), which protects whistleblowers from retaliation on the basis of commencing, testifying in or providing assistance in an SEC investigation or administrative matter. Specifically, under the statutory definition of "whistleblower," only individuals who report to the SEC "in a manner established[] by rule or regulation" are eligible,[35] and SEC Rule 21F-9 requires whistleblowers to submit information either online or through a specified written form.[36] An individual who reports to the SEC using some other method would not be protected from retaliation under Dodd-Frank, even if he or she were terminated because of testimony in an SEC investigation or hearing. "Nothing in today's opinion prevents the agency from enumerating additional means of SEC reporting – including through testimony protected by clause (ii)," the Court stated.[37]

Implications of the Decision

A number of commentators have already predicted dire consequences from the Digital Realty decision. Some foresee a flood of additional (and, some would suggest, baseless) reporting to the SEC. Others anticipate that whistleblowers will feel compelled to report to the SEC where they otherwise would not have in order to avail themselves of Dodd-Frank's anti-retaliation protections, including the private right of action. Still others have expressed concern that whistleblowers will bypass internal reporting mechanisms entirely and go directly to the SEC without their employers' knowledge. Thus, it is argued, companies will be drawn into expensive, distracting and needless SEC investigations. Whether these predictions turn out to be true remains to be seen, but there are reasons to think that such a parade of horribles may not come to pass.

As both the Court observed[38] and as many commentators have already noted, of the SEC whistleblower award recipients who have been insiders of a company that is the subject of an SEC report, the vast majority – approximately 80 percent – have also reported internally to the company. SEC reporting therefore seems to go hand-in-hand with internal reporting, and there is little reason that ought to change because of Digital Realty.

The dire prognostications also ignore the fact that there are reasons individuals refrain from reporting to the SEC that have – or will have – little to do with not knowing it is necessary to trigger anti-retaliation protections.

General awareness of the Digital Realty case is likely to be low. There is ample scholarship about the general lack of public awareness and accurate understanding of Supreme Court decisions even where they are well-publicized. Although the decision is currently receiving some attention in the business and legal community, there is little reporting on the case in other fora. It therefore seems unlikely that line employees will alter their day-to-day conduct based on the Digital Realty decision (or any other Supreme Court decision).

Indeed, few individuals are likely to know about the possibility of making any kind of whistleblower report unless they retain counsel who tells them about it. According to the SEC, almost a quarter of SEC whistleblower award recipients submitted their reports anonymously (and thus, through counsel), and half of award recipients overall were represented by counsel when they made their reports.

Perhaps most importantly, counsel, in turn, is likely to think twice before recommending a client report to the SEC because a client who is in a position to make a credible report of a potential securities law violation may have personal exposure, if only as a witness. For example, an outside accountant or insider accounting staffer who learns of accounting irregularities may have discovered them by personally participating in them (perhaps unwittingly, perhaps not).

Moreover, anyone who makes a whistleblower report to the SEC must do so under penalty of perjury and potentially faces a lengthy, ongoing commitment of cooperation if the SEC decides to pursue the matter further. As a result, some employees may well conclude it is not in their interest to report to the SEC.

There is also little likelihood that increased SEC reporting (if it happens) automatically means more SEC investigations and enforcement actions. For one, the SEC does not open an investigation of every whistleblower report. Rather, the regulator has said that it escalates only those cases "with high-quality information that warrant the additional allocation of Commission resources." In particular, "[t]ips that make blanket assertions or general inferences based on market events, or which do not relate to the federal securities laws are less likely to be sent to or pursued by Enforcement staff." Even without these screening mechanisms, which likely cull the most frivolous reports, more reporting cannot, as a practical matter, directly lead to a greater number of investigations or enforcement actions without a significant increase in the SEC's budget.

For more on whistleblower issues, see "How Promoting Internal Reporting Can Reduce Risk of Regulatory Intervention for Hedge Fund Managers" (Aug. 11, 2016); and "How Hedge Fund Managers Can Protect Privileged Internal Investigations Without Violating SEC Whistleblower Rule 21F-17" (May 21, 2015).

What Digital Realty Means for Employers

Even if there is no increase in SEC reporting as a result of the Digital Realty decision, the case highlights the importance of an employer taking any report of potential wrongdoing seriously and not retaliating because of it. Of course, whether specifically lawful or not, retaliating against employees who make reports of perceived wrongdoing – meritorious or otherwise – inevitably deters that reporting, which can be disastrous to any business.

Indeed, implicit in some commentators' concerns about the possibility of employees reporting to the SEC without their employers' knowledge is the notion that it would otherwise be permissible and appropriate to retaliate against an employee who merely reports internally.[39] Sarbanes-Oxley, however, prohibits and creates a remedy for that, albeit one with certain constraints that make it less appealing to a plaintiff. Accordingly, a prudent employer whose conduct is potentially subject to any kind of SEC oversight or investigation and who receives an internal report of a potential securities law violation should take it extremely seriously, and should also assume it could be or has been reported to the SEC.

Finally, employers that institute their own internal anonymous whistleblowing programs should take great care not to try to identify sources of anonymous reports and should document their responses to all reports, anonymous or not.

See "Can Hedge Fund Managers Use Whistleblower Hotlines to Help Create and Demonstrate a Culture of Compliance?" (Jul. 23, 2010); and "Best Practices for Fund Managers to Mitigate Litigation and Regulatory Risk Before Terminating Employees" (Feb. 9, 2017).

Anne E. Beaumont is a litigation partner in the New York office of Friedman Kaplan Seiler & Adelman LLP. Her practice focuses on representation of investment and asset management firms and their managers and investors, as well as financial services litigation matters and disputes involving derivatives and other complex financial products and transactions. She also counsels and trains financial services industry clients on legal, compliance, due diligence and other issues, and advises investment and asset managers and their professionals on employment and separation issues.

Alexander D. Levi is an associate at Friedman Kaplan. He specializes in complex commercial litigation with a special focus on contract actions, employment and securities law. He represents clients in the financial services, real estate and other industries and has experience arguing summary judgment and other motions before state and federal district and appellate courts.

The authors thank Eric Corngold, head of Friedman Kaplan's white collar department, and Lance J. Gotko, head of the firm's employment practice group, for their thoughtful insights.

[1] No. 16-1276, 2018 WL 987345 (U.S. Feb. 21, 2018).
[2] 116 Stat. 745. The anti-retaliation provision of Sarbanes-Oxley is found at 18 U.S.C. § 1514A.
[3] 124 Stat. 1376. Dodd-Frank's whistleblower provisions are found in 15 U.S.C. § 78u-6.
[4] 18 U.S.C. § 1514A(a)(1).
[5] Id.
[6] 15 U.S.C. § 78u-6(a)(6) (emphasis added).
[7] 15 U.S.C. § 78u-6(h)(1)(A)(i)-(iii).
[8] See 15 U.S.C. § 78u-6(j).
[9] See 17 CFR § 240.21F.
[10] See 17 CFR § 240.21F(a).
[11] See 17 CFR § 240.21F(b).
[12] 15 U.S.C. § 78u-6(b)(1).
[13] SEC, 2017 Annual Report to Congress Whistleblower Program, Nov. 15, 2017, available at: https://www.sec.gov/files/sec-2017-annual-report-whistleblower-program.pdf.
[14] 18 U.S.C. § 1514A(b)(1).
[15] See id. § 1514A(b)(2)(D).
[16] 15 U.S.C. § 78u-6(h)(1)(B)(iii).
[17] 18 U.S.C. § 1514A(c)(2)(B).
[18] 15 U.S.C. § 78u-6(h)(1)(C)(ii).
[19] 18 U.S.C. § 1514A(c)(1) & (c)(2)(C).
[20] 15 U.S.C. § 78u-6(h)(1)(C)(iii).
[21] Somers v. Digital Realty Tr., Inc., 119 F. Supp. 3d 1088, 1092 (N.D. Cal. 2015) (internal quotation marks omitted).
[22] See Chevron, U.S.A. v. Natural Resource Defense Council, Inc., 467 U.S. 837 (1984).
[23] Somers v. Digital Realty Tr. Inc., 850 F.3d 1045, 1050 (9th Cir. 2017).
[24] Compare Berman v. Neo@Ogilvy LLC, 801 F.3d 145, 146 (2d Cir. 2015) ("We conclude that the pertinent provisions of Dodd–Frank create a sufficient ambiguity to warrant our deference to the SEC's interpretive rule. . . ."), with Asadi v. G.E. Energy (USA), L.L.C., 720 F.3d 620, 630 (5th Cir. 2013) ("We conclude that the plain language of § 78u–6 limits protection under the Dodd–Frank whistleblower-protection provision to those individuals who provide 'information relating to a violation of the securities laws' to the SEC.").
[25] Digital Realty Tr., Inc. v. Somers, 16-1276, 2018 WL 987345, at *4 (U.S. Feb. 21, 2018) (quoting 15 U.S.C. § 78u–6(a)(6)).
[26] Id.
[27] Id. In a separate concurrence, Justices Thomas, Alito and Gorsuch disagreed with this portion of the Court's opinion, joining it "only to the extent it relies on the text of" Dodd-Frank. Id. at *15.
[28] Id. at *13.
[29] Id. at *11.
[30] By contrast, if Dodd-Frank were read to protect employees who report only internally, then clause (iii) would arguably have a much broader independent force because it would protect employees terminated as a result of internal reporting, regardless of whether they also reported to the SEC.
[31] Digital Realty, 2018 WL 987345, at *11.
[32] Id. at *12.
[33] Id. at *12.
[34] Id. The U.S. noted that neither the statutory definition of "whistleblower" nor Dodd-Frank's anti-retaliation provision requires a temporal or subject-matter relation between the violation reported to the SEC and the one reported internally.
[35] 15 U.S.C. § 78u-6(a)(6).
[36] 17 C.F.R. § 240.21F-9(a)(1)-(2).
[37] Digital Realty, 2018 WL 987345, at *13.
[38] Id. at *11.
[39] It also makes no sense for an employee to bypass internal reporting mechanisms and report directly to the SEC solely to trigger a Dodd-Frank-based retaliation claim because an employer cannot be alleged or shown to have terminated an employee (or taken other adverse employment action) "because of" a report to the SEC if the employer did not know about it.