

## BYU Law Review

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Volume 2012 | Issue 1

Article 2

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3-1-2012

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### Recommended Citation

Geoffrey Christopher Rapp, *Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. Rev. 73 (2012).

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# Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act

Geoffrey Christopher Rapp\*

## I. INTRODUCTION

A decade ago, when the collapse of Enron<sup>1</sup> and scandals at Tyco<sup>2</sup> and WorldCom<sup>3</sup> shook Wall Street, Congress reacted by enacting the now much-maligned<sup>4</sup> Sarbanes-Oxley Act (SOX).<sup>5</sup> Among SOX's

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1. Manish Gupta, *Elan, Enron and the Aftermath of Scandal: A Comparative Analysis of Recent Irish and American Corporate Governance Legislation*, 39 CAL. W. INT'L L.J. 1, 18 (2008) ("Perhaps the best known bankruptcy, though not the largest, involved Houston-based energy trader Enron Corporation. Enron hid assets and liabilities in over 2000 business entities, many of which were wholly-owned special purpose entities that were not included on Enron's financial statements.").

2. Joan T.A. Gabel et al., *Evolving Regulation of Corporate Governance and the Implications for D&O Liability: The United States and Australia*, 11 SAN DIEGO INT'L L.J. 365, 371 (2010) ("Tyco, a maker of equipment for various industries (including electrical, fire and security, healthcare and telecommunications), became embroiled in a similar scandal involving financial misstatements and a blatant misuse of corporate funds.").

3. Christian A. Young, Note, *Looking Back on WorldCom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 SUFFOLK U. L. REV. 521, 536 (2007) (explaining that WorldCom's tale "involve[d] a large scale accounting scandal resulting in the financial collapse, and subsequent bankruptcy filing, of WorldCom, Inc").

4. SOX has generated much controversy and been criticized as costly for small businesses and foreign companies and blamed "in part for reduced foreign listings on the New York Stock Exchange." Terry Morehead Dworkin, *SOX and Whistleblowing*, 105 MICH. L. REV. 1757, 1758-59 (2007).

5. Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act), Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of U.S.C. titles 11, 15, 18, 28, and 29). In the aftermath of various corporate scandals, "[t]he bill raced through Congress," Gabel et al., *supra* note 2, at 375, passing by a vote of 99-0 in the Senate. Beverley H. Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change*, 44 AM. BUS. L.J. 1, 4 (2007). The "unusual rapidity of this vote, in a body no longer known for its civility, signaled that perhaps Congress had not carefully considered all the provisions." *Id.* For a scathing critique of the

more prominent features was the first federal enactment providing whistleblower protection for insiders with knowledge of financial fraud.<sup>6</sup> SOX criminalized retaliation against whistleblowers,<sup>7</sup> creating a new administrative remedy for aggrieved tipsters under the auspices of the Occupational Safety and Health Administration (OSHA).<sup>8</sup>

Ten years later, when the collapse of America's shadow-banking system<sup>9</sup> led Wall Street to receive an unprecedented federal bailout, Congress once again<sup>10</sup> reacted with a legislative hydra,<sup>11</sup> the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).<sup>12</sup> As before, whistleblowers took center stage. In Dodd-Frank, however, whistleblowers not only receive protection from termination or adverse employment action but can also lay claim to financial bounties for bringing information to the Securities and

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merits and process of adoption of SOX, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) (arguing that the policies included in SOX "may . . . be characterized as recycled ideas advocated for quite some time by corporate governance entrepreneurs").

6. 18 U.S.C.A. § 1514A (West 2010).

7. *Id.* § 1513(e).

8. OSHA's designation as the investigating agency has struck a number of observers as odd. Prior to SOX, OSHA "had no experience . . . with such problems." Earle & Madek, *supra* note 5, at 3. To be sure, OSHA "already administer[ed] some whistleblower statutes," but those statutes often involve "more concrete and less vague" protected activity than blowing the whistle "with respect to violations of accounting principles." *Id.* at 15. The investigation of "securities-related irregularities" is "presumably outside of OSHA's usual arena." *Id.*

9. Christopher T. Hines, *Returning to First Principles of Privilege Law: Focusing on the Facts in Internal Corporate Investigations*, 60 KAN. L. REV. 101, 105 (2011) ("As we now know, a credit bubble of historic proportions, which initially formed in the housing markets through excessive subprime lending, eventually infected the overall financial markets through a complex web of transactions linking financial institutions both in the United States and abroad.").

10. "It seems that with every new corporate or financial crisis/scandal/failure, we end up discussing many of the same issues and concerns as with prior ones." M. Thomas Arnold, *"It's Déjà Vu All Over Again": Using Bounty Hunters to Leverage Gatekeeper Duties*, 45 TULSA L. REV. 419, 438 (2010).

11. The Act was the "most comprehensive financial reform legislation since the 1930s." BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY (2010), available at <http://www.llsdc.org/attachments/files/232/CRS-R41350.pdf>.

12. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1367 (codified as amended in scattered sections of U.S.C. titles 7, 12, 15, and 31) [hereinafter Dodd-Frank Act].

Exchange Commission (SEC) that leads to successful securities enforcement actions.<sup>13</sup>

With the recent release of the SEC's final rule 21F<sup>14</sup> to govern the application of Dodd-Frank § 922,<sup>15</sup> which embraces whistleblower bounties for securities fraud tipsters,<sup>16</sup> it is appropriate to reflect on the nature and meaning of this provision. Law professors had called for whistleblower bounties for financial fraud tipsters in the decade that followed the enactment of SOX. Pamela Bucy's 2002 article, *Private Justice*,<sup>17</sup> made the case for private litigation of securities fraud disputes, as well as citizen environmental suits.<sup>18</sup>

I argued in 2007 in *Beyond Protection*<sup>19</sup> that the SOX framework—which provides security against retaliation but little positive incentive to encourage whistleblowing—was inadequate motivation for those with access to information about serious corporate fraud. I argued that payments could be made out of the “Fair Funds” collected by the SEC to provide restitution for injured investors.<sup>20</sup> In a follow-up piece in 2009, *False Claims, Not Securities Fraud*,<sup>21</sup> I criticized the lukewarm embrace of whistleblower bounties in the Obama Administration's Investor Protection Act, which became the precursor of Dodd-Frank. Unfortunately, the initial proposed language left a high degree of discretion in the hands

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13. *Id.* § 922, 15 U.S.C.S. § 78u-6 (Lexis Supp. 2011) (amending § 21F of the Securities Exchange Act of 1934).

14. The SEC was originally set to release the final rules by April 21, but the Commission announced in April that it would miss that deadline. Joe Palazzolo, *SEC Will Miss Deadline for Whistleblower Rules*, WALL ST. J. BLOG (Apr. 21, 2011, 5:35 PM), <http://tinyurl.com/7et94cd> (subscription required). The final rules were adopted by the Commission in a May 25, 2011, vote. Those rules took effect August 12. *See* Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300 (June 13, 2011) (to be codified at 17 C.F.R. pts. 240 and 249) [hereinafter SEC Final Rules].

15. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6.

16. *Id.*

17. Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 44, 105 (2002).

18. *Id.* at 128.

19. *See* Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 92 (2007).

20. *Id.* at 147–50. This aspect of the proposal was called “interesting” given the “amount of money that the fair funds provision of Sarbanes-Oxley is generating,” in the neighborhood of \$2 billion in just 2009. Arnold, *supra* note 10, at 467 nn.417–18 (footnote omitted).

21. Geoffrey Christopher Rapp, *False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers*, 15 NEXUS 55 (2010).

of the SEC. Historically, the Commission had rarely exercised its discretion to pay tipsters in the insider trading context, where bounties had long been authorized.<sup>22</sup> In a paper written before the enactment of Dodd-Frank, Tomas Arnold argued for a mandatory whistleblower bounty scheme for financial fraud tipsters providing original information that was a “substantial factor” in leading to a corporate restatement of earnings.<sup>23</sup>

Dodd-Frank’s new whistleblower provision represents a victory for those who had called for whistleblower bounties in the securities fraud context. Unfortunately, Dodd-Frank’s embrace of this policy proposal may prove to be, like SOX before it, a missed opportunity. Although Dodd-Frank drew some of its inspiration from the False Claims Act (FCA)<sup>24</sup>—the “gold-standard”<sup>25</sup> of whistleblower protection and bounty rewards—it fell short in one critical respect. While whistleblowers were provided with a process for seeking rewards, Dodd-Frank failed to embrace the crucial *qui tam*<sup>26</sup>

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22. See *infra* notes 430–40 and accompanying text.

23. See Arnold, *supra* note 10, at 464. Professor Arnold’s proposal had the following core components: (1) bounties would only be available where existing bounty schemes did not apply; (2) bounties would only be paid where the informant provided a written disclosure to a firm’s audit committee; (3) government or corporate employees tasked with internal investigations would be barred from claiming bounties; (4) bounties would be “generous enough to incentivize” a person to blow the whistle; (5) the proposal would “provide for mandatory and not discretionary payment of bounties”; and (6) bounties would only be paid “if the original information disclosed is a substantial factor leading to a restatement of the company’s financial statements.” *Id.* Most distinctively when compared to Dodd-Frank, however, Arnold’s proposal would vest discretion to identify the amount of the award in a firm’s own audit committee, rather than the SEC. See *id.* at 464–65.

24. 31 U.S.C. §§ 3729–3733 (2006). For example, the statute’s “voluntary disclosure” and “original information” components, 15 U.S.C.S. § 78u-6(a)(3) (Lexis Supp. 2011), draw on the FCA’s “original source” requirement, 31 U.S.C. § 3730(c)(4)(B). Similarly, the upper limit for bounty awards, thirty percent mirrors that of the FCA. *Id.* § 3730(d). However, the statute’s more immediate model was the IRS whistleblower program. See MARK JICKLING, CONG. RESEARCH SERV., R41503, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE IX, INVESTOR PROTECTION 3 (2010) (“The program is modeled on the Internal Revenue Service Whistleblower program.”).

25. While at least one scholar characterized SOX as the “gold standard” of whistleblower protection, see Cynthia Estlund, *Rebuilding the Law of the Workplace in an Era of Self-Regulation*, 105 COLUM. L. REV. 319, 376 (2005), most research on the statute would dispute that characterization. Instead, it is the FCA that is “the most vibrant and dominant of all *qui tam* actions available in the United States today.” Elizabeth I. Winston, *The Flawed Nature of the False Marking Statute*, 77 TENN. L. REV. 111, 140 (2009).

26. The phrase “*qui tam*” is a short-hand for the Latin *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, or “who pursues this action on our Lord the King’s behalf as well as his own.” Vt. Agency of Natural Res. *ex rel.* Stevens, 529 U.S. 765, 768 n.1 (2000) (citing 3 WILLIAM BLACKSTONE, COMMENTARIES \*160).

provisions of the FCA that allow whistleblowers to *litigate cases independently* from federal action. Perhaps because of the power of the Wall Street lobby,<sup>27</sup> which regularly puts the “Military-Industrial Complex” to shame,<sup>28</sup> whistleblowers under Dodd-Frank will remain spectators in most stages of the enforcement actions triggered by their revelations.

This Article addresses the new whistleblower provisions along three dimensions. First, does Dodd-Frank embrace the ideal version of whistleblower bounties? Second, to what extent can the new statute be expected to change behavior in corporate America and alter the securities enforcement landscape? Finally, in considering alternatives to Dodd-Frank’s approach, what does the FCA reveal about the failings of the new law?<sup>29</sup>

This project is a timely one, as the increased statutory protection under SOX has led to a flurry of post-2002 research on the behavior of whistleblowers. Both from the perspective of empirical economics and behavioral psychology, researchers have gleaned new understandings of the motivations of whistleblowers and the effectiveness of bounties in spurring reporting and aiding the detection of fraud. This Article takes up these new sources to provide perspective on Dodd-Frank. For instance, a detailed 2010 econometric study by Alexander Dyck, Adair Morse, and Luigi Zingales<sup>30</sup> (the “Dyck Study”), provides support for the notion that

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27. andré douglas pond cummings, *Procuring “Justice”? Citizens United, Caperton, and Partisan Judicial Elections*, 95 IOWA L. REV. BULL. 89, 107 (2010) (“Wall Street leadership chose to use millions of dollars of TARP funds, provided by U.S. taxpayers, to pay lobbyists to fiercely lobby against new financial services regulations Congress was considering in light of the reckless behavior of those same executives.”).

28. President Eisenhower warned of the “acquisition of unwarranted influence, whether sought or unsought, of the military-industrial complex.” Dwight D. Eisenhower, Farewell Radio and Television Address to the American People, in PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES, DWIGHT D. EISENHOWER 1035, 1038 (1961).

29. In fact, whistleblowers wary of the obstacles to getting paid under the Dodd-Frank law may choose to pursue their claims using the more powerful FCA, at least to the extent that they work for companies that have yet to pay back federal bailout funds and so remain partially owned by the federal government. See generally, Ben Maiden, *Firms Face Private Suits over Bailout*, COMPLIANCE REP., April 27, 2009, at 1, 11, available at <http://www.compliancereporter.com/pdf/CR042709.pdf> (“Someone will come up with a theory that if you violate one of the post-hoc [TARP] conditions that you are violating the FCA,” said defense attorney John Boese, of counsel with Fried, Frank, Harris, Shriver & Jacobson.” (alteration in original)); Rapp, *supra* note 21 (arguing that the FCA empowers whistleblowers to pursue bounties in stock fraud cases involving companies receiving federal bailout funds).

30. See Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN.

“the role of monetary incentives [for whistleblowers] should be expanded.”<sup>31</sup> Similarly, a 2010 study by Robert Bowen, Andrew Call, and Shiva Rajgopal found that, contrary to what some in the corporate lobby might fear, whistleblowing is rarely “frivolous, misleading, or unreliable.”<sup>32</sup> Instead, whistleblowing allegations tend to uncover previously existing “unknown agency problems” at target firms and identify genuine instances of financial misconduct.<sup>33</sup>

This Article represents the third stage of my project on whistleblower bounties.<sup>34</sup> With the benefit of the newly enacted statute, the policy proposals developed in earlier pieces can be compared to the new law and to likely claims under its provisions. Section 922 was erroneously trumpeted in some circles as providing “qui tam” provisions;<sup>35</sup> in fact, its biggest failure may be that it does not create true qui tam structures. That is, the law facilitates payments to whistleblowers, but provides no avenue for whistleblowers to pursue securities fraud actions directly. Instead, payments are only available in instances in which the SEC recovers civil fines.

This Article builds on my earlier work by probing the differences between a bounty scheme which simply makes rewards available and one which gives whistleblowers the opportunity to pursue litigation themselves. To the extent that whistleblowers are motivated by concerns other than money—as indicated by recent experimental studies using a behavioral psychology approach—the qui tam model offers more hope for stimulating whistleblowing than the reward-only option selected by Dodd-Frank. Qui tam gives whistleblowers a chance to tell their stories and to restore their reputations, and gives “voice” to the reality of their experiences.

Other limitations of the new statute include its restriction to cases in which the monetary sanctions imposed total more than \$1

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2213 (2010).

31. *Id.* at 2251.

32. See Robert M. Bowen et al., *Whistle-Blowing: Target Firm Characteristics and Economic Consequences*, 85 ACCT. REV. 1239, 1242 (2010).

33. *Id.* at 1241.

34. In the first stage of the project, see Rapp, *supra* note 19, I argued for bounty rewards for securities fraud whistleblowers. In the second stage, see Rapp, *supra* note 21, I evaluated the proposed bounty scheme in the Obama administration’s draft investor protection statute.

35. See Richard Renner, *CNBC Notices Whistleblower Provisions of Dodd-Frank Act*, WHISTLEBLOWERS PROTECTION BLOG (July 27, 2010), <http://tinyurl.com/7y2n2ky>.

million.<sup>36</sup> Moreover, the Act grants the SEC broad discretion regarding the amount of an award. While the statute makes awards mandatory once its many threshold criteria are met,<sup>37</sup> the Commission is granted discretion to decide the level of award (from ten to thirty percent of the funds generated by an enforcement action).<sup>38</sup> In current FCA practice, whistleblowers may argue their proposed share in court; it is not clear what kind of presentation, if any, the Commission will entertain from whistleblowers seeking bounties under the new statute.

Dodd-Frank was not, by any means, a complete failure. Its most important achievement is that, in contrast to the Administration's proposed Investor Protection Act of 2009,<sup>39</sup> it provides for judicial review of SEC decisions not to pay bounties. Dodd-Frank allows a decision not to pay a bounty to be appealed by whistleblowers to an appropriate United States Court of Appeals. Given the deference afforded administrative agencies,<sup>40</sup> it is doubtful that a large share of no-award decisions will be second-guessed, but the avenue is at least available for potential claimants.

Only time will tell whether the new whistleblower provisions provide the kind of fix for Wall Street's corruption or ineptitude that SOX apparently failed to produce. However, based on the failures of the new statute to embrace true qui tam structures, the most likely prognosis is grim. This Article advances the case for an Informer's Act for Dodd-Frank whistleblowers, a variant of a traditional qui tam action that could supplement the new law and help it fulfill its promise. Part II of this Article discusses the background for Dodd-Frank and the legislative and rulemaking history of the new whistleblower provision. Part III discusses the drivers of securities fraud and how whistleblower policy might impact detection and

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36. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6 (Lexis Supp. 2011) (amending § 21F of the Securities Exchange Act of 1934).

37. *Id.* § 922(F)(b)(1).

38. *Id.*

39. Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 922 (2009) (proposing to amend the Securities and Exchange Act of 1934 by inserting section 21F), *available at* <http://www.llsdc.org/attachments/files/265/Adm-bill-T09-A.pdf>.

40. An agency's interpretation will be accepted unless the statute at issue forbids that interpretation, or the interpretation, for other reasons, "exceeds the bounds of the permissible." *Barnhart v. Walton*, 535 U.S. 212, 218 (2002) (citing *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984)). Once the agency has promulgated rules, its own interpretation of those rules will be similarly entitled to deference. *Auer v. Robbins*, 519 U.S. 452, 457-58 (1997).



deterrence. Part IV explores the literature on whistleblowing in an effort to capture the effect of the new statute on motivating financial fraud tipsters to come forward. Part V compares the new law to the federal FCA and other precedents to gain insight into the likely ramifications of the new provision. Part VI lays out suggested improvements to help the new law fulfill its promise.

## II. DODD-FRANK BECOMES LAW

### A. Pre-SOX Whistleblower Protection

In the bad old days before SOX provided its whistleblower protection, would-be tipsters were left unprotected by federal law from retaliation for revealing information about corporate and financial fraud. A patchwork of state laws<sup>41</sup> and common law wrongful termination claims provided the best hope for a terminated employee seeking to recover damages. Potential whistleblowers typically had to rely on the “‘vagaries’ of state law for protection.”<sup>42</sup> Such protection was sporadic, if present at all,<sup>43</sup> and the treatment of whistleblowers was haphazard.<sup>44</sup> State whistleblowing laws were “murky, piecemeal, disorganized,” and highly variable “from jurisdiction to jurisdiction.”<sup>45</sup>

Many of these state laws limited protection for whistleblowers based on the party to whom the whistleblower reported wrongdoing.<sup>46</sup> A majority of states only protected whistleblowers

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41. Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1161 (2010) (“Antiretaliation protections have developed as a patchwork of state and federal statutory and common law exceptions to the employment-at-will regime, a century-old default rule that has allowed employers to terminate their employees ‘for good cause, for no cause, or even for morally wrong cause.’”).

42. Valerie Watnick, *Whistleblower Protections Under the Sarbanes-Oxley Act: A Primer and Critique*, 12 FORDHAM J. CORP. & FIN. L. 831, 842 (2007) (citation omitted).

43. Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 68–69 (2007).

44. Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1042 (2004).

45. *Id.* at 1049.

46. Gerard Sinzduk, *An Analysis of Current Whistleblower Laws: Defending a More Flexible Approach to Reporting Requirements*, 96 CALIF. L. REV. 1633, 1633 (2008).

who filed reports with governmental entities.<sup>47</sup> The majority did *not* protect individuals who reported their suspicions within the firm.<sup>48</sup>

State statutes also varied in terms of whether they protected only whistleblowers who revealed actual violations of the law or also those who were mistaken but had a reasonable belief that such a violation occurred.<sup>49</sup> Some state statutes applied only to public health and safety violations, while others protected employees who reported any sort of legal violation.<sup>50</sup> Some state statutes also limited protection to only public sector employees.<sup>51</sup>

In discussing SOX prior to its adoption, one senator noted that corporate employers knew exactly what to do within state law to avoid a suit by a whistleblowing employee.<sup>52</sup> Given the location of many financial services firms in New York, and the Empire State's historically weak whistleblower protections,<sup>53</sup> state law was particularly ineffective in protecting securities fraud whistleblowers. The difficulties confronting whistleblowers under state law in pursuing anti-retaliation claims "discouraged employees from consistently coming forward with information."<sup>54</sup>

Statutory protection for whistleblowers was supplemented, in some states, by the recognition of a common law tort claim for wrongful discharge in violation of public policy.<sup>55</sup> As with statutory protections, the requirements for pursuing such common law claims varied "substantially from jurisdiction to jurisdiction."<sup>56</sup> Some scholarship has characterized courts' recognition of common law wrongful termination claims based on whistleblowing as "frequent,"<sup>57</sup> although there remains a significant degree of uncertainty "over the scope of such protections."<sup>58</sup>

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47. *Id.*

48. *Id.* at 1634.

49. *Id.* at 1637.

50. *Id.*

51. *Id.*

52. Watnick, *supra* note 42, at 842 (citing 148 CONG. REC. S7418-21 (2002)).

53. New York law only protected whistleblowers reporting threats to public health. *Id.* at 858.

54. Moberly, *supra* note 43, at 76.

55. Sinzdak, *supra* note 46, at 1643.

56. *Id.* at 1643-44.

57. Feldman & Lobel, *supra* note 41, at 1162.

58. *Id.*

*B. SOX—A Failed First Attempt to Foster Whistleblowing*

SOX provides both an anti-retaliation provision to protect whistleblowers and what Richard Moberly calls a “structural model” to encourage greater whistleblowing.<sup>59</sup> SOX’s anti-retaliation provision creates a civil action for whistleblowers subject to adverse employment action by reporting companies,<sup>60</sup> and also criminalizes such retaliation.<sup>61</sup> The central idea of the anti-retaliation provision is “to motivate employees” to blow the whistle “by providing employees who make complaints with protection from employer retaliation in the workplace.”<sup>62</sup> On its face, SOX “appears to provide strong substantive and procedural protections for whistleblowers.”<sup>63</sup> But in fact, its provisions “give[] the illusion of protection without truly meaningful opportunities or remedies for achieving it.”<sup>64</sup>

Section 806 articulates whistleblower protections for individuals who cooperate with legal investigations and those who report misconduct to an internal firm supervisor.<sup>65</sup> The whistleblower provisions only apply to individuals engaging in “protected activity,” defined broadly to include “reporting information to Congress, any investigative agency of the federal government, or a supervisor at the employer itself.”<sup>66</sup> A whistleblower does not have to show an actual violation of federal law to gain protection, but is only required to show that she had a “reasonable belief” that a violation had occurred.<sup>67</sup> A whistleblower has to file a complaint with the Secretary of Labor and can bring a federal lawsuit if no decision results within 180 days.<sup>68</sup> Whistleblowers have to show that they were subject to an

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59. The structural model “requires that corporations provide employees with a standardized channel to report organizational misconduct internally within the corporation.” Richard E. Moberly, *Sarbanes-Oxley’s Structural Model to Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107, 1109.

60. See Arnold, *supra* note 10, at 460.

61. *Id.*

62. Jarod Spencer Gonzalez, *A Pot of Gold at the End of the Rainbow: An Economic Incentives-Based Approach to OSHA Whistleblowing*, 14 EMP. RTS. & EMP. POL’Y J. 325, 326 (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1538336](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1538336).

63. Moberly, *supra* note 43, at 83.

64. Dworkin, *supra* note 4, at 1764.

65. 18 U.S.C. § 1514A (2006). The option of bringing a claim in federal court is a “‘safety valve’ . . . designed to encourage the Department of Labor to process SOX whistleblower claims within the 180-day time frame.” Gonzalez, *supra* note 62, at 333.

66. Watnick, *supra* note 42, at 844.

67. *Id.* at 845.

68. Earle & Madek, *supra* note 5, at 5.

“unfavorable personnel action” and that their protected activity was a contributing factor.<sup>69</sup> The “contributing factor” requirement, the statute’s causation element, has proven “the most significant and most difficult factor to prove in a Sarbanes-Oxley whistleblower case.”<sup>70</sup>

Among the remedies available to successful claimants are orders of reinstatement, standard back pay, and special damages, “including attorneys’ fees, litigation costs, and expert witness fees.”<sup>71</sup>

SOX’s protections have a number of holes, and its shield has been characterized as “narrow in scope and more illusory than real.”<sup>72</sup> The statute is procedurally complex,<sup>73</sup> and provides no punitive damages in civil actions by whistleblowers, meaning that a terminated whistleblower’s only likely victory would be an award of back pay and attorney’s fees.<sup>74</sup> A short statute of limitations requires whistleblowers to file a complaint within ninety days after a violation occurs.<sup>75</sup> No jury trial right exists under the SOX provisions for those whistleblowers bringing claims in federal court.<sup>76</sup> At the OSHA stage of a complaint, employers are permitted to make submissions to which a complaining employee has no right to respond.<sup>77</sup>

Another problem is that the procedures established in SOX have not been “closely followed” by the governmental actors tasked with enforcing the anti-retaliation protections.<sup>78</sup> Most cases linger for “longer than the mandated 180 days.”<sup>79</sup> In past cases, both OSHA and Department of Labor Administrative Law Judges (ALJs) “rigidly construed” SOX’s legal requirements.<sup>80</sup> OSHA also tends to “misapply Sarbanes-Oxley’s burden of proof for the few cases that survived the agency’s strict legal scrutiny.”<sup>81</sup>

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69. *Id.*

70. Watnick, *supra* note 42, at 849.

71. Moberly, *supra* note 43, at 78.

72. Deborah L. Seifert et al., *The Influence of Organizational Justice on Accountant Whistleblowing*, 35 ACCT., ORGS. & SOC. 707, 709 (2010).

73. Dworkin, *supra* note 4, at 1765.

74. Earle & Madek, *supra* note 5, at 3.

75. *Id.* at 6.

76. Gonzalez, *supra* note 62, at 334.

77. Watnick, *supra* note 42, at 864.

78. *Id.* at 840.

79. *Id.* at 840–41.

80. Moberly, *supra* note 43, at 67, 71.

81. *Id.* at 72.

OSHA's role as gatekeeper for SOX claims has struck observers as odd,<sup>82</sup> and the agency has not proven an effective arbiter of whistleblower claims in either SOX or other contexts. The agency's employees lack the "necessary training and equipment to do their jobs," and despite mandatory training, the agency does not "ensure[] attendance" at such courses.<sup>83</sup> In particular, SOX requires investigators to "understand complex securities and navigate complicated legal issues in order to conduct an investigation," but OSHA has failed to develop any "specialized training on specific, complex" issues raised by the statute.<sup>84</sup> Program enforcement varies across OSHA's regional offices, and its national coordinator "lacks mechanisms, such as access to accurate data and actual case files, to monitor compliance with policies and procedures."<sup>85</sup> In spite of the growth in its area of responsibility for whistleblower complaints over the past two decades, OSHA has seen no appreciable increase in its whistleblower investigator staffing levels.<sup>86</sup>

Empirical research has lent support to the notion that SOX's protections are inadequate. The Dyck Study found that after the enactment of SOX, the percentage of whistleblowers who were employees *fell* from eighteen to thirteen percent.<sup>87</sup> If in fact SOX provided robust protection for whistleblowers, one would have expected the trend to move in the opposite direction. Success rates for SOX whistleblowers were terrible in the early years of the Act. Only 3.6% of cases were initially resolved by OSHA in favor of complaining employees, and only 6.5% of appeals to Department of Labor Administrative Law Judges were successful.<sup>88</sup>

Ultimately, SOX "failed to fulfill the great expectations generated by the Act's purportedly strong anti-retaliation protections."<sup>89</sup>

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82. *See supra* note 8.

83. GOV'T ACCOUNTABILITY OFFICE, GAO-10-722, WHISTLEBLOWER PROTECTION: SUSTAINED MANAGEMENT ATTENTION NEEDED TO ADDRESS LONG-STANDING PROGRAM WEAKNESSES 2 (2010).

84. *Id.* at 24.

85. *Id.* at 2.

86. *Id.* at 16-17.

87. Dyck et al., *supra* note 30, at 2250.

88. Moberly, *supra* note 43, at 67.

89. *Id.* at 74.

*C. Core Features of the Dodd-Frank Statute*

Although it provided protection for whistleblowers, SOX was missing any “financial incentive for whistleblowers or informants.”<sup>90</sup> SOX “scream[ed] out for a bounty program,” given its “exceedingly weak” anti-retaliation provision, the massive potential for fraud not likely to otherwise be detected by regulators, and the ability to tie the value of a bounty to the level of fraud revealed by a whistleblower.<sup>91</sup> The eventual development of bounties in Dodd-Frank could potentially represent a “giant step forward for whistleblowing.”<sup>92</sup>

Section 922 of the Dodd-Frank Act<sup>93</sup> amends the Securities Exchange Act of 1934,<sup>94</sup> creating “Section 21F.”<sup>95</sup> The new provision applies only to “covered judicial or administrative action[s],” defined as judicial or administrative actions brought by the SEC “that result[] in monetary sanctions exceeding \$1 million.”<sup>96</sup> This threshold can be met by combining sanctions obtained in an SEC action with sanctions obtained in “related actions,” which include Department of Justice or State Attorney General criminal actions or the investigation by Self-Regulatory Organizations (SROs), but not the proceeds of private securities litigation.<sup>97</sup> Although the statute itself seems to imply that sanctions paid to some regulatory agency other than the SEC would be counted in the calculation of whether or not an action met the \$1 million threshold,<sup>98</sup> the SEC’s proposed and final rules, in a narrow reading of the statute, only count the proceeds of a related action if those sanctions are paid to the SEC.<sup>99</sup>

Other provisions provide anti-retaliation protections for some

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90. Arnold, *supra* note 10, at 460.

91. Gonzalez, *supra* note 62, at 346.

92. *Id.* at 347.

93. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6 (Lexis Supp. 2011) (amending § 21F of the Securities Exchange Act of 1934).

94. 15 U.S.C. § 78 (2006).

95. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6.

96. *Id.* § 78u-6(a)(1).

97. *See id.* § 78u-6(b)(1).

98. *See id.* § 78u-6(a)(1) (“The term ‘covered judicial or administrative action’ means any judicial or administrative action brought by the Commission under the securities laws that results in monetary sanctions exceeding \$1,000,000.”).

99. Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300, 34,363 (June 13, 2011) (to be codified at 17 C.F.R. § 240.21F-3).

securities fraud whistleblowers who are not protected by SOX,<sup>100</sup> but the bounty scheme will be the focus of this Article's discussion.

The statute defines "whistleblower" as an individual or individuals who provide "information relating to a violation of the securities laws" to the SEC, leaving to the SEC the task of defining rules regarding *how* that information needs to be submitted.<sup>101</sup> To be eligible to claim a bounty, a whistleblower must be the source of "original information," defined by the statute as information derived from the "independent knowledge or analysis of a whistleblower," "not known to the [SEC] from any other source," and not "exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental . . . investigation, or from the news media."<sup>102</sup>

Under the statute, the payment of a bounty is mandatory. The SEC "shall pay an award" of ten to thirty percent of the collected monetary sanctions resulting from "successful enforcement" actions.<sup>103</sup> The amount of the award—that is, where in the specified range an award will fall—is left to the discretion of the SEC, although the law provides some guidance. The SEC "shall take into consideration" the significance of the information provided, the degree of assistance provided by the whistleblower, the "programmatic interest" of the SEC in "detering violations of the securities laws by making awards to whistleblowers," and "additional relevant factors," excluding, however, the "balance"<sup>104</sup> of the Securities and Exchange Commission Investor Protection Fund used

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100. Katrina Grider, *Employment Law Update: US Supreme Court, Fifth Circuit, and More*, ADVOCATE: TEX. ST. BAR LITIG. SEC. REP., Spring 2011, at 1, 13–14 ("[Section 929A of the Dodd-Frank Act] eliminates a significant loophole that some courts have read into SOX that has substantially narrowed the scope of SOX coverage. Elevating form over substance, some judges have permitted publicly-traded companies to avoid liability under SOX merely because the parent company that files reports with the SEC has few, if any, direct employees, and instead employs most of its workforce through non-publicly traded subsidiaries."); *see also* Ted Uliassi, Comment, *Addressing the Unintended Consequences of an Enhanced SEC Whistleblower Bounty Program*, 63 ADMIN. L. REV. 351, 357 (2011) ("While the antiretaliation cause of action provided by [SOX] to public company employee whistleblowers is likely to be available to many [Dodd-Frank] whistleblowers, the [Dodd-Frank] cause of action is not limited to whistleblowers who are employees of publicly traded companies."). In addition, Dodd-Frank has a longer statute of limitations period making it a "more attractive option." *Id.*

101. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(a)(6).

102. *Id.* § 78u-6(a)(3).

103. *Id.* § 78u-6(b)(1).

104. *Id.* § 78u-6(c)(1).

to pay bounties.<sup>105</sup> Government employees and law enforcement officers, including state officials, are excluded from bounty eligibility, as are whistleblowers convicted of “criminal violations” relating to the SEC enforcement action and “any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws.”<sup>106</sup> Similarly, whistleblowers knowingly submitting false information are ineligible for a bounty.<sup>107</sup>

Whistleblowers are permitted to be represented by counsel, and may maintain their anonymity up to the point at which an award is paid.<sup>108</sup> The decision by the SEC to deny an award may be appealed “to the appropriate court of appeals for the United States” within 30 days after a denial decision is made.<sup>109</sup> However, no appeal of the *amount* of the award is authorized.<sup>110</sup>

### *1. Evolution of the Act*

Several important changes occurred between the original submission of the proposal as part of the Obama Administration’s Investor Protection Act of 2009 (submitted on July 22, 2009) and Dodd-Frank’s eventual enactment. In the Administration’s original draft, the SEC was granted purely discretionary authority to pay

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105. This fund was created in § 922 of Dodd-Frank. *Id.* § 78u-6(g). Money to be deposited in the account includes any monetary sanctions collected for enforcement actions not allocated to an investor compensation “Fair Fund” pursuant to § 308 of SOX. *Id.* The “Fair Fund provision of Sarbanes-Oxley allows the SEC to distribute money penalties to injured investors” and “herald[ed] a new compensatory role for the agency.” Verity Winship, *Fair Funds and the SEC’s Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1103 (2008). Prior to the enactment of SOX, any monetary sanctions not considered “disgorgement” of ill-gotten gains were paid into the U.S. Treasury. *Id.* at 1118. However, the Commission retained discretion to decide whether sanctions would be allocated to the fund. *Id.* at 1119.

In addition to paying awards, the fund can be used to fund SEC Inspector General activities. 15 U.S.C.S. § 78u-6(g)(2)(B). This represented a change from the original version of the Act, in which the fund could be used either to compensate whistleblowers or to fund “investor education initiatives designed to help investors protect themselves against securities fraud or other violations of the securities laws, or the rules and regulations thereunder.” Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 21F(f) (2009).

106. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(c)(2).

107. *Id.* § 78u-6(i).

108. *Id.* § 78u-6(d).

109. *Id.* § 78u-6(f).

110. *Id.*



awards of up to thirty percent.<sup>111</sup> In the final law, however, the payment of awards was mandatory.<sup>112</sup> The original draft included no minimum payment floor,<sup>113</sup> leaving open the possibility of bounties below ten percent. These changes were made in Senator Dodd's "committee print" of his Restoring American Financial Stability Act, submitted on March 15, 2010.<sup>114</sup> That version of the bill also added the criteria under which the SEC would determine the amount of the award.<sup>115</sup>

Similarly, in the original draft of the Act, the decision to pay an award could not be appealed.<sup>116</sup> In the final version of the Act, the appeal of a denial of an award, but not the amount of the award, can be made to a U.S. Circuit Court.<sup>117</sup> Senator Dodd's early drafts of the bill would have included the right to appeal the SEC's determination of "what amount to make awards."<sup>118</sup> However, the right to appeal was later limited to the decision of whether to make an award, with no right to appeal the amount of the award.<sup>119</sup> Senator Dodd explained that "the whistleblower cannot appeal the SEC's monetary award determination," and that this amendment was made so as to "limit the SEC's administrative burden and not to encourage making small awards."<sup>120</sup>

The Administration's original bill also omitted the extensive definition of "original source" that was included in the final bill. The Administration's bill simply stated that a whistleblower "who voluntarily provided original information" could be paid a bounty.<sup>121</sup>

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111. Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 922 (2009) (proposing to amend the Securities and Exchange Act of 1934 by inserting section 21F), *available at* <http://www.llsdc.org/attachments/files/265/Adm-bill-T09-A.pdf>.

112. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(b).

113. H.R. 3817 § 922 (proposing to amend section 21F(b) of the Securities and Exchange Act).

114. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 922 (2010) (proposing to amend the Securities and Exchange Act of 1934 section 21F(b)(1)). For the legislative history, see S. REP. NO. 111-176, at 111, 231 (2010).

115. H.R. 3817 § 922 (proposing to amend section 21F(c)(1)).

116. *Id.* (proposing to amend section 21F(e)).

117. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(f) (Lexis Supp. 2011) (amending section 21F of the Securities Exchange Act of 1934).

118. S. 3217 § 922 (proposing to amend section 21F(f)).

119. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(f) (amending section 21F of the Securities Exchange Act of 1934).

120. 156 CONG. REC. S5929 (daily ed. July 15, 2010) (statement of Sen. Dodd).

121. H.R. 3817 § 922 (proposing to add section 21F(a) to the Securities and Exchange Act of 1934).

The lengthier definition that appeared in the final bill was added in Senator Dodd's Discussion Draft, submitted on November 10, 2009.<sup>122</sup>

The limitation on accountants who discovered fraud in connection with an audit required by the securities laws was also added after the Administration's original draft.<sup>123</sup> It first appeared in the version of Senator Dodd's bill reported by the Committee on Banking, Housing and Urban Affairs on April 15, 2010.<sup>124</sup>

## 2. Congressional testimony

There was relatively little debate in congressional hearings focused on the whistleblower component of the financial reform package prior to the law's enactment.<sup>125</sup> In hearings of the House Committee on Financial Services on July 17, 2009, Representative Paul Kanjorski (D-PA) described the goals of the program: "[W]e ought to put more cops on the beat by allowing the Commission to pay bounties to whistleblowers whose tips result in catching fraudsters."<sup>126</sup> He repeated this "cops on the beat" view in hearings later that year.<sup>127</sup>

On October 6, 2009, Denise Crawford, Texas Securities Commissioner and President of the North American Securities Administrators Association, an organization of state Blue Sky law regulators, suggested that "the problem isn't that people weren't

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122. Discussion Draft of Restoring American Financial Stability Act of 2009, S. 3217 111th Cong. § 922 (2009), available at <http://www.llsdc.org/attachments/files/276/Bill-111th-S3217-Discussion-draft.pdf>.

123. *Id.* § 923 (proposing to amend section 21F(b)(2)).

124. S. 3217, 111th Cong. (2010), available at <http://www.llsdc.org/attachments/files/275/bill-111th-S3217-Cmte-Prt.pdf>.

125. See Recent Legislation, *Dodd-Frank Act, Pub. L. No. 111-203, § 922, 128 Stat. 1376, 1841-49 (2010) (to be codified at 15 U.S.C. § 78u-6)*, 124 HARV. L. REV. 1829, 1830 (2011) ("Although the progress of the Dodd-Frank bill through the House and Senate was marked by intense industry lobbying and divisive partisan struggles, the whistleblower provisions received little attention on the road to passage.").

126. *Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 62 (2009), available at <http://democrats.financialservices.house.gov/Hearings/hearingDetails.aspx?NewsID=1150>.

127. *Additional Reforms to the Securities Investor Protection Act: Hearing Before the H. Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 94 (2009), available at <http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-94.pdf>.

coming to the Securities and Exchange Commission.”<sup>128</sup> She noted that that the SEC receives close to 750,000 tips a year, but the “problem is that they were ignoring them or at least not making good determinations with regard to those complaints that really needed to be followed up on.”<sup>129</sup> The problem wasn’t that whistleblowers were “reticent to complain,” but that “they are not getting the response of the agency presently.”<sup>130</sup>

### 3. Discussion

Several features of the statute deserve particular comment. Some of the language of the statute is clearly designed to avoid the pitfalls that have emerged in judicial interpretation of similar provisions of the FCA. The FCA bars suits “*based upon* the public disclosure of allegations” at various hearings, governmental investigations, or in the news media.<sup>131</sup> Some courts have interpreted “based upon” to mean “derived from,” but other courts have interpreted “based upon” more broadly, akin to “similar to,” to impose jurisdictional bans on many potential FCA plaintiffs.<sup>132</sup> The Dodd-Frank Act avoids this kind of potential limitation for bounty seekers by limiting the “public disclosure” restriction to potential tipsters whose information was *exclusively based* on the public proceedings or media coverage. Additionally, the FCA requires bounty seekers to demonstrate that they had “direct and independent” knowledge; the “direct[ness]” requirement imposes “[t]he most significant limitation” by requiring relators to see fraud with their own eyes.<sup>133</sup> Wisely, the Dodd-Frank provision avoids this potential restriction by declining to include the word “direct.” Instead, the new law merely requires that the information be based on “independent” knowledge.

The new law also adds “independent . . . analysis” to the list of

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128. *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing before the H. Comm. on Fin. Serv.*, 111th Cong. 84 (2009), available at <http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-84.pdf>.

129. *Id.*

130. *Id.*

131. 31 U.S.C. § 3730(e)(4) (2006) (emphasis added).

132. Beverly Cohen, *Trouble at the Source: The Debates Over the Public Disclosure Provisions of the False Claims Act's Original Source Rule*, 60 MERCER L. REV. 701, 716–17 (2009).

133. *Id.* at 718–21.

how a whistleblower can qualify as a source of “original information.” In the FCA context, relators have been able to claim bounties where they conduct an investigation uncovering information about fraud even though the information uncovered came from some other source. Still, in that context “[c]ourts have imposed an extremely high standard before finding a private investigation equivalent to direct and independent knowledge.”<sup>134</sup> In the FCA context, mere “independent analysis” is not likely to be found sufficient to trigger a bounty.<sup>135</sup> The Dodd-Frank provision invites the SEC to be more open to paying bounties in circumstances where the analysis conducted by a whistleblower provides the key component of her “information.” Where an independent analysis creates new “information,” a whistleblower might qualify for a Dodd-Frank bounty.

However, the \$1 million threshold is more problematic. Penalties imposed by the SEC include nonmonetary sanctions. Historically, the SEC was only permitted to seek injunctive relief and disgorgement of illicit profits through courts’ equitable powers to fashion “ancillary relief.”<sup>136</sup> In 1990, the Remedies Act gave the SEC authority to seek disgorgement in administrative proceedings (as opposed to just in judicial proceedings)<sup>137</sup> and “broad power, both in court and in administrative proceedings, to seek penalties for any violation of the federal securities statutes.”<sup>138</sup>

Even after the 1990 Act, however, nonmonetary sanctions “are common” and include “cease-and-desist orders or permanent injunctions” that in fact “appear to impose extremely small penalties.”<sup>139</sup> The “crown jewels” of SEC settlements are “obey-the-law injunction[s],”<sup>140</sup> which are broad orders “prohibiting the

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134. *Id.* at 725.

135. *See id.*; United States *ex rel.* Stinson v. Prudential Ins. Co., 944 F.2d 1149, 1160 (3d Cir. 1991) (holding that under the FCA, relators must have substantive information about the fraud, not just background information allowing them to “understand the significance of a publicly disclosed transaction or allegation”).

136. Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 320 (2008).

137. *Id.* at 321.

138. *Id.* at 323.

139. Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 594 (2008).

140. Jayne W. Barnard, *Corporate Therapeutics at the Securities and Exchange Commission*, 2008 COLUM. BUS. L. REV. 793, 818.

defendant from future violations of securities laws.”<sup>141</sup> Such injunctions—in and of themselves—involve no monetary sanction, provide no “restitution for the victims of violations,” and may impose few “costs on securities violators who may have profited enormously from their misconduct.”<sup>142</sup> What is the crown jewel for the SEC has been referred to by the U.S. Supreme Court as a “mild prophylactic.”<sup>143</sup> Moreover, the SEC has recently begun to seek what Jayne Barnard refers to as “therapeutic settlements”—resolving enforcement actions by having wrongdoers “creat[e] . . . new management positions, adopt[] . . . new accounting and reporting practices, reconfigur[e] . . . corporate training programs, and establish[] . . . specific board-level committees and procedures.”<sup>144</sup> The SEC’s preference for nonmonetary enforcement may only be growing.

Monetary penalties are “less common.”<sup>145</sup> Of the firms targeted by the SEC between 1978 and 2002, only eight percent—just 47 out of 585—were assessed a monetary penalty.<sup>146</sup> The mean monetary penalty was over \$100 million.<sup>147</sup> However, this mean figure is misleading as an indication of the typical sanction because its value is inflated by the \$2.28 billion fine levied against WorldCom.<sup>148</sup> The median fine (which measures the middle point among fines levied, rather than an average) was far lower—just \$890,000.<sup>149</sup>

In other words, the SEC imposes fines that could trigger Dodd-Frank’s whistleblower bounty provision less than ten percent of the time, and in those cases, *more than half* of fined firms faced fines below the minimum \$1 million threshold needed to trigger award eligibility. These figures may indeed *overstate* the potential reach of

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141. Jon Carlson, Note, *Securities Fraud, Officer and Director Bars, and the “Unfitness” Inquiry After Sarbanes-Oxley*, 14 FORDHAM J. CORP. & FIN. L. 679, 682 (2009). Whether such broad injunctions are enforceable has been called into question by some federal courts. See SEC v. Smyth, 420 F.3d 1225, 1232 n.14 (11th Cir. 2005).

142. Carlson, *supra* note 141, at 682.

143. *Id.* at 682 n.22 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963)).

144. Barnard, *supra* note 140, at 796.

145. Karpoff, *supra* note 139, at 594.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* at 595.

the new bounty law, since now that the law is in place, firms seeking to discredit whistleblowers may deliberately target fines below the \$1 million threshold in their settlement discussions with SEC regulators. Moreover, since the SEC will not have to process the administrative tasks associated with paying a bounty when the fine levied is under that threshold, one might expect the SEC to be amenable to negotiations producing such lower results.

The new statute does nothing to allow whistleblowers to capture a share of the far greater sanctions levied in civil class actions by aggrieved investors.<sup>150</sup> Moreover, the largest impact of enforcement actions is in lost market value of targeted firms<sup>151</sup>—something not addressed by the new law. The bottom line is that the new law does a very poor job of calibrating expected rewards for whistleblowers with the true costs of financial fraud for investors.

A relatively simple solution would be to include the proceeds of private securities fraud class actions in calculating the “related action” sanctions for establishing the \$1 million floor. The problem with this solution would be that some whistleblowers would meet the \$1 million threshold via “related actions” in cases where there was no monetary sanction awarded in an SEC enforcement action itself and therefore nothing would have been deposited in the SEC’s whistleblower fund. This would raise the question of where the money to pay an award would come from. Importantly, *all* sanctions obtained by the SEC (other than those allocated to investor compensation) are deposited in the new whistleblower fund.<sup>152</sup> This is the case whether or not a whistleblower is involved in the enforcement action, at least until the fund reaches a \$300 million balance.<sup>153</sup> As a result, the solvency of the fund is not likely to ever become an issue.

The \$1 million limitation may also exacerbate a potential perverse effect of bounties that some critics have attributed to the FCA. These critics have suggested that the FCA “creates incentives for employees to hide fraud until it has reached levels under which

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150. Civil damages were awarded more than five times as often in private cases than fines were imposed in enforcement actions. *Id.*

151. *Id.*

152. Dodd-Frank Act § 922, 15 U.S.C.S. § 78u-6(g)(3)(A) (Lexis Supp. 2011) (amending § 21F of the Securities Exchange Act of 1934).

153. *Id.*

their awards for disclosure will be maximized.”<sup>154</sup> Whistleblowers might thus be encouraged to “‘save up’ information rather than taking steps to correct the misconduct of which they are aware.”<sup>155</sup>

In connection with the FCA, this criticism may have little merit—there is to date little evidence that this often occurs.<sup>156</sup> Moreover, it is hard to establish what process a potential whistleblower would use to determine how to “optimize” potential rewards for disclosure. Indeed, since the FCA follows a “first-to-file” approach<sup>157</sup> and only awards bounties to the “original source” of information, a potential whistleblower seeking an FCA bounty would likely balance any potential gain from delayed reporting against the chances of “poaching” by another tipster. In the context of Dodd-Frank, however, the hard threshold below which no awards are permitted creates a very real possibility that a potential whistleblower will be forced to delay reporting until the magnitude of fraud seems likely to trigger the bounty provision. Certainly, one can imagine plaintiffs’ counsel avoiding filing claims for bounties until it appears likely an SEC enforcement action would seek a significant penalty as opposed to merely a cease-and-desist order.

The \$1 million floor may also, perversely, limit the incentives for whistleblowers in certain contexts where monetary sanctions seem unlikely. While sanctions might be sought in connection with Ponzi schemes that victimize unsophisticated investors, since there is little likelihood of recovering funds, the SEC may settle such cases without seeking sanctions that meet the \$1 million threshold.<sup>158</sup> Large corporations are also more likely to be subject to large fines; small market firms, given the reduced potential for investor loss, are less likely to be subjected to SEC actions seeking high levels of sanctions but may be precisely the firms most likely to commit fraud without concern for private securities litigation.<sup>159</sup> Similarly, given that the Commission considers ability-to-pay in crafting sanctions,<sup>160</sup>

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154. Thomas L. Carson et al., *Whistleblowing for Profit: An Ethical Analysis of the Federal False Claims Act*, 77 J. BUS. ETHICS 361, 361–62 (2008).

155. Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403, 412 (2010).

156. Carson et al., *supra* note 154, at 362.

157. See Richard D. Fincher, *Mediating Whistleblower Complaints: Integrating the Emotional and Legal Challenges*, DISP. RESOL. J., Feb.–Apr. 2009, at 65.

158. Black, *supra* note 136, at 344.

159. *Id.*

160. Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the*

SEC actions against individuals are less likely to trigger bounty awards. Individuals, however, are responsible for “caus[ing] entities to violate the securities laws.”<sup>161</sup>

The \$1 million floor represents an arbitrary figure, one Congress pulled out of the air with absolutely no explanation of why that amount is the only one to merit bounty awards. It has no link to the average level of sanction awarded in SEC cases; moreover, since the enforcement sanction levied may not precisely track the magnitude of fraud on investors, it has no firm connection to the seriousness of the offense a whistleblower reports.

A possible justification for the floor—or a floor in the general neighborhood of \$1 million—might be that it reflects what would be necessary to offset the lost wages to a whistleblower for a one-year period. If bounties were permitted at levels below \$1 million in enforcement sanctions, the ten to thirty percent bounty share would mean whistleblowers were being paid less than \$100,000–\$300,000 for bringing information to light. That would, for many financial industry employees, be less than what they would have earned in a single year had they stayed silent and not blown the whistle. Perhaps the \$1 million threshold can be justified on the grounds that whistleblower bounties are only effective where they provide at least a year’s worth of compensation for expected losses in earnings resulting from retaliation. However, since whistleblowers enjoy separate anti-retaliation protection under SOX, that linkage is difficult to defend.

#### *D. Proposed SEC Rules*

Dodd-Frank required the SEC to develop rules and regulations to govern the administration of the new whistleblower provision. The initial proposed rules were released on November 3, 2010,<sup>162</sup> with the final rules to be issued by April 21, 2011,<sup>163</sup> although the

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1980s, 82 IND. L.J. 575, 614 (2007) (explaining that the SEC “considered a defendant’s ability to pay when requesting penalties”).

161. Black, *supra* note 136, at 344.

162. Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 75 Fed. Reg. 70,488 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pts. 240, 249) [hereinafter SEC Proposed Rules].

163. See SEC, ANN. REP. ON WHISTLEBLOWER PROGRAM 4 (Oct. 2010), *available at* [http://www.sec.gov/news/studies/2010/whistleblower\\_report\\_to\\_congress.pdf](http://www.sec.gov/news/studies/2010/whistleblower_report_to_congress.pdf).



SEC missed that deadline by a month.<sup>164</sup> The SEC formed a cross-disciplinary working group to draft implementation rules and solicited comments from the public.<sup>165</sup> The SEC's proposed Regulation 21F sought to provide whistleblower rules that were "clearly defined and user-friendly."<sup>166</sup>

Among the important issues considered by the SEC were the definition of "voluntary" submissions,<sup>167</sup> the scope of "original information" and "independent knowledge,"<sup>168</sup> and whether whistleblowers should be required to submit claims using "in-house complaint and reporting procedures, thereby giving employers an opportunity to address misconduct, before they make a whistleblower submission to the Commission."<sup>169</sup> In the end, the Commission decided not to impose what might be thought of as an internal exhaustion requirement,<sup>170</sup> a decision which has sparked controversy.

In Proposed Rule 21F-4(c), the Commission elaborated on when a whistleblower's information would be deemed to have "led to the successful enforcement" of an SEC action.<sup>171</sup> The proposed rule would have largely required that whistleblowers be the source of information leading to the opening of an enforcement action; where an action had already been initiated, whistleblowers could only recover bounties in the rare case where the information provided was "essential" and "would not have otherwise [been] obtained in the normal course of the investigation."<sup>172</sup> Since during the ordinary course of an investigation the SEC would likely interview many corporate employees, most of the information in the hands of a potential whistleblower would have likely been found anyway; in practice, then, the proposed rule virtually eliminated the possibility of a bounty payment except where the whistleblower's tip leads to the onset of enforcement action. The only example provided by the SEC of an employee who could potentially qualify for a bounty in

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164. See SEC Final Rules, *supra* note 14.

165. *Id.*

166. SEC Proposed Rules, *supra* note 162, at 70,488.

167. *Id.* at 70,490-91.

168. *Id.* at 70,491-98.

169. *Id.* at 70,496.

170. *Id.*

171. *Id.* at 70,497 (internal quotation marks omitted).

172. *Id.*

connection with a previously opened investigation was an employee interviewed by the SEC who later comes forward with a *hot doc*, a document that “had been concealed from the staff” and “establish[ed] proof of wrongdoing” critical to the SEC “sustain[ing] its burden of proof.”<sup>173</sup> In practice, most targets of SEC investigations are highly cooperative,<sup>174</sup> so the Commission’s expectation that such payments would be “rare”<sup>175</sup> is likely an understatement.

The proposed rules also required that the whistleblower’s information “‘significantly contribute[.]’ to the success of an enforcement action.”<sup>176</sup> To meet that requirement, in effect, the statute’s causation element, a whistleblower would need to submit high-quality, reliable, specific information that is “meaningful[ly]” connected to the successful enforcement action.<sup>177</sup> Vague information, unsupported tips, or “tangential evidence” would not meet this requirement.<sup>178</sup> Moreover, even where an SEC enforcement action is successful, if the whistleblower’s information was linked to claims rejected by a court, the whistleblower would be excluded from claiming a bounty—even if the investigation itself was initiated based on those eventually rejected claims and uncovered other actionable examples of fraud.<sup>179</sup>

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173. *Id.* at 70,498.

174. Companies will usually “cooperate fully in the federal investigation, and then implement stringent compliance policies and internal monitors.” Bruce Hinchey, *Punishing the Penitent: Disproportionate Fines in Recent FCPA Enforcements and Suggested Improvements*, 40 PUB. CONT. L.J. 393, 418 (2011). A “substantial body of anecdotal evidence suggests that the SEC regularly asks subjects of its investigations to effect a broad waiver of privilege by turning over internal reports and other protected materials.” Elias C. Selinger, *An Unredeemed Promise: How Courts Can Prevent Offensive Collateral Estoppel from Undercutting the Policy Goals of Amended Federal Rule of Evidence 408*, 102 NW. U. L. REV. 1953, 1966 (2008). Choosing not to cooperate comes at a stiff price, and can make it more likely that the target will be referred to the Department of Justice for a criminal investigation. *Id.* It will “usually benefit a corporation to cooperate with the SEC . . . .” Christine J. Unger, Note, *Section 1103 of the Sarbanes-Oxley Act: Securities and Exchange Commission v. Gemstart-TV Guide International Inc, and the Ninth Circuit’s Interpretation of “Extraordinary Payments,”* 29 W. NEW ENG. L. REV. 231, 250 (2006).

175. SEC Proposed Rules, *supra* note 162, at 70,497–98.

176. *Id.* at 70,497.

177. *Id.*

178. *Id.*

179. *Id.* at 70,498.

In elaborating on the statute's guiding criteria<sup>180</sup> for determining the amount of an award within the authorized ten to thirty percent range, the Commission added several considerations. The SEC could also consider 1) whether the subject matter of the investigation "is a Commission priority;" 2) any "unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action;" 3) whether *prior* to providing tips "the whistleblower took steps to prevent the violations from occurring or continuing," as well as any remedial steps taken by the whistleblower; and 4) "whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the Commission."<sup>181</sup> While not a requirement for obtaining an award in the Commission's proposed rules, internal reporting would trigger a "higher percentage award."<sup>182</sup>

The Commission's proposed rules excluded from the calculation of the monetary sanctions to be imposed any sanctions paid by the whistleblower or by an entity based on actions the whistleblower directed, planned, or initiated.<sup>183</sup> The SEC also added foreign officials to the categories of excluded individuals provided by the statute.<sup>184</sup> In addition, the proposed rules would exclude from bounty payments anyone who had a "pre-existing legal or contractual duty to report the securities violations."<sup>185</sup> Such individuals would not be considered to have made "voluntary" submissions of information, given the existence of a legal duty.<sup>186</sup> As examples, the Commission mentions law enforcement officers, regulators, SRO employees, and auditors retained to file either annual or other reports with the SEC, but also includes "other similarly situated persons."<sup>187</sup>

The SEC received 240 comment letters from a variety of sources on its proposed rules, along with 1,300 form letters connected to a

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180. *See supra* text accompanying note 105.

181. SEC Proposed Rules, *supra* note 162, at 70,500.

182. *Id.*

183. *Id.* at 70,509.

184. *Id.* at 70,515.

185. *Id.* at 70,520.

186. *Id.* at 70,491.

187. *Id.*

petition.<sup>188</sup> Some comments supported the proposed rule, while many were critical—some because commenters felt the rules went too far, others because they felt the rules did not go far enough to reward whistleblowers.

The Auditing Standards Committee of the American Accounting Association argued that the rules did not provide enough of an incentive for whistleblowers. The Committee, for instance, saw “little support for the \$1,000,000 minimum,” noting that in a case “settled for just under the minimum, the whistleblower would receive nothing.”<sup>189</sup> The Auditing Standards Committee also argued against a requirement of internal reporting,<sup>190</sup> but a number of accounting industry firms contacted the SEC to urge that such a requirement be adopted. PricewaterhouseCoopers LLP wrote to argue that the proposed rules “do not go far enough to ensure that any information reported to the SEC pursuant to the whistleblower rules will be reported internally on at least a contemporaneous basis.”<sup>191</sup> Similarly, the Institute for Internal Auditors wrote to urge the rule be amended to “explicitly require that whistleblowers have first utilized their company’s internal reporting process—or demonstrated to the Commission’s satisfaction that such a process was nonexistent or ineffective—in order to be eligible for receiving any award.”<sup>192</sup> KPMG wrote to argue that the exclusion of public company accounting employees from claiming bounties was too narrow.<sup>193</sup>

The issue of whether reporting should be required first via internal channels has proven one of the most controversial aspects of the new law. In a September 24, 2010, hearing before the House Committee on Financial Services, Darla Stuckey, the Senior Vice

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188. See *Comments on Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC.GOV, <http://www.sec.gov/comments/s7-33-10/s73310.shtml> (last visited Jan. 21, 2012); SEC Final Rules, *supra* note 14, at 34,300.

189. See Eileen Taylor et al., *Comment Letter on file No. S-33-10*, SEC.GOV (Dec. 17, 2010), <http://www.sec.gov/comments/s7-33-10/s73310-224.pdf>.

190. *Id.*

191. Pricewaterhouse Coopers, *Comment Letter on File No. S-33-10*, SEC.GOV (Dec. 22, 2010), <http://www.sec.gov/comments/s7-33-10/s73310-281.pdf>.

192. Richard F. Chambers, *Comment Letter on File No. S7-33-10*, SEC.GOV (Dec. 17, 2010), <http://www.sec.gov/comments/s7-33-10/s73310-229.pdf>.

193. KPMG, *Comment Letter on File No. S-33-10* (Dec. 17, 2010), <http://www.sec.gov/comments/s7-33-10/s73310-152.pdf>.

President for Policy and Advocacy at the Society of Corporate Secretaries and Governance Professionals, argued that under the new law “employee[s] will now have a significant financial incentive to bypass raising the issue with the company at all for fear of losing the bounty, because if he raises to the company first, the company might beat him or her to the SEC.”<sup>194</sup> She pointed to an ad playing before showings of the new movie *Wall Street: Money Never Sleeps*, which attempts to recruit whistleblowers to the web site SECsnitch.com by promising “potential riches” and the chance to “do a good thing.”<sup>195</sup> She testified that the new law would be “contrary to long-established public policy” and “undercuts the well-established internal compliance programs put in place after SOX that companies have spent so much money on.”<sup>196</sup> She argued that bounties should not be granted only where “the whistleblower bypasses the company.”<sup>197</sup>

Similarly, Covington and Burling, the Washington, D.C., law firm, submitted a letter on behalf of a number of Fortune 500 corporations. The letter argued that the Commission ought to use its broad grant of authority under the statute to define the appropriate rules for implementation of whistleblower bounties to impose a requirement on bounty-seekers that they make use of an “effective internal reporting procedure[.]” or lose eligibility for an award.<sup>198</sup>

Also controversial is the exclusion of individuals who have pre-existing legal or contractual duties to report securities violations. The National Whistleblower Center urged this portion of the proposed rules be cut and argued that it was not required by the statute.<sup>199</sup> As compromise language, the Center suggested that the Commission limit only those employees with “an explicit and binding pre-existing legal duty” of which the “whistleblower is aware.”<sup>200</sup> One objection to the proposed rules is that covered firms could easily circumvent

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194. *Executive Compensation Oversight After the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 27 (2010) (statement of Darla Stuckey, Senior Vice President for Policy and Advocacy at the Society of Corporate Secretaries and Governance Professionals).

195. *Id.*

196. *Id.*

197. *Id.*

198. Robert A. Long et al., *Comment Letter on File No. S-33-10*, SEC.GOV (Feb. 18, 2011), <http://www.sec.gov/comments/s7-33-10/s73310-283.pdf>.

199. Stephen Kohn, *Comment Letter on File No. S-33-10*, SEC.GOV (March 17, 2011), <http://www.sec.gov/comments/s7-33-10/s73310-301.pdf>.

200. *Id.*

them by including in employment contracts a contractual requirement to report violations to the SEC. Moreover, it is possible that the Commission or courts could adopt an expansive view of common law fiduciary duties that, for some employees, requires disclosure (so as to trigger the benefits of cooperation with the SEC) and would thus be a bar to claiming a bounty.

The National Whistleblower Center also criticized the SEC's approach to linking bounties to "significant contribut[ions] to the success of the action," arguing that recovery of bounties should also be permitted where the tip "led to the successful enforcement of the law."<sup>201</sup>

### *E. Post-Enactment Legislative Proposals*

In May 2011, as the SEC neared finalization of its proposed rules, Republican members of Congress began to attack the Dodd-Frank reforms through what detractors, according to National Public Radio, called "death by a thousand cuts."<sup>202</sup>

Among the Dodd-Frank provisions targeted was the whistleblower bounty measure. Freshman Congressman Michael Grimm (R-NY), a former FBI agent, introduced a discussion draft of a bill that would have made several changes,<sup>203</sup> most notably requiring internal reporting in order to trigger eligibility for a bounty.<sup>204</sup> The bill would also have eliminated the mandatory minimum for a bounty, enabling the SEC to pay no bounty even in high-sanction cases.<sup>205</sup> Finally, in an unusual provision, the bill would have prohibited contingency fee arrangements for attorneys representing whistleblowers.<sup>206</sup> I was among the witnesses who

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201. *Id.* at 11.

202. Audie Cornish, *Republicans Propose 'Tweaks' to New Financial Rules*, NPR (May 10, 2011), <http://www.npr.org/2011/05/10/136057308/republicans-propose-tweaks-to-new-financial-rule>.

203. See H.R. 2483, 112th Cong. (Discussion Draft 2011), *available at* <http://online.wsj.com/public/resources/documents/050411propdfchanges.pdf>.

204. See Geoffrey Christopher Rapp, *Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions: Written Testimony Submitted to the U.S. House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises 3-4* (Univ. of Toledo Legal Studies Research Paper No. 2011-02), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1844586](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1844586).

205. *Id.*

206. *Id.*

testified in the committee hearings on the bill held on May 11,<sup>207</sup> in which a significant amount of time was dedicated to the contingency fee provision. I argued that it was contrary to the established practice in other areas of whistleblower law,<sup>208</sup> indeed, outside of criminal defense work and domestic relations law there are no widespread outright prohibitions on contingency fee arrangements.<sup>209</sup>

Congressman Grimm introduced the bill as H.R. 2483, the Whistleblower Improvement Act of 2011,<sup>210</sup> on July 11. Although the final bill deleted the controversial contingency fee prohibition, the bill is likely to face opposition in the United States Senate and “significant hurdles to make it through Congress.”<sup>211</sup>

### F. Final Rules

The SEC voted 3-2 to adopt its final whistleblower rules on May 25, 2011.<sup>212</sup> The Final Rules did not embrace the business community’s preferred internal reporting requirement, but did emphasize those aspects of the rules that encouraged internal reporting.<sup>213</sup> Positive participation in an internal reporting process would increase the percentage level for a whistleblower’s bounty,

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207. A webcast of the hearings is available at <http://financialserv.edgeboss.net/wmedia/financialserv/hearing0511112pm.vwx>.

208. Rapp, *supra* note 204, at 7.

209. The ABA’s Model Rules of Professional Conduct prohibit contingency fees in connection with criminal defense and domestic relations. MODEL RULES PROF’L CONDUCT R. 1.5 (1983). Otherwise, “America’s contingency fee system operates relatively unrestrained.” Victor E. Schwartz & Christopher E. Appel, *The Importance of Authenticity, Necessity, and Learning from Our Mistakes*, 38 PEPP. L. REV. 551, 566 (2011). There are a few stray state statutes restricting contingent fee arrangements, for instance, in connection with lobbying for the passage of particular legislation. *See, e.g.*, OHIO REV. CODE ANN. § 101.77 (West 2010); TEX. GOV’T CODE ANN. § 305.22 (West 2010). However, such examples are not comparable to the representation of a whistleblower seeking a bounty; they are justified based on concerns about their effect on the lawmaking process and good government.

210. H.R. 2483, 112th Cong. (2011), *available at* <http://www.govtrack.us/congress/billtext.xpd?bill=h112-2483>.

211. Ashby Jones, *For Whistleblower Fans, A Grimm Proposal*, WALL ST. J. L. BLOG (May 5, 2011, 4:52 PM), <http://blogs.wsj.com/law/2011/05/05/for-whistleblower-fans-a-grimm-proposal/>.

212. Samuel Estreicher & Terri Chase, *SEC Issues Final Rules on Whistleblower Protections and Bounty Program*, N.Y. L.J. (July 13, 2011), [http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1202500480179&SEC\\_Issues\\_Final\\_Rules\\_on\\_Whistleblower\\_Protections\\_and\\_Bounty\\_Program&slreturn=1&hblogin=1](http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1202500480179&SEC_Issues_Final_Rules_on_Whistleblower_Protections_and_Bounty_Program&slreturn=1&hblogin=1).

213. SEC Final Rules, *supra* note 14, at 34,300–01.

while “interference” with an internal process would lead to a reduced award.<sup>214</sup> This was among the factors listed in the initial proposed rules, but it received greater emphasis in the final version.<sup>215</sup> The final rules also added two provisions to avoid undercutting internal reporting systems. First, if a whistleblower reported internally and a company then contacted the SEC, the information reported by the company would be attributed to the whistleblower, in effect, reducing the incentive to bypass the company that some have attributed to the proposed rules.<sup>216</sup> Second, whistleblowers were given an additional thirty days to report their concerns to the SEC (to 120 days from ninety in the proposed rules).<sup>217</sup>

The final rules adopted a somewhat simplified claims process.<sup>218</sup> In addition, the final rules provided that if a whistleblower’s report to the SEC led to multiple actions producing sanctions below the \$1 million level that *collectively* totaled more than \$1 million, those could be aggregated to determine whether the minimum sanction needed to trigger an award had been obtained.<sup>219</sup>

The final rules also softened the requirements for “voluntary” disclosure. Under the final rules, a whistleblower could be entitled to a bounty so long as the whistleblower provided information prior to a request by the government to provide the information,<sup>220</sup> in other words, unlike under the Proposed Rules, a whistleblower need not be the initial source responsible for the opening of an investigation. Similarly, the final rules relaxed the “pre-existing legal duty rule.” Under the final rules, only pre-existing duties to report violations *to the Commission* (as opposed to higher authorities within a corporation) would be grounds for exclusion from reward eligibility.<sup>221</sup> Only preexisting duties arising from contracts with the Commission or another regulatory authority would provide a basis for denial due to the existence of a *contract*; a corporation now cannot avoid triggering bounties by inserting language into

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214. *Id.* at 34,301.

215. The final version carved the provision out in its own paragraph, rather than listing it among the factors to be taken into account. *Id.* at 34,367.

216. *Id.* at 34,301.

217. *Id.* at 34,360.

218. *Id.*

219. *Id.* at 34,301.

220. *Id.* at 34,364.

221. *Id.* at 34,309.



employment contracts mandating that employees report violations to the SEC.<sup>222</sup>

The Commission made substantial changes in the rules concerning the meaning of “[i]nformation that leads to successful enforcement,” lowering the standard for whistleblowers.<sup>223</sup> The final rules deleted the words “significantly contributed” to the success of an action from the standard for triggering an award.<sup>224</sup>

### III. UNDERSTANDING SECURITIES FRAUD

#### A. *The Fraud Triangle*

Fraud costs a typical organization five percent of its annual revenue.<sup>225</sup> Globally, that meant \$2.9 trillion dollars in losses as a result of fraud in 2009 alone.<sup>226</sup> In tough economic times, rates of fraud typically rise.<sup>227</sup> A slowing economy may increase pressure on companies to satisfy short-term financial objectives, pressure which can sometimes stimulate fraud.<sup>228</sup> Economic downturns also leave individuals in less secure financial situations, which can provide motivation to commit fraud.<sup>229</sup> In recent years, the highest rates of financial fraud occurred during recession periods.<sup>230</sup> Moreover, securities fraud has particular social costs, in addition to those visited on the victims of fraud, since potential investors’ fear of fraud makes them less likely to purchase shares without being compensated by way of a discount.<sup>231</sup>

Fraud is one of the oldest concepts in Anglo-American law. It

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222. *Id.*

223. *Id.* at 34,365.

224. *Id.*

225. ASS’N OF CERTIFIED FRAUD EXAMINERS, 2010 REPORT TO THE NATIONS, *available at* <http://www.acfe.com/rtn-highlights.aspx> [hereinafter ACFE].

226. *Id.*

227. Carmen Nobel, *4 Ways to Avoid Small-Business Fraud*, THE STREET (July 13, 2010, 7:26 AM), [http://www.thestreet.com/story/10803855/1/4-ways-to-avoid-small-business-fraud.html?cm\\_ven=GOOGLE](http://www.thestreet.com/story/10803855/1/4-ways-to-avoid-small-business-fraud.html?cm_ven=GOOGLE).

228. Albert P. Lilienfeld, *Financial Fraud: Does an Economic Downturn Mean an Uptick?*, in AUDIT COMMITTEE WORKSHOP 2009: MEETING THE CHALLENGES OF THE FINANCIAL CRISIS 497, 499 (PLI Corporate Law and Practice Course Handbook Series No. 19189).

229. *Id.* at 500.

230. *Id.* at 499.

231. Amanda M. Rose, *The Multiplier Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2179 (2010).

has its origins in the independent *writ of deceit*, which existed in England as early as the thirteenth century.<sup>232</sup> As a legal concept, fraud requires plaintiffs to prove the elements of the offense, ranging from three<sup>233</sup> to five<sup>234</sup> to six<sup>235</sup> to nine<sup>236</sup> to eleven<sup>237</sup> across jurisdictions.

In its most discrete three-element form, fraud requires a plaintiff to show defendant made a *material false* statement with intent to induce reliance, on which the *plaintiff justifiably relied*, resulting in *damages*.<sup>238</sup> Securities fraud, most notably the SEC's Rule 10b-5,<sup>239</sup> mirrors in large part these common law elements.<sup>240</sup>

One explanatory theory for fraud consists of Donald Cressey's so-called "fraud triangle": Opportunity, Pressure, and

232. The writ of deceit existed since at least 1201 A.D. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 727 (5th ed. 1984).

233. Randy D. Gordon, *Rethinking Civil RICO: The Vexing Problem of Causation in Fraud-Based Claims under 18 U.S.C. § 1962(c)*, 39 U.S.F. L. REV. 319, 324 n.30 (2005).

234. See *Robinson Helicopter Co. v. Dana Corp.*, 102 P.3d 268, 274 (Cal. 2004) ("The elements of fraud are: (1) a misrepresentation (false representation, concealment, or nondisclosure); (2) knowledge of falsity (or scienter); (3) intent to defraud, i.e., to induce reliance; (4) justifiable reliance; and (5) resulting damage.").

235. *Norman v. Apache Corp.*, 19 F.3d 1017, 1022 (5th Cir. 1994) (explaining that under Texas law, fraud requires plaintiff to show: "(1) a material representation was made; (2) the representation was false; (3) the speaker made the representation knowing it was false or made it recklessly without any knowledge of its truth and as a positive assertion; (4) the speaker made the representation with the intention that it should be relied upon by the party; (5) the party acted in reliance upon the misrepresentation; and (6) the party thereby suffered injury").

236. See *Nielson v. Flashberg*, 419 P.2d 514, 517-18 (Ariz. 1966) (explaining that the elements of fraud are: "(1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) his intent that it should be acted upon by and in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) his reliance on its truth; (8) his right to rely thereon; [and] (9) his consequent and proximate injury").

237. *Hanson v. Ford Motor Co.*, 278 F.2d 586, 591 (8th Cir. 1960) (explaining that the eleven elements of fraud in Minnesota are (1) a representation; (2) that was false; (3) concerning a past/present fact; (4) material; (5) susceptible of knowledge; (6) known to be false; (7) intend to induce another to act; (8) inducement of the other to act; (9) in reliance on the representation; (10) damages; and (11) causation). Minnesota has subsequently condensed its list of elements to five.

238. RESTATEMENT (SECOND) OF TORTS § 525 (1977) ("One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.").

239. 17 C.F.R. § 240.10b-5 (1948) (amended 1951).

240. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005).

Rationalization.<sup>241</sup> The *opportunity* to commit fraud arises when there is a lack of internal control, inadequate supervision and review, a lack of separate authority, and an inadequate system for detecting and punishing fraud. *Pressure* to commit fraud can result from employees' personal financial problems, vices and addictions, and unrealistic performance goals. *Rationalization* by fraudsters helps overcome natural and learned inhibitions as individuals conceive of justifications for their illicit conduct. Examples of common forms of rationalization include retaliation (a fraudster is responding to a perceived injustice against him), "everyone else is doing it,"<sup>242</sup> temporary violations to be remedied later<sup>243</sup>—that is, "I will pay it back,"<sup>244</sup> "the firm can afford it,"<sup>245</sup> "I'm not hurting anyone,"<sup>246</sup> and the like.<sup>247</sup>

Securities fraud operates under these same dynamics. The separation of ownership and control in modern firms creates agency costs, with managers' incentives poorly aligned at times with those of investors. Because the costs for investors of monitoring managers are prohibitive, managers have the *opportunity* to engage in securities fraud, "best . . . understood as a species of agency costs."<sup>248</sup> Managers may face *pressure* to commit fraud in order to "mask[] the negative effects of strategic or tactical management decisions on the

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241. JOSEPH T. WELLS, OCCUPATIONAL FRAUD AND ABUSE 11 (1997) (citing DONALD R. CRESSEY, OTHER PEOPLE'S MONEY: A STUDY IN THE SOCIAL PSYCHOLOGY OF EMBEZZLEMENT (1953)).

242. The "Crowd Follower" form of fraud involves "people who believe that they're just going with the flow, acting in a way that is consistent with industry practice." Lori Richards, *Speech by SEC Staff: "Why Does Fraud Occur and What Can Deter or Prevent It?"*, 1732 PLI/CORP 907, 913 (PLI Corporate Law and Practice Course Handbook Series No. 18789, 2009).

243. Under the "borrower" form of fraud a person may truly believe he is simply "borrowing" the money, and intend[s] to pay it back." *Id.* at 911.

244. Kathleen Barney, *This Thing Called Forensic Accounting*, ARIZ. ATT'Y, July–Aug. 2007, at 34, 38.

245. *Id.*

246. *Id.*

247. J. Michael Cook, *Fraud and the Role of the Audit Committee*, in SECOND ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE: WHAT BOARD MEMBERS NEED TO KNOW TO BE EFFECTIVE TODAY & TOMORROW, 1177, 1182 (PLI Corporate Law and Practice Course Handbook Series No. 3254, 2004); Albert Lilienfeld, *Antifraud Programs and Controls*, in AUDIT COMMITTEE WORKSHOP 2005: WHAT AUDIT COMMITTEE MEMBERS & LAWYERS WHO ADVISE THEM NEED TO KNOW NOW, 371, 391 (PLI Corporate Law and Practice Course Handbook Series No. 5944, 2005).

248. Rose, *supra* note 231, at 2182.

performance of the company.”<sup>249</sup> Securities fraud perpetrators “must *rationalize* or ‘neutralize’ the harm that they do, and the courts are full of fraud defendants who, even when confronted with the likelihood of a long term in prison, deny the illegality of their conduct, minimize its significance, or seek to place the blame on somebody else.”<sup>250</sup>

Donald Langevoort provided a further elaboration on the source of pressure to commit securities fraud, hoping to answer the question, “Why do companies falsely portray themselves to the capital markets in filings with the [SEC] . . . and through other publicity?”<sup>251</sup> He argued that securities fraud arises from managers receiving inaccurate (or overly rosy) information, which they then pass on to shareholders and remain committed to even after the information is subsequently revealed as false.<sup>252</sup> The “optimism-commitment whipsaw effect”<sup>253</sup> induces *pressure* to commit fraud and provides managers with a *rationalization* for defrauding investors.

The current framework for combating securities fraud provides inadequate checks on the *opportunity* to commit fraud. While the legal and regulatory environment is predicated on the notion that regulators will detect fraud, there is very little support for this position. Alexander Dyck, an economist at the University of Toronto, and his coauthors, recently published a study of 216 major scandals between 1996 and 2004.<sup>254</sup> The SEC was found to have detected just seven percent of reported corporate fraud.<sup>255</sup> Similarly, private securities litigation does a poor job of rooting out fraud, accounting for only three percent of the cases.<sup>256</sup>

Policies which stimulate whistleblowing target two of the three

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249. Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 401 (2008).

250. Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 PENN ST. L. REV. 189, 211 (2008) (emphasis added).

251. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Misdemean Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 105 (1997).

252. *Id.* at 108.

253. *Id.* at 147.

254. The study looked only at fraud in U.S. companies with more than 750 million in assets. Dyck et al., *supra* note 30, at 2213.

255. *Id.* at 2214.

256. *Id.*

legs of the fraud triangle. First, increased whistleblowing raises the likelihood of detection, thus reducing the *opportunity* to commit fraud. Second, the threat of whistleblowing—and the public condemnation it triggers—makes *rationalization* more difficult.

#### IV. UNDERSTANDING WHISTLEBLOWERS

The subject of much recent media attention, the “whistleblower” was identified as *Time* magazine’s “Person of the Year” in 2002, with a cover depicting Enron “whistleblower” Sherron Watkins, Colleen Rowley of the FBI, and Cynthia Cooper of WorldCom.<sup>257</sup> Whistleblowing is the single most effective way to detect fraud. Employee disclosures are the most common source of fraud detection.<sup>258</sup> More than forty percent of fraud detection occurs as a result of tips.<sup>259</sup>

The first reason why whistleblowing is the best way to detect fraud is that whistleblowers who are insiders actually have access to information sources. According to the Dyck Study of corporate fraud, having access to information “increases an actor’s probability of detecting fraud by 15 percentage points.”<sup>260</sup> Insiders have both access to information itself and to the processes used to cover up the truth.

One of the major impediments to revealing fraud is the cost “of identifying and gathering fraud-relevant information,” and insiders “face[] a much lower cost (in fact, often no cost)” in discovering such information.<sup>261</sup> Even though outside interests—like market arbitrageurs, short sellers, and regulators—may have reputational or financial incentives to seek out fraud, for such actors “detecting fraud is like looking for a needle in a haystack.”<sup>262</sup> Insider-employee whistleblowers “clearly have the best access to information,” since

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257. TIME, Dec. 30, 2002, at cover, *available at* <http://www.time.com/time/covers/0,16641,20021230,00.html>. Whether Watkins qualifies as a true “whistleblower” is a matter of some debate, since she did not at any point take her concerns outside of the firm’s leadership.

258. Deborah L. Seifert, *The Influence of Organizational Justice on the Perceived Likelihood of Whistleblowing* 1–2 (Dec. 2006) (unpublished Ph.D. dissertation, Washington State University), *available at* [http://www.dissertations.wsu.edu/Dissertations/Fall2006/d\\_seifert\\_120806.pdf](http://www.dissertations.wsu.edu/Dissertations/Fall2006/d_seifert_120806.pdf); Nobel, *supra* note 227.

259. ACFE, *supra* note 225.

260. Dyck et al., *supra* note 30, at 2215.

261. *Id.* at 2214.

262. *Id.*

“[f]ew, if any frauds can be committed without the knowledge and often the support of several employees.”<sup>263</sup> Insiders often also have the technical skills to comprehend the sometimes complex financial transactions that are at the core of many modern instances of fraud.

Insiders are in a unique position because they can “alert employers to problems before those problems escalate.”<sup>264</sup> Absent reporting by internal whistleblowers, “future incidents of massive corporate wrongdoing, along the lines of the Enron scandal or the Bernard Madoff Ponzi scheme might never be revealed, or might have been revealed too late.”<sup>265</sup>

Without whistleblowing, existing measures to detect fraud in financial settings are limited. Government enforcement alone is ineffectual “because of the sheer massiveness of the market.”<sup>266</sup>

#### A. *Why Do Whistleblowers Come Forward?*

Whistleblower motives are typically characterized by a high degree of complexity.<sup>267</sup> The process of whistleblowing may be idiosyncratic,<sup>268</sup> with the reasons motivating a particular individual being unique to that person and her place in an organization. Still, it is possible to identify both the incentives that favor individuals blowing the whistle and those that caution against such activity.

Whistleblowers become such at the culmination of a decision tree which can lead to one of two outcomes: blow the whistle or stay silent. Whether they do so consciously or unconsciously,<sup>269</sup> whistleblowers must engage in a sort of cost-benefit analysis in deciding whether, and how, to blow the whistle on corporate

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263. *Id.* at 2240.

264. Sinzdak, *supra* note 46, at 1635.

265. Michael J. Kaufman & John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation*, 19 CORNELL J.L. & PUB. POL’Y 637, 668 (2010).

266. *Id.* at 675.

267. Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1909 (2007).

268. Michael Regh et al., *Antecedents and Outcomes of Retaliation Against Whistleblowers: Gender Differences and Power Relationships*, 19 ORG. SCI. 221, 235 (2008).

269. One author suggested that most whistleblowers felt they had no choice other than to blow the whistle, with “[c]hoiceless choice . . . as close as many whistle-blowers get to evaluating their own narratives.” C. Fred Alford, *Whistle-Blower Narratives: The Experience of Choiceless Choice*, 74 SOC. RES. 223, 223, 229 (2007).

fraud.<sup>270</sup> If we presume they act rationally,<sup>271</sup> whistleblowers are “people for whom the expected benefits of blowing the whistle exceeded the expected costs.”<sup>272</sup> However, research on why whistleblowers come forward faces a significant methodological problem: study subjects will invariably be those who came forward, rather than stayed silent. Such analyses will thus “overstate the benefits and/or understate the costs” of potential whistleblowing.<sup>273</sup>

The benefits of whistleblowing depend in part on the professional identity of a potential whistleblower. External analysts who discover fraud, for instance, are no more likely to be promoted if they blow the whistle, but according to the Dyck Study are less likely to be demoted than analysts not involved in whistleblowing.<sup>274</sup> For some potential classes of whistleblowers, then, there may be career-related reasons to bring fraud to light. That is not likely to be the case for most inside whistleblowers, however, as discussed in the section which follows.

Perhaps the strongest motivating factor for whistleblowers is the desire to do the “right” thing.<sup>275</sup> Whistleblowing has an ethical dimension. Individuals are more likely to report wrongdoing if they feel a sense of responsibility (perhaps to “colleagues and employer” or to their profession), and where “personal ethical values” favor reporting.<sup>276</sup> Whistleblowing is more likely when employees have a

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270. Matthias Schmidt, “Whistle Blowing” *Regulation and Accounting Standards Enforcement in Germany and Europe—An Economic Perspective*, 25 INT’L REV. L. & ECON. 143, 152 (2005) (“Within the decision process to blow or not to blow the whistle, the observer has to balance benefits of his action with the possible costs.”).

271. Whistleblowers are not solely motivated by hard “pros” and “cons”. Instead, affective factors, such as one’s self-esteem, can influence the decision to report wrongdoing. Mary B. Curtis, *Are Audit-Related Ethical Decisions Dependent upon Mood?*, 68 J. BUS. ETHICS 191, 194 (2006). For low self-esteem individuals, the costs of potential whistleblowing may appear higher, *see id.*, producing observed patterns of whistleblowing that seem inconsistent with the rational-choice framework. Similarly, a negative mood may make individuals adopt the attitude that “unethical activities are commonplace,” reducing the pressure to blow the whistle. *Id.*

272. Dyck et al., *supra* note 30, at 2231–32.

273. *Id.* at 2215.

274. *Id.*

275. Gregory Liyanarchchi & Chris Newdick, *The Impact of Moral Reasoning and Retaliation on Whistle-Blowing: New Zealand Evidence*, 89 J. BUS. ETHICS 37, 41 (2009) (“[O]ne of the most important factors that affect an individual’s decision on whistle-blowing is his or her moral behavior . . . . [I]ndividuals with higher levels of moral reasoning are more likely to blow the whistle than are individuals with lower levels of moral reasoning.”).

276. Curtis, *supra* note 271, at 193.

high level of “moral intensity.”<sup>277</sup> Whistleblowers are motivated by “altruistic concerns” including “the desire to correct the wrongdoing which is harming the interests of the organization itself, the consumers, the co-workers and the society at large.”<sup>278</sup>

Whistleblowers also want a chance to tell their story, in their own words.<sup>279</sup> The desire to tell a story becomes more profound as a whistleblower wends her way through investigation and litigation, awaiting a day in court in which her allegations can finally, at long last, be verified or discounted. Successful whistleblowing, after all, requires not just an initial report, but “persistence in reporting.”<sup>280</sup> “[O]ne’s commitment to his or her own personal moral judgments is a significant determinant of both” the initial reporting and “the extent to which one is willing to persevere in that reporting.”<sup>281</sup>

Another factor favoring whistleblowing, in some cases, is the desire to avoid personal sanction for complicity in fraudulent schemes.<sup>282</sup> Some whistleblowers may become tipsters to avoid prosecution or civil liability for participating in, or covering up, a fraudulent scheme. Potential liability appears to have been a motivating factor in thirty-five percent of the employee whistleblower cases reviewed in the Dyck Study.<sup>283</sup> Whistleblowers may also reveal fraud to protect their own reputations, although it rarely seems to be a concern for subordinate employees, for whom changing jobs without whistleblowing may be “the best way to avoid . . . reputational loss.”<sup>284</sup>

Some whistleblowers may be seeking to retaliate for having been dismissed. It is difficult to determine when an employee has been dismissed due to expected or actual whistleblowing, or when an employee blows the whistle *because* she has been terminated.<sup>285</sup> Still, the Dyck Study observed a connection between claims of wrongful

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277. Eileen Z. Taylor & Mary B. Curtis, *An Examination of the Layers of Workplace Influences in Ethical Judgments: Whistleblowing Likelihood and Perseverance in Public Accounting*, 93 J. BUS. ETHICS 21, 22 (2010).

278. Siddhartha Dasgupta & Ankit Kesharwani, *Whistleblowing: A Survey of Literature*, 9 IUP J. CORP. GOVERNANCE 57, 62 (2010).

279. Alford, *supra* note 269, at 224.

280. Taylor & Curtis, *supra* note 277, at 23.

281. *Id.* at 30.

282. Dyck et al., *supra* note 30, at 2245.

283. *Id.*

284. *Id.*

285. *Id.*



dismissal and whistleblowing by employees, with twenty-nine percent of such employee-whistleblowers also bringing wrongful dismissal claims.<sup>286</sup> It is possible that ineffective employees could seek to “fend off legitimate criticism or disciplinary measures” by claiming the protected “status of a whistle blower.”<sup>287</sup> “Disgruntled employees are more likely to [blow the whistle] . . . and revenge is often a common feature in whistleblower cases.”<sup>288</sup> Moreover, firms might be forced to tolerate ineffective employees out of a concern for the “enormous trouble” such employees could cause if they were to blow the whistle.<sup>289</sup>

It is sometimes difficult to assess whether whistleblowers in fact lodged frivolous claims, particularly during the investigation of their charges, because whistleblowers’ narratives often take on the character of a “paranoid narrative.”<sup>290</sup> Whistleblowers embrace paranoia as “an accurate emotional reading of an emotional reality.”<sup>291</sup>

Sometimes, whistleblowers are motivated to identify fraud based on their status as competitive rivals of fraudsters. In connection with the massive Ponzi scheme orchestrated by Wall Street financier Bernie Madoff, whistleblower Harry Markopolos repeatedly sought to bring the fraud to the attention of regulators, pressing the issue for nearly a decade.<sup>292</sup> Markopolos was motivated, at least in part, by his former status as a rival of Madoff.<sup>293</sup> His personal motivation to discredit Madoff may be one of the reasons why Markopolos was

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286. *Id.*

287. Schmidt, *supra* note 270, at 158 (citing James Gobert & Maurice Punch, *Whistleblowers, the Public Interest, and the Public Interest Disclosure Act 1998*, 63 MOD. L. REV. 25, 32 (2000)).

288. Macey, *supra* note 267, at 1907.

289. Schmidt, *supra* note 270, at 159.

290. Alford, *supra* note 269, at 225, 231–33.

291. *Id.* at 231.

292. Felicia Smith, *Madoff Ponzi Scheme Exposes “The Myth of the Sophisticated Investor”*, 40 U. BALT. L. REV. 215, 241 (2010).

293. Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part II)*, 104 NW. U. L. REV. 421, 428 (2010). Markopolos was a “potential competitor” of Madoff who had been asked by his employer to develop a fund that would replicate Madoff’s. Heather Hiznay, Recent Development, *How the Bernard Madoff Scandal Exposed Weakness in Asset Management Regulation*, 28 REV. BANKING & FIN. L. 383, 413, 420 (2009).

ignored by the SEC.<sup>294</sup> Again, the lesson may be that regardless of the motivations of a whistleblower, fraud may still have occurred.

*B. What Countervailing Incentives Does a Whistleblower Face?*

Like the benefits of whistleblowing, the costs of revealing ongoing fraud in the financial setting depend on the category of person considering becoming a tipster. For nearly all potential whistleblowers—with the possible exception of one kind of external whistleblower, journalists<sup>295</sup>—the costs of blowing the whistle are significant.<sup>296</sup> Many whistleblowers in the Dyck Study gave a sobering perspective on their experience: “If I had to do it over again, I wouldn’t.”<sup>297</sup> In considering the decision whether or not to blow the whistle on fraud, most individuals will be less likely to report fraud if the perceived costs are high.<sup>298</sup>

For gatekeepers like auditors, blowing the whistle has a “clear cost”—the auditor will likely “lose the client”—and there is no evidence that blowing the whistle will lead to reputational gains that will attract future business.<sup>299</sup>

For employees, the most prominent cost of whistleblowing is the threat to one’s career. One author put it bluntly: “Most whistleblowers are fired.”<sup>300</sup> In the Dyck Study, eighty-two percent of whistleblowers reported that they were “fired, quit under duress, or had significantly altered responsibilities.”<sup>301</sup> An earlier study found that nearly ninety percent of whistleblowers were fired or demoted.<sup>302</sup>

One whistleblower was moved into a broom closet, had his computer taken away, and was finally shifted to the mailroom (the

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294. Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernie Madoff*, 2009 MICH. ST. L. REV. 947, 954 n.45.

295. Journalists who break stories of corporate fraud are “more likely to find a better job” than peers who do not sleuth out such stories. Dyck et al., *supra* note 30, at 2215.

296. Bowen et al., *supra* note 32, at 1243 (“[T]he personal cost to the whistle-blower can be high.”).

297. Dyck et al., *supra* note 30, at 2216 (internal quotation marks omitted).

298. Curtis, *supra* note 271, at 194.

299. See Dyck et al., *supra* note 30, at 2215.

300. Alford, *supra* note 269, at 223.

301. Dyck et al., *supra* note 30, at 2216.

302. Kim R. Sawyer, Jackie Johnson, & Mark Holub, The Necessary Illegitimacy of the Whistleblower 4 (July 2006) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=917316](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917316).

individual in question was a nuclear physicist).<sup>303</sup> Whistleblowers who remain on the job can suffer an “endless chain of abasement.”<sup>304</sup> Others have been referred to psychiatrists.<sup>305</sup> Up to twenty-seven percent of whistleblowers are sued by their employers.<sup>306</sup> Even those not retaliated against by their firm may find themselves forced to change industries or careers,<sup>307</sup> with the potential of being subjected to blacklisting even through informal or tacit collusion among former colleagues and employers.<sup>308</sup> Some sixty-four percent of whistleblowers in one study reported being blacklisted from other jobs in their field.<sup>309</sup> One whistleblower’s lawyer reflected that his client would “never get a job in Corporate America again.”<sup>310</sup> Whistleblowers are viewed as likely “repeat offenders,” and employing a whistleblower is thought to be risky.<sup>311</sup>

Employers appear to “prefer loyal employees to honest ones,”<sup>312</sup> and in many companies “management as well as other employees tend to regard whistle blowers as disloyal.”<sup>313</sup> Whether whistleblowing is in fact incompatible with loyalty to one’s employer is open to debate.<sup>314</sup> However, because whistleblowing runs contrary to the standard notion that loyalty involves “devotion to [an employer’s] actual practices irrespective of whether or not they are ultimately good for the employer or morally acceptable,”<sup>315</sup>

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303. Alford, *supra* note 269, at 230.

304. *Id.*

305. Brian Martin & Will Rifkin, *The Dynamics of Employee Dissent: Whistleblowers and Organizational Jiu-Jitsu*, 4 PUB. ORG. REV. 221, 226 (2004); Liyanarchchi & Newdick, *supra* note 275, at 41 (“Another more severe form of retaliation is to order whistle-blowers to take psychiatric fitness-for-duty examinations.”).

306. Sawyer, *supra* note 302, at 4.

307. Dyck et al., *supra* note 30, at 2240, 2245. *But see* Schmidt, *supra* note 270, at 160 (“Empirical evidence on the perception of actual retaliation by whistle blowers in carefully conducted analyses of various cases in the US is rather mixed.”).

308. Janet Malek, *To Tell or Not To Tell? The Ethical Dilemma of the Would-Be Whistleblower*, 17 J. ACCOUNTABILITY IN RES. 115, 118 (2010).

309. Sawyer, *supra* note 302, at 11.

310. Dyck et al., *supra* note 30, at 2245.

311. Sawyer, *supra* note 302, at 2.

312. Dyck et al., *supra* note 30, at 2245.

313. Schmidt, *supra* note 270, at 151.

314. *See generally* Jukka Varelius, *Is Whistle-blowing Compatible with Employee Loyalty?*, 85 J. BUS. ETHICS 263 (2009) (arguing that whistleblowers are loyal employees and serve the moral good of their employers).

315. *Id.* at 266.

whistleblowing is often equated with disloyal “snitching.”<sup>316</sup> Empirical evidence documents that employers are reluctant to hire individuals who have blown the whistle on past employers, believing that whistleblowing is “a breach of employee loyalty to the organization.”<sup>317</sup>

Even whistleblowers vindicated in a subsequent investigation may be considered too high risk for other employers. Similarly, even if an employee is not fearful of termination and seeks to remain with the same firm after blowing the whistle, she may rightly fear that her career advancement will be negatively affected.<sup>318</sup> The threat of retaliation “creates a strong disincentive for whistle-blowing.”<sup>319</sup> Even where whistleblowers are assured protection against retaliation, they may still be discouraged from reporting fraud by the fear that such promises will be breached or that such protections are illusory.<sup>320</sup> Retaliation against whistleblowers may also be affected by gender dynamics: at least some research suggests that “female whistleblowers may experience more retaliation than male whistleblowers.”<sup>321</sup> Whistleblowing itself may “represent[] a violation of stereotypical role expectations for women,”<sup>322</sup> triggering more harsh retaliation.

Even where whistleblowers may enjoy some hope of victory thanks to an anti-retaliation provision like the one in SOX, the delays associated with obtaining such victory can be costly. In one SOX whistleblower case, the plaintiff, although eventually victorious, was forced to sell his family farm, move to a smaller house, and accumulated nearly \$100,000 in legal bills.<sup>323</sup> “[W]histleblowers are not actually protected in the sense that they can be secure in their

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316. See Fincher, *supra* note 157, at 64 (“Employers tend to view whistleblowers as disloyal and insubordinate, even when the whistleblower does not take the matter outside the company.”); Gonzalez, *supra* note 62, at 326 (“[E]mployees who complain . . . are often viewed as snitches.”).

317. Liyanarachchi & Newdick, *supra* note 275, at 40.

318. Dyck et al., *supra* note 30, at 2250–51. In an earlier study of federal employee whistleblowers, eighteen percent were assigned to less desirable duties and eleven percent were denied a promotion. See Luigi Zingales, *Want to Stop Corporate Fraud? Pay off Those Whistle-Blowers*, WASH. POST, Jan. 18, 2004, at B02.

319. Carson et al., *supra* note 154, at 364.

320. *Id.*

321. Rehg et al., *supra* note 268, at 235.

322. *Id.*

323. Earle & Madek, *supra* note 5, at 25.

position while pressing their claims.”<sup>324</sup> They face “protracted legal battles waged at personal expense.”<sup>325</sup>

The threat of retaliation is most salient in connection with instances of severe fraud, the kind that would likely impugn the organization were it publicly revealed.<sup>326</sup> Yet, it is precisely in connection with that kind of fraud that the public interest is most positively affected by the revelation of wrongdoing. Thus, in that context, public policy levers are most needed to encourage whistleblowing.

Of course, actual instances of retaliation against whistleblowers are not the best guide to how retaliation affects *potential* whistleblowers. Surprisingly, many whistleblowers do not expect that they will be the victims of retaliation.<sup>327</sup> Such individuals may be operating under an over-optimism bias. But it may very well be that other pressures against whistleblowing are more important in shaping the decision-making process of potential tipsters. If so, anti-retaliation provisions like the one in SOX will likely do little to affect the level of whistleblowing.<sup>328</sup>

In addition to the economic consequences of revealing fraud, whistleblowers will experience significant personal hardship while their claims are investigated and in connection with subsequent litigation. Most will be fired, and among those, most will ultimately lose their marriages. A majority will “turn to alcohol or drugs for some period during their long journey.”<sup>329</sup> Under the harsh glare of litigation’s spotlight, a whistleblower can be expected to experience “personal attacks on one’s character during the course of a protracted dispute.”<sup>330</sup> Whistleblowers are often labeled as “‘difficult personalit[ies],’ incompetent, inadequately trained,” or erroneous in their assessment of fraud.<sup>331</sup> A whistleblower’s employee file will be “scrutinized and old complaints or allegations pulled out—

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324. *Id.* at 51.

325. Carson et al., *supra* note 154, at 364.

326. Regh et al., *supra* note 268, at 225.

327. Sawyer et al., *supra* note 302, at 10.

328. It is possible that the enactment of anti-retaliation provisions could raise awareness among potential whistleblowers of the prevalence of retaliation. It is equally plausible, however, that anti-retaliation measures could lead potential tipsters to overestimate the protection that they will actually be provided.

329. Alford, *supra* note 269, at 223.

330. Dyck et al., *supra* note 30, at 2245.

331. Martin & Rifkin, *supra* note 305, at 229.

sometimes from many years earlier—and used to justify [retaliatory] actions.”<sup>332</sup> Smear campaigns against whistleblowers undermine their moral legitimacy and, “by implication, the legitimacy of their whistleblowing.”<sup>333</sup> As a result, whistleblowers typically feel “exhausted, highly emotional, and under severe stress . . . agitated by the prospect of confronting the wrongdoers, and depressed and in a panic about their career.”<sup>334</sup>

Nor can the social costs of whistleblowing be discounted, and they may indeed be surprisingly strong.<sup>335</sup> Whistleblowing challenges the usual workplace realities of “collegiate loyalty and team spirit.”<sup>336</sup> Whistleblowers may experience “distancing and retaliation from fellow workers and friends,”<sup>337</sup> and come to be treated as outsiders.<sup>338</sup> Whistleblowers can face “extensive ostracism” which may overwhelm any protection the anti-retaliation provisions of SOX provides.<sup>339</sup> In one study, twenty percent of federal employee whistleblowers reported being “shunned” by co-workers and managers, and twenty-five percent reported being the target of verbal harassment or intimidation.<sup>340</sup>

One source of this ostracism is likely the significant negative effects whistleblowing tends to have on the long-run trajectory of the firms involved. Firms targeted by whistleblowers are “more likely to restate their earnings and be subject to shareholder litigation in the three years following the whistle-blowing allegation.”<sup>341</sup> Whistleblowing tends to “be an early indicator of future negative economic consequences for targeted firms.”<sup>342</sup> Co-employees of a

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332. *Id.*

333. Sawyer, *supra* note 302, at 11.

334. Fincher, *supra* note 157, at 67.

335. Matthew J. Marquez, *The Rejection of Moral Rebels: Resenting Those Who Do the Right Thing*, 95 J. PERSONALITY & SOC. PSYCHOL. 76, 76 (2008) (“The violence of this backlash against whistleblowers . . . is surprising precisely because the exact same behavior draws admiration and respect from observers not directly involved in the situation—and also because this rejection does not just come from peers who stand to suffer . . . but also from peers who merely failed to report . . . abuse.”).

336. Wim Vandekerckhove & Eva E. Tsahuridu, *Risky Rescues and the Duty to Blow the Whistle*, 97 J. BUS. ETHICS 365, 370 (2010).

337. Dyck et al., *supra* note 30, at 2245.

338. Sawyer, *supra* note 302, at 2.

339. Dyck et al., *supra* note 30, at 2250.

340. Zingales, *supra* note 318, at 2.

341. Bowen et al., *supra* note 32, at 1241.

342. *Id.* at 1266.

whistleblower likely have difficulty identifying management as the cause of subsequent layoffs and are equally likely to blame the whistleblower for later negative performance of the firm.<sup>343</sup>

In addition, co-employees of a whistleblower may believe that the whistleblower's choice "condemns the [coworker]'s own behavior and . . . shakes the [coworker's] confidence in being a good, moral person."<sup>344</sup> Even where whistleblowers do not explicitly condemn those who may have known of ongoing fraud and remained silent, the act of whistleblowing itself "should be perceived as an implied reproach against (and implicit rejection of) those not making the same choice."<sup>345</sup>

Given the tremendous personal, social, and economic costs of whistleblowing, why would anyone blow the whistle? For some, the answer might be that the ordinary meaning of social ostracism is reduced. That is to say, whistleblowers might be outcasts who have less to lose than others. Whistleblowers might be oddballs who do not value unity and psychological harmony to the same degree that ordinary employees do. Whistleblowers might even be insane, or at least not psychologically balanced. Of course, just because a whistleblower is crazy, that does not mean she has not spotted genuine and serious fraud.

### C. *How Can Financial Bounties Change the Analysis?*

Prior to Dodd-Frank's new provisions, financial rewards were available to whistleblowers in relatively few settings.<sup>346</sup> The FCA, for instance, applies only to "the very few industries where the government is a significant buyer."<sup>347</sup> Dodd-Frank's expansion of whistleblower bounties reflects a recognition that by increasing the "*benefit* side of the cost-benefit analysis" confronting a potential whistleblower, private individuals are more likely to come forward.<sup>348</sup>

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343. Taylor & Curtis, *supra* note 277, at 22 ("[T]hose internal to the organization often view the whistleblower's report (rather than the initial wrongdoing) as the cause of their losses.").

344. Marquez, *supra* note 335, at 77.

345. *Id.*

346. Feldman & Lobel, *supra* note 41, at 1168 ("Rewards are not as prevalent as antiretaliation protections . . .").

347. Dyck et al., *supra* note 30, at 2246.

348. Gonzalez, *supra* note 62, at 339.

The “courageous few may need a little bit more of a push to stick their neck out.”<sup>349</sup>

Empirical research on whistleblowing has indicated that financial incentives create a significant motivation to detect and report fraud, which is observable “regardless of the severity of the fraud.”<sup>350</sup> According to one study, in the health care industry, where federal payments under the FCA are available to whistleblowers, fraud was detected as a result of an inside tipster in forty-one percent of the cases, compared to just fourteen percent of the cases in all other industries where employees are less likely to be rewarded with whistleblower bounties.<sup>351</sup> The presence of a “strong monetary incentive to blow the whistle does motivate people with information to come forward.”<sup>352</sup>

The gains for whistleblowers under the FCA can be tremendous. Payouts may average as high as \$46.7 million for successful qui tam relators.<sup>353</sup> Qui tam cases take years to pursue, and the results can be uncertain, but the financial incentive appears to be “an important factor in leading the employee to talk.”<sup>354</sup> In total, since the FCA was strengthened in 1986, the federal government has recovered nearly \$16 billion in settlements and judgments, with nearly sixteen percent of the recovered funds “distributed to the individuals who helped bring the fraud to light.”<sup>355</sup>

In economic terms, whistleblowers gamble their entire accumulated human capital investment against various potential gains—to their firm and self—of blowing the whistle. A whistleblower is unlikely to remain in her current position and is unlikely to be rehired to perform the same role for a different employer. As a result, an employee’s human capital investment associated with preparing for the particular position she holds disappears the moment she blows the whistle. For whistleblowing to make sense in a purely pecuniary calculus, the financial returns from whistleblowing must offset the lost human capital investment. If typical whistleblowers are mid-career middle managers, they have an

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349. *Id.*

350. Dyck et al., *supra* note 30, at 2215.

351. *Id.*

352. *Id.*

353. *Id.* at 2215–16.

354. *Id.* at 2245.

355. Bowen et al., *supra* note 32, at 1246.



investment in human capital terms that could easily be in the hundreds of thousands of dollars. Back pay is likely inadequate to provide offsetting benefits because it does nothing to protect a whistleblower's future prospects. However, the bounty scheme employed by the FCA, and potentially by Dodd-Frank, might provide a sufficient carrot to make the decision to blow the whistle more palatable.

Whistleblower bounties in the financial fraud setting might be particularly effective given the relative sophistication and capitalist bent of financial industry employees. Unlike an FCA whistleblower, who might be a defense contractor engineer who is unfamiliar with the nuances of the Federal Acquisition Regulations,<sup>356</sup> or a nurse not versed in the details of the Medicare reimbursement provisions,<sup>357</sup> a financial fraud whistleblower is more likely to have some sort of finance or accounting training that enables her to comprehend, synthesize, and evaluate information that points to fraud. When properly calibrated, bounty schemes "encourage informants to gather information, analyze what they know, seek out additional documentation, and organize the information in a useful and comprehensible form."<sup>358</sup> Moreover, since "[p]eople in the financial industry are singularly motivated by wealth,"<sup>359</sup> potential bounty rewards might mean more to them than to potential whistleblowers working in other sectors of the economy.

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356. The Federal Acquisition Regulations (FAR) define the proper claims for reimbursement in government procurement contracts, and violations of the FAR are often the key component of an FCA case. *See, e.g.*, U.S. *ex rel.* Dekort v. Integrated Coast Guard Sys., 705 F. Supp. 2d 519, 537 n.5 (N.D. Tex. 2010) (defendant responding to engineer's FCA case by arguing that plaintiff's "allegations are inconsistent with the government's contract formation rules under the Federal Acquisition Regulations"); U.S. *ex rel.* Whipple v. Rockwell Space Operations Co., No. CIV.A.H-96-3626, 2002 WL 864246, at \*11 (S.D. Tex. Apr. 3, 2002) (rejecting engineer's FCA claim because supposed fraud actually consisted of "allowable costs" under the Federal Acquisition Regulations).

357. *See, e.g.*, Wagemann v. Doctor's Hosp. of Slidell, LLC, No. 09-3506, 2010 WL 3168087, at \*7 (E.D. La. Aug. 6, 2010) (holding that a nurse's allegations of Medicare overbilling failed due to inability to demonstrate that allegedly fraudulent activities increased the "fixed amount paid by Medicare"); U.S. v. Thorek Hosp., No. 04 C 8034, 2008 WL 1883454, at \*3 (N.D. Ill. Apr. 25, 2008) (holding that nurse's "vague allegations" of Medicare overbilling failed because they did not establish submission of false claims for reimbursement to the government). The Medicare law has created "complex reimbursement schemes." N.Y.C. Health & Hosps. Corp. v. Wellcare of N.Y., Inc., No. 10 Civ. 6748(SAS), 2011 WL 70565, at \*5 (S.D.N.Y. Jan. 7, 2011).

358. Barnard, *supra* note 155, at 414.

359. *Id.* at 411.

Another way that bounties incentivize reporting has less to do with whistleblowers themselves, and more to do with lawyers. Where bounties are available, plaintiffs' counsel will represent and advocate on behalf of whistleblowers, and invest substantial sums investigating an alleged fraud in order to prepare potential bounty claims or cases. The plaintiff's bar may also serve a valuable screening role by helping to weed out those cases that are unlikely to lead to successful enforcement action. Even if bounties have only a limited role in tipping the scale for a whistleblower, because they can stimulate the growth of an active plaintiff's bar, they may profoundly impact the actual effect that whistleblowers are able to have. Where no bounties are available, whistleblowers may abandon their efforts to expose fraud, unassisted by counsel willing to advocate on their behalf.

Several arguments have been raised against bounty awards. Some critics question their effectiveness.<sup>360</sup> Others argue that bounties encourage frivolous claims<sup>361</sup> or claims regarding ambiguous behavior that may or may not be fraud, and impose administrative costs on courts and agencies forced to oversee such programs. Critics also allege that bounties are morally corrupting.<sup>362</sup>

Some empirical research has questioned the efficacy of bounty rewards in promoting whistleblowing. Most subjects in Yuval Feldman and Orly Lobel's study indicated that whistleblowers would be motivated to speak up out of moral concern, not by financial bounties.<sup>363</sup> Bounties most powerfully affected reporting in the experiments where moral concerns were absent.<sup>364</sup> Where moral concerns were relatively low, small bounties actually decreased the likelihood individuals would blow the whistle.<sup>365</sup> The authors speculate that low rewards might interfere with the relationship between the moral dimension of misconduct and the likelihood of

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360. See Feldman & Lobel, *supra* note 41, at 1202.

361. See *infra* nn. 369–70 and accompanying text.

362. See *infra* nn. 376–77 and accompanying text.

363. See Feldman & Lobel, *supra* note 41, at 1202.

364. See *id.*

365. *Id.* at 1194 (“Respondents least likely to report were those offered a low reward while they had a low perception of misconduct severity. Reporting in those circumstances was even lower than situations where no incentive was present.”); *id.* at 1202 (“Most surprisingly, our experiment shows that where misconduct is expected to evoke a lower level of moral outrage, the introduction of small bounties may actually decrease the rate at which it is reported.”).

reporting.<sup>366</sup> Perhaps low-level rewards are counterproductive because individuals perceive such rewards as likely to lead other employees to report wrongdoing first; as a result, potential whistleblowers may doubt whether coming forward themselves is necessary. Arguably, however, in the context of financial fraud the moral need to blow the whistle is less salient than in other settings, where the decision to remain silent could compromise health and safety of employees or customers. Indeed, there is considerable moral ambiguity surrounding corporate fraud—with white collar crime not widely perceived as a serious moral problem.<sup>367</sup> For this reason, relatively large whistleblower bounties may be more useful in the financial fraud setting than in public safety contexts where the moral benefit of blowing the whistle is clear cut.<sup>368</sup>

Bounties might lead to frivolous instances of whistleblowing, with employees seeking lottery-sized payouts by pointing to imagined or concocted instances of fraud. It is possible that “large rewards could principally spur false or groundless claims,”<sup>369</sup> and Jonathan Macey has speculated that where bounties are involved, “there are likely to be several false complaints for every valid one.”<sup>370</sup> Moreover, individuals can differ on “what actually constitutes illegal, immoral or illegitimate” business practices, and whistleblowers acting in good-faith could nevertheless “misinterpret[] a situation” in ways that could have lasting negative effects on firms.<sup>371</sup> Expanding the direct rewards for whistleblowing, as Dodd-Frank does, might “aggravate negative effects since one cannot preclude the incentive for individuals to blow the whistle for purely opportunistic reasons.”<sup>372</sup>

However, the Dyck study provides contrary evidence, suggesting that the rate of frivolous claims by whistleblowers is *lower* in the health care industry, where FCA bounties have long been available,

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366. *Id.*

367. Pamela H. Bucy, *Moral Messengers: Delegating Prosecutorial Power*, 59 SMU L. REV. 321, 335 (2006) (noting that American society has an “ambivalent attitude toward white collar crime”).

368. Feldman & Lobel, *supra* note 41, at 1202 (“When the ethical significance attached to the reporting act is absent, the level of monetary compensation offered through the regulatory scheme is decisive.”).

369. Schmidt, *supra* note 270, at 158.

370. Macey, *supra* note 267, at 1937.

371. Schmidt, *supra* note 270, at 158.

372. *Id.* at 164.

than in other industries: “[T]here is no evidence that having stronger monetary incentives to blow the whistle leads to more frivolous suits.”<sup>373</sup> Like the FCA, the Dodd-Frank bounty scheme requires whistleblowers to present fairly specific information about alleged fraud, and “[f]abricating such details would be difficult” and “a risky undertaking in light of the punishments and sanctions that often befall whistleblowers and the legal risks of engaging in perjury.”<sup>374</sup> As a result, the “vexatious litigation and administrative expense criticisms” lodged against bounty programs are “largely overblown.”<sup>375</sup>

Some critics have also argued that bounties are morally corrupting because they “monetize virtue.”<sup>376</sup> By introducing “selfish motives for whistle-blowing,” the moral value of whistleblowing is arguably reduced.<sup>377</sup> A similar argument has been lodged against imposing a duty to rescue in the common law of tort on the grounds that a financial obligation to rescue would cheapen the moral value of heroic service.<sup>378</sup>

There are a number of responses to this “morally corrupting” argument. First, even if an individual’s motives for whistleblowing are selfish, that does not necessarily render the *act* of whistleblowing morally wrong.<sup>379</sup> Where it serves the public good, the act of whistleblowing is morally right even if the “person who performs it is not virtuous or praiseworthy.”<sup>380</sup> Second, financial incentives may be morally justified if they lead to fewer cases in which individuals make the morally *wrong* decision not to blow the whistle.<sup>381</sup> A third objection to the argument is that individuals’ moral senses are “deep-seated, relatively unchangeable traits of character” that are unlikely to be negatively affected by the availability of such incentives.<sup>382</sup>

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373. Dyck et al., *supra* note 30, at 2246.

374. Carson et al., *supra* note 154, at 369.

375. Gonzalez, *supra* note 62, at 340.

376. Barnard, *supra* note 155, at 413.

377. Carson et al., *supra* note 154, at 365.

378. See Vandekerckhove & Tsahuridu, *supra* note 336, at 374 (“Imposing a duty to rescue not only limits people’s autonomy but also removes morality and moral responsibility from the individual.”).

379. See Carson et al., *supra* note 154, at 366.

380. *Id.*

381. *Id.*

382. *Id.*

Critics of bounty schemes also argue that such measures encourage external reporting and discourage “first reporting the problem internally to appropriate authorities.”<sup>383</sup> However, the SEC’s final rules have taken some steps to address this concern in the Dodd-Frank context.<sup>384</sup>

Finally, critics argue that bounties can raise administrative costs for enforcement agencies already overburdened with investigations and stressed by limited resources. The biggest objection to bounties for securities fraud tipsters is likely that the SEC “already receives more tips than it can reasonably handle.”<sup>385</sup> To avoid making matters worse, implementation of a bounty scheme would have to be “preceded by the creation of a tip-handling system that is capable of recognizing the kinds of information that are worthy of further pursuit.”<sup>386</sup> Fortunately, the SEC has created a new Office of Market Intelligence that may be up to the task.<sup>387</sup> Of course, a true *qui tam* structure avoids some of the administrative burdens associated with whistleblowing by empowering private actors to pursue claims on behalf of the government. The *qui tam* structure also adds value by making an individual who is likely highly intelligent, motivated, and committed to uncovering the truth at the heart of a fraudulent scheme available to the investigating authorities.<sup>388</sup>

Early indications are that the new program will lead to a sharp rise in tips provided to the SEC. In the aftermath of media coverage over the provision’s enactment, the SEC reported that “[t]ips from whistleblowers . . . have increased significantly.”<sup>389</sup> Prior to Dodd-Frank, the SEC received perhaps two dozen “high-value” tips per

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383. *Id.* at 367.

384. *See generally* Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300, 34,300–01 (June 13, 2011) (to be codified at 17 C.F.R. pts. 240, 249).

385. Barnard, *supra* note 155, at 412.

386. *Id.* at 410.

387. *See id.* The Office of Market Intelligence spent \$21 million to develop a “Tips, Complaints and Referrals” (TCR) database. *See* Sarah N. Lynch & Matthew Goldstein, *SEC Builds New Tips Machine to Catch the Next Madoff*, REUTERS (July 27, 2011), <http://www.reuters.com/article/2011/07/27/us-sec-investigations-idUSTRE76Q2NY20110727>. This database gives some 2,300 SEC employees access to tips, allowing them to check for whistleblower information in connection with potential investigations. The Office has also built a 41-member Market Intelligence Unit with an FBI special agent embedded in the team. *Id.*

388. Rapp, *supra* note 19, at 130.

389. Dave Clarke, *SEC Gets More Whistleblower Tips*, REUTERS (Feb. 4, 2011), <http://tinyurl.com/7axxa4p>.

year; between July 2010 (when Dodd-Frank was signed into law) and February 2011, the SEC received as many as one to two high-value tips *per day*.<sup>390</sup> Notably, tips in the aftermath of Dodd-Frank have also been increasingly submitted by attorneys representing whistleblowers, rather than the tipsters themselves.<sup>391</sup> As the program's final rules take effect, the number of tips will surely rise.<sup>392</sup>

Where the protection provided by SOX is uncertain, the potential to obtain a bounty may offset the career harm a whistleblower expects to suffer. For such individuals, the potential gains now available under the Dodd-Frank bounty provision might provide reason to go to the SEC in spite of the absence of protection from termination under SOX.

#### V. PROGNOSIS FOR THE DODD-FRANK BOUNTY PROVISION

This section takes a three-part approach to considering the likely effectiveness of the new Dodd-Frank law in regard to promoting whistleblowing and deterring corporate fraud. First, it considers the SEC's past experience with whistleblower bounties. Second, it discusses the model for the Dodd-Frank scheme, the Internal Revenue Service's (IRS) whistleblower program. Finally, it compares the Dodd-Frank approach to a true *qui tam* structure such as the one provided by the federal FCA.

One possible way to gauge the likely impact of the Dodd-Frank bounty scheme would be to examine two sets of cases from the period prior to its enactment: successful OSHA investigations of wrongful termination claims involving SOX securities fraud whistleblowers<sup>393</sup> and SEC enforcement actions spurred by

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390. *Id.* But see Kaja Whitehouse, *SEC Whistleblower Call Draws Few Tipsters*, N.Y. POST, Feb. 22, 2011, <http://tinyurl.com/72a85m2> (noting that 168 tips were received in the first 6.5 months of the program's existence—a rate of less than one per day).

391. Clarke, *supra* note 389.

392. Whitehouse, *supra* note 390. Some whistleblowers may have refrained from contacting the SEC out of a fear that the final rules will require internal reporting in order to claim a bounty. *Id.*

393. In the world of OSHA Sarbanes-Oxley whistleblower claims, the stories of successful SOX whistleblowers might provide a useful glimpse of the likely future impact of the Dodd-Frank bounty scheme. Of course, even whistleblowers unsuccessful in SOX anti-retaliation claims before OSHA evaluators and Department of Labor ALJs might be successful in seeking bounties under the new law. Where the SOX whistleblower complaint was unsuccessful, it may have been due to the difficulty in establishing causation. Whistleblowers unable to gain protection from retaliation might still be entitled to bounties under Dodd-Frank where a successful SEC enforcement action was initiated. However, where OSHA or ALJ claims were

whistleblower tips. Imagining the application of the new rules to these anecdotes might shed light onto how the new provision is likely to shape the reporting of financial fraud. Unfortunately, there are simply too few well-documented cases to provide much insight on the effectiveness of the new provision.

To date, successful OSHA whistleblower tips have simply not spurred *any* SEC enforcement action, much less actions producing the required \$1 million sanction. Under SOX, after a whistleblower files a complaint with OSHA, OSHA informs the SEC of the violation.<sup>394</sup> Richard Moberly found that “[e]ven though the SEC receives summaries of whistleblower allegations filed with OSHA, the SEC has not publicly recommended that the Department of Justice investigate any person accused of retaliating against a whistleblower.”<sup>395</sup> In response to congressional inquiry, the SEC explained that it intended to leave whistleblower enforcement to the Department of Labor.<sup>396</sup>

One SOX whistleblower who obtained a favorable settlement after a positive OSHA investigation was JP Morgan’s Peter Sivere. The SEC had launched an investigation into JP Morgan’s mutual fund trading practices.<sup>397</sup> In his role as a surveillance analyst, Sivere was tasked with retrieving e-mails to respond to an SEC subpoena. After uncovering one he deemed relevant, he contacted superiors, whom he believed took no action.<sup>398</sup> He was removed from the project and subsequently took Family and Medical Leave Act (FMLA) leave.<sup>399</sup> After returning to work, he was eventually terminated. Before that occurred, however, Sivere forwarded various e-mails to the SEC (from the AOL email address “bountyman04@aol.com”).<sup>400</sup> The e-mails read, in part:

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successful, that suggests investigators found the most merit in complainant’s assertions that they engaged in “protected activity,” which may overlap with the new law’s definitions of “original information” and “voluntary disclosure.”

394. Moberly, *supra* note 43, at 79.

395. *Id.* at 148–49 (footnote omitted).

396. *Id.* at 149.

397. SEC OFFICE OF INSPECTOR GENERAL, REPORT OF INVESTIGATION, CASE NO. OIG-501, at 6 (2009), *available at* <http://pogoarchives.org/m/fo/sec-oig-report-20090330.pdf> [hereinafter, SEC OIG]. The various documents contained in the SEC’s report use separate numbering systems, so as to aid the reader, the page numbers here will refer to the PDF page numbers rather than the page number listed on the individual item in the report.

398. *Id.*

399. *Id.*

400. *Id.* at 32.

---Original Message---

From: Bountyman04@aol.com

Sent: Sunday, June 13, 2004, 10:05 AM

To: ENFORCEMENT

Subject: "Application for Award of Bounty"

Commission:

I am a Compliance Officer at a major broker dealer. I have in my possession, E-mails that may or may not be helpful to your examination of this broker dealer in connection with mutual fund transactions.<sup>401</sup>

When he forwarded the e-mails to the SEC, Sivere initially requested a bounty,<sup>402</sup> but at the time those were only authorized for insider trading cases.<sup>403</sup> Sivere subsequently filed an OSHA SOX complaint.<sup>404</sup> JP Morgan's response, which Sivere eventually obtained via a FOIA request,<sup>405</sup> made reference to conversations Sivere had with SEC investigators.<sup>406</sup> Sivere thus learned that the SEC attorney he had spoken with—in violation of SEC policy—had revealed his name to counsel representing JP Morgan.<sup>407</sup> A report from the SEC's Office of Inspector General (SEC OIG) found that its attorney had revealed that information to a partner at Davis Polk and actively "encouraged" the use of the information in defense of the SOX OSHA complaint.<sup>408</sup> JP Morgan eventually settled the OSHA complaint after OSHA issued a letter indicating that it had reasonable cause to believe a violation of SOX had occurred.<sup>409</sup> There was apparently no SEC enforcement action triggered by Sivere's tips;

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401. *Id.* at 66.

402. *Id.* at 2.

403. *See infra* nn.428–39 & accompanying text.

404. SEC OIG, *supra* note 397, at 7.

405. FOIA, the Freedom of Information Act, allows individuals to obtain access to previously unreleased governmental records. *See* 5 U.S.C. § 552 (2010).

406. SEC OIG, *supra* note 397, at 8.

407. *Id.* at 10–11.

408. *Id.* at 11.

409. Letter from U.S. Dep't of Labor, Occupational Health & Safety Admin. to JP Morgan, *available at* <http://www.complianceweek.com/s/documents/JPMorgan-OSHA.pdf>.



moreover, he might not have been deemed to be a “voluntary” source of information, since part of his job was to report to the SEC. Even though he was a successful SOX whistleblower, Dodd-Frank would likely have provided him no bounty.

Another SOX claimant, George Fort, served as CFO of Tennessee Commerce Bancorp.<sup>410</sup> He was terminated by the bank, he alleged, in “retaliation for raising numerous concerns relating to internal controls, insider trading, and other related matters.”<sup>411</sup> Fort refused to sign a 2008 10K,<sup>412</sup> expressing concerns about SOX compliance and other issues.<sup>413</sup> The Federal Deposit Insurance Corporation received a letter from a “Concerned Depositor” that raised concerns similar to those voiced by Mr. Fort, and the company suspected he had sent that letter.<sup>414</sup> He was terminated on May 5, 2008.<sup>415</sup> After Fort filed an OSHA complaint, the Department of Labor (DOL) found “reasonable cause to believe [he] was unlawfully discharged” in violation of SOX.<sup>416</sup> The District Court for the Middle District of Tennessee issued a temporary restraining order upholding the DOL determination.<sup>417</sup> The Sixth Circuit issued a preliminary injunction at the bank’s request, staying the application of the OSHA order.<sup>418</sup>

The defendant, in litigation, produced a letter supposedly sent by the SEC to Tennessee Commerce Bank on December 3, 2009, indicating that it would “not recommend any enforcement actions” against the bank “as a result of Complainant’s concerns.”<sup>419</sup>

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410. U.S. Attorney’s Office for the Middle Dist. of Tenn., *Tennessee Commerce Bank Ordered to Reinstate Chief Financial Officer*, U.S. DEP’T JUSTICE (May 20, 2010), <http://www.justice.gov/usao/tnm/pressReleases/2010/5-20-10.html>.

411. *Id.*

412. A 10K is the annual report required by the SEC for domestic issuers of securities. *See Form 10-K*, U.S. SEC. & EXCHANGE COMMISSION (June 26, 2009), <http://www.sec.gov/answers/form10k.htm>.

413. *Solis v. Tenn. Commerce Bancorp., Inc.*, 713 F. Supp. 2d 701, 706 (M.D. Tenn. 2010).

414. *Id.* at 707.

415. *Id.*

416. *Id.* at 703.

417. *Id.* at 717.

418. Geert De. Lombaerde, *As You Were: Appeals Court Ruling Undoes Tennessee Commerce CFO Switch*, NASHVILLE POST, May 25, 2010, [http://nashvillepost.com/news/2010/5/25/as\\_you\\_were\\_appeals\\_court\\_ruling\\_undoes\\_tennessee\\_commerce\\_cfo\\_switch](http://nashvillepost.com/news/2010/5/25/as_you_were_appeals_court_ruling_undoes_tennessee_commerce_cfo_switch) (last visited Oct. 28, 2011).

419. *Solis*, 713 F. Supp. 2d at 709.

However, no such letter appears in the Westlaw database of no-action letters. Fort's complaint was eventually dismissed with prejudice, presumably because of a settlement by the parties.<sup>420</sup> Again, the lack of an SEC action would have meant that no bounty was paid.

A second source of insight into the fate of potential Dodd-Frank bounty claimants might be the recent SEC investigations launched as a result of whistleblower tips. Perhaps the best known recent SEC investigation launched as a result of whistleblower tips, at least in part, relates to the Ponzi scheme orchestrated by financier Bernie Madoff. That story has been discussed in detail in articles by other authors.<sup>421</sup>

Another SEC investigation triggered by a whistleblower was of Citigroup Asset Management ("CAM"), a Citigroup and Smith Barney business venture that provides advisory and management services to investment funds.<sup>422</sup> CAM initially used a "transfer agent," First Data, but then, in the late 1990s created a subsidiary called Citicorp Trust Bank ("CTB") that took on the responsibilities of transfer agent but actually farmed the bulk of the work to First Data at a reduced fee while keeping a substantial share of the fees.<sup>423</sup> In effect, investor funds were pocketed by CAM, which was charged with managing those funds.<sup>424</sup>

The SEC received a whistleblower tip in September 2003 regarding the failure of CAM to disclose the arrangements to the boards of the funds managed by CAM. As the result of an investigation, the defendants agreed to pay more than \$200 million in fines.<sup>425</sup> While this would certainly meet the minimum sanction

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420. *Solis v. Tenn. Commerce Bancorp, Inc.*, No. 3:10-cv-472, 2010 WL 6225647, at \*1 (M.D. Tenn. Oct. 29, 2010).

421. See, e.g., Hurt, *supra* note 294; Mark Klock, *Lessons Learned from Bernard Madoff: Why We Should Partially Privatize the Barney Fifes at the SEC*, 42 ARIZ. ST. L.J. 783 (2010); Donald J. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICH. ST. L. REV. 889; Clarence Pozza, Jr. et al., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113 (2010); Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 363, 380 (2009) ("The SEC's mishandling of the Madoff investigation is indefensible."); Smith, *supra* note 292.

422. *Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC*, 595 F.3d 86, 89 (2d Cir. 2010).

423. *Id.* at 89–90.

424. *Id.* at 90.

425. *Id.* at 91.

level to trigger a bounty under Dodd-Frank had the statute been in place, the record contains no real information about the identity of the whistleblowers. Whether they would have been eligible under the new provision is therefore a mystery.

A. *Comparison to Previous SEC Authority to Pay Insider Trading Bounties*

The SEC was granted the authority to pay whistleblowers in insider trading cases by the Insider Trading and Securities Fraud Act of 1988.<sup>426</sup> Between 1988 and 2010, the SEC “had paid out less than \$160,000 in total to only five whistleblowers.”<sup>427</sup> The SEC’s previous experience with bounties has indicated “the unsuccessful and unappealing features of would-be reward systems”<sup>428</sup> managed by the Commission. In the past, the SEC has “shown little or no interest in whistleblower claims.”<sup>429</sup>

Under the Insider Trading and Securities Fraud Act, the SEC was given “sole discretion” to determine “whether, to whom, or in what amounts to make payments,” and the decision not to make a payment was “not subject to judicial review.”<sup>430</sup> What may be open to debate, then, is whether the SEC’s former whistleblower program had any effect in terms of producing “speedy resolution of cases of corporate fraud or materially false financial statements.”<sup>431</sup> For a potential bounty-seeker, there was simply no certainty that any payment would be made.<sup>432</sup> Even where the SEC brought a successful enforcement action, informants had no guarantee of a bounty.<sup>433</sup>

In administering the program, the SEC’s Enforcement Division has demonstrated “antipathy towards paying such bounties.”<sup>434</sup> As a result, the SEC bounty program has not been widely utilized.<sup>435</sup> Moreover, there is “scant evidence” that the payouts had any

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426. 15 U.S.C. §§ 78t-1, 78u-1, 80b-4(a) (2006).

427. Michael Mann et al., *Enforcement Initiatives*, 1867 PLI/CORP 479, 487 (2011).

428. Feldman & Lobel, *supra* note 41, at 1170.

429. Moberly, *supra* note 43, at 148.

430. Arnold, *supra* note 10, at 461.

431. *Id.* at 468.

432. Gonzalez, *supra* note 62, at 346.

433. Feldman & Lobel, *supra* note 41, at 1171.

434. Barnard, *supra* note 155, at 410.

435. *Id.*; Gonzalez, *supra* note 62, at 344.

noticeable effect on the incidence of insider trading.<sup>436</sup>

The insider trading bounty provisions were repealed with the enactment of Dodd-Frank, which subsumed the former program applicable only to insider trading cases.<sup>437</sup> However, the SEC's poor record under the prior program does make one doubtful about how successful the Commission will be in implementing the new Dodd-Frank bounty scheme.

### *B. Comparison to IRS Authority to Pay Tax Fraud Tipsters*

The IRS has long had the authority to pay awards to individuals who report tax cheats, although prior to 2006, such awards were discretionary.<sup>438</sup> “[T]he IRS has been highly conservative in providing rewards to informants.”<sup>439</sup> As a result, the IRS program was historically underutilized.<sup>440</sup> The IRS rewarded bounties to only about eight percent of informants and returned only three to six percent of recovered funds to whistleblowers.<sup>441</sup>

After 2006, however, the Internal Revenue Code<sup>442</sup> was amended to make such bounty awards mandatory in certain circumstances.<sup>443</sup> The new law also “significantly increase[d] the financial rewards paid to informants in high value cases and create[d] a separate Whistleblower Office within the IRS.”<sup>444</sup> The IRS has now “collected hundreds of millions of dollars in unpaid taxes based on information received from informants under its bounty program.”<sup>445</sup>

Under the 2006 amendments, whistleblowers are eligible for the maximum award from the IRS only if they reveal information on tax fraud amounting to at least \$2 million by individuals with incomes greater than \$200,000.<sup>446</sup> Whistleblowers are entitled to bounties

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436. Gonzalez, *supra* note 62, at 344–45.

437. Rescission of Rules Pertaining to the Payment of Bounties, SEC Release No. 34-62921, 75 Fed. Reg. 57,384-01 (Sept. 15, 2010) (to be codified at 17 C.F.R. pt. 201).

438. Feldman & Lobel, *supra* note 41, at 1168–69; Gonzalez, *supra* note 62, at 343.

439. Feldman & Lobel, *supra* note 41, at 1168.

440. See Gonzalez, *supra* note 62, at 343.

441. Feldman & Lobel, *supra* note 41, at 1168.

442. 26 U.S.C. § 7623(b) (2006).

443. Feldman & Lobel, *supra* note 41, at 1168–69.

444. *Id.* at 1168.

445. Barnard, *supra* note 155, at 411.

446. This \$2 million figure includes “penalties, interest and other amounts in dispute.” *Whistleblower—Informant Award*, IRS, <http://www.irs.gov/compliance/article/0,,id=180171,00.html> (last updated July 19, 2011).

only where the information “substantially contribute[d] to a decision to take administrative or judicial action that results in the collection of a tax.”<sup>447</sup> Where these income and disputed amount thresholds are satisfied, an award is mandatory and whistleblowers collect between fifteen and thirty percent of the payments made by the tax cheat.<sup>448</sup> Informants can also “appeal the amount or denial of a reward in the U.S. Tax Court.”<sup>449</sup> Claims for bounties involving taxpayers with lower incomes or involving lesser disputed amounts are still subject to the IRS’s discretion (that is, bounties are not mandatory), and maximum payouts are generally limited in such cases to no more than fifteen percent of recovered amounts.<sup>450</sup>

Like Dodd-Frank, the IRS program imposes floors, both in terms of the disputed amount and the income of the target of the whistleblower’s allegations, before an award is mandatory. Unlike Dodd-Frank, however, the IRS program does not explicitly link these floors to any particular recovery by the federal government—instead, they are linked to the disputed tax liability. This is a critical distinction between the IRS program and Dodd-Frank. Under Dodd-Frank, the minimum floors have nothing to do with the level of fraud; under the IRS program, they are linked to the level of fraud. Moreover, settlement negotiations between a tax cheat and the government that produce a relatively small payment on the disputed amount will not affect *whether* a whistleblower can claim a bounty, only the amount of the bounty paid. Another difference between the IRS program and Dodd-Frank, addressed by part of the proposal advanced in the next section of this Article, is that the IRS has discretion to pay awards even in cases involving instances of fraud that are below the statutory thresholds.

The revamped IRS program was the model for Dodd-Frank,<sup>451</sup> but its success has been mixed. The IRS published its most recent required annual report on its whistleblower program in July 2011.<sup>452</sup>

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447. Gonzalez, *supra* note 62, at 343.

448. *Id.* at 343–44.

449. Feldman & Lobel, *supra* note 41, at 1169.

450. *Id.*

451. Uliassi, *supra* note 100, at 359.

452. See IRS, FISCAL YEAR 2010 REPORT TO THE CONGRESS ON THE USE OF SECTION 7623 (2011), available at [http://www.irs.gov/pub/whistleblower/annual\\_report\\_to\\_congress\\_fy\\_2010.pdf](http://www.irs.gov/pub/whistleblower/annual_report_to_congress_fy_2010.pdf); Michael Cohn, *IRS Paid Fewer Whistleblower Awards Last Year*, ACCOUNTING TODAY (July 22, 2011), <http://www.accountingtoday.com/news/IRS-Paid-Fewer-Whistleblower-Awards-Last-Year-59299-1.html>.

Even though the number of tips doubled in the year reviewed (2010), the IRS actually paid out *fewer* awards than it had in the year before, and *half* as many as in 2008.<sup>453</sup> The IRS was circumspect regarding the reasons behind the decline. The report stated that “[t]he number and amount of awards paid each year can vary significantly,” but provided only one explanation—a change in the timing of payouts so that whistleblowers were not paid until the period for appealing a tax-case determination had run, even in cases where no appeal had yet been filed.<sup>454</sup>

### *C. Comparison to False Claims Act Bounty Model*

The FCA was enacted in 1863 “to reduce the incidence of fraud among the suppliers of munitions and other war materials to the Union government during the Civil War.”<sup>455</sup> The FCA was subject to “far-reaching amendments” in 1986, which “made [the FCA] an attractive weapon to combat fraud in virtually any program involving federal funds.”<sup>456</sup> “The Act called on private persons to bring to justice those defrauding the government by bringing ‘*qui tam*’ suits against the perpetrators.”<sup>457</sup>

Qui tam complaints are filed under seal with the Department of Justice, which is given the option to intervene in the case.<sup>458</sup> Of the 4294 cases filed between 1987 and the end of 2003, the government declined to intervene in fully sixty-two percent of the cases.<sup>459</sup> (The government “declined to intervene in 2653 cases” and intervened, or otherwise pursued, in 750, while 891 cases remained under investigation.)<sup>460</sup> Where the government declines to intervene, a whistleblower can proceed with the case alone—and will typically receive a higher percentage of the government’s damages to reflect the additional burden placed on a private plaintiff.<sup>461</sup>

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453. Cohn, *supra* note 452.

454. IRS, *supra* note 452, at 14–15.

455. Macey, *supra* note 267, at 1904.

456. *Id.* at 1904–05.

457. Carson et al., *supra* note 154, at 362.

458. Dayna Bowen Matthew, *The Moral Hazard Problem with Privatization of Public Enforcement: The Case of Pharmaceutical Fraud*, 40 U. MICH. J.L. REFORM 281, 286 (2007).

459. Carson et al., *supra* note 154, at 363.

460. *Id.*

461. *Id.*

Even where the government declines to intervene, it retains the right to intervene at a later date and even to settle or seek dismissal of the *qui tam* case over a whistleblower's objection.<sup>462</sup>

Many of the features of the new Dodd-Frank whistleblower bounty provision have rightly been subject to criticism. The level of bounty likely may be too small to stimulate whistleblowing in serious cases. Like the SEC's failed whistleblower bounty for insider trading, Dodd-Frank limits recovery to a percentage of fines levied in enforcement actions, rather than a share of the underlying fraud available to a FCA whistleblower.<sup>463</sup> This may mitigate to some degree the salience of financial rewards. Experimental research by Yuval Feldman and Orly Lobel suggests that low expected bounty awards may actually be counterproductive, triggering *less* reporting than anti-retaliation protections or measures aimed at "triggering internal motivations of potential reporting individuals."<sup>464</sup> Similarly, the exclusion of certain potential whistleblowers—such as those with existing legal duties—and the procedural hurdles involved in the SEC's rules may limit the statute's effectiveness. These criticisms, however, are directed more at how the statute is calibrated—that is, the precise choices made in the whistleblowing rules—and less at the core design of the Dodd-Frank bounty scheme.

The more serious problem with Dodd-Frank is that it does not vest whistleblowers with standing to pursue their claims against fraudsters directly. Instead, the SEC remains a gatekeeper for, and potential roadblock to, potential investigations. There are two reasons why the absence of *qui tam* structures may undercut the statute's effectiveness. First, the SEC may continue to be unresponsive to whistleblower tips, with reporting leading to relatively little enforcement action. A *qui tam* structure would provide a sort of escape valve, under which a whistleblower could pursue a claim—and a bounty—even if the SEC remains inactive. Second, the *qui tam* structure provides a greater possibility that a whistleblower's complaints will be resolved in an open, public forum. To the extent that nonmonetary incentives play a role in motivating whistleblowing, Dodd-Frank's structure may be a poor policy choice precisely because it leaves resolution of cases solely in the hands of

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462. Matthew, *supra* note 458, at 287–90.

463. Feldman & Lobel, *supra* note 41, at 1171.

464. *Id.* at 1155.

the SEC, which has a history of preferring settlements over open enforcement proceedings.<sup>465</sup>

*1. Dodd-Frank bounties do not prevent the SEC from remaining a roadblock to tipsters.*

The possibility of financial reward is just one of the mechanisms that makes the FCA successful. The second is what has been called the “dual-plaintiff” aspect of the FCA.<sup>466</sup> Even if the government decides not to intervene, whistleblowers can pursue their claims. This provides “powerful quality control” and “a way for knowledgeable and helpful insiders to work hand-in-hand with regulators lending expertise and resources” to the government.<sup>467</sup> In a true qui tam structure, private persons “are not required to obtain permission or clearance of any sort before suing”; rather, “[t]hey alone decide who, what, how, and whether to charge a defendant.”<sup>468</sup>

The absence of true qui tam structures also renders the new bounty scheme vulnerable to the same “systematic breakdowns” that prevented the SEC from identifying Bernie Madoff’s fraudulent Ponzi scheme.<sup>469</sup> Even though tipsters had pressed the issue for a decade,<sup>470</sup> the SEC failed to act.<sup>471</sup> Had a qui tam option been available to whistleblowers, investigations could have proceeded even after the government declined to intervene. In fact, whistleblower Markopolos *mistakenly* believed he would be eligible for a bounty.<sup>472</sup> While Dodd-Frank’s realization of bounty options would have made that prospect realistic, the tremendous delay occasioned by the SEC’s failure to intervene allowed Madoff’s fraudulent scheme to

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465. See David M. Weiss, *Reexamining the SEC’s Use of Obey-the-Law Injunctions*, 7 U.C. DAVIS BUS. L.J. 239, 249–50 (2006) (“Most SEC enforcement proceedings are settled—not litigated on the merits . . . . Settlements allow the SEC quick and easy victories without dedicating timely and expensive resources to investigation and litigation.”).

466. Pamela H. Bucy, *“Carrots and Sticks”: Post-Enron Regulatory Initiatives*, 8 BUFF. CRIM. L. REV. 277, 321 (2004) (internal quotation marks omitted).

467. *Id.*

468. Bucy, *supra* note 367, at 328.

469. Smith, *supra* note 292, at 242 (internal quotation marks omitted).

470. *Id.* at 241.

471. See Barnard, *supra* note 155, at 412 (“The single greatest failure in the SEC’s involvement with Bernie Madoff . . . was the [SEC Enforcement] Division’s failure to understand and pursue the information brought to it (repeatedly) by Harry Markopolos.”).

472. *Id.*



spiral to unparalleled magnitude.<sup>473</sup> Markopolos's experience demonstrates how meaningful private actions could be to "supplement SEC enforcement efforts and other failed corporate governance mechanisms."<sup>474</sup>

While some have suggested that the Markopolos debacle "will be avoided" through the creation of a bounty scheme,<sup>475</sup> without the availability of a true qui tam vehicle, this suggestion is open to question.

There are four reasons why the SEC is likely to remain a roadblock to whistleblowers seeking bounties under the new law. First, the SEC will continue to face resource limitations in enforcing the program. Second, the dual responsibility for whistleblowers now in effect (with the DOL reviewing SOX retaliation claims and the SEC reviewing claims for bounties) may result in relatively less regulatory attention from both agencies. Third, the SEC has long been plagued by allegations of "regulatory capture" by industry. Fourth, the SEC may continue to view whistleblower programs with distaste because they represent an implicit challenge to the regulatory Agency's effectiveness.

The first problem facing the SEC in administering the new program involves resource limitations. Dodd-Frank significantly expanded the SEC's budget.<sup>476</sup> While the SEC immediately began planning to spend these funds, budget negotiations have stalled the infusion of such resources.<sup>477</sup> Moreover, the SEC was underfunded before Dodd-Frank,<sup>478</sup> and the new burdens the Agency acquired under Dodd-Frank, which extend well beyond the area of whistleblower bounties, mean that the Agency will continue to face resource shortfalls. Were the SEC to have genuine bargaining power to set its budget, a "remotely realistic figure" would probably be

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473. Markopolos testified that if action had been taken when he first raised the alarm, losses could likely have been between \$3 and \$7 billion; instead, Madoff's scheme reached an estimated \$50 billion before it unraveled. Mary Kreiner Ramirez, *Prioritizing Justice: Combating Corporate Crime from Task Force to Top Priority*, 93 MARQ. L. REV. 971, 995 n.126 (2010).

474. Kaufman & Wunderlich, *supra* note 265, at 678.

475. Cody Vitello, *The Wall Street Reform Act of 2010 and What It Means for Joe & Jane Consumer*, 23 LOY. CONSUMER L. REV. 99, 106 (2010).

476. Joan MacLeod Heminway, *Sustaining Reform Efforts at the SEC: A Progress Report*, BANKING & FIN. SERVS. POL'Y REP., Apr. 2011, at 1, 10.

477. *Id.*

478. *Id.*

many times its current level of funding.<sup>479</sup> At best, the SEC will pursue only a small selection of tips received due to its staffing limitations.<sup>480</sup> The SEC is forced to make “hard choices about the optimal use of its resources to enforce the securities laws,”<sup>481</sup> and it is likely that those hard choices will leave many whistleblowers ineligible for bounties.

The second problem is that the new law creates a bifurcated regulatory structure for a typical whistleblower who has been the victim of retaliation. Such individuals might choose to both file an OSHA claim to address their retaliation damages and also file appropriate paperwork with the SEC to claim a bounty for reporting fraud. Where multiple regulatory agencies have responsibility for the same claims, it is possible that “issues of concern will fall between the jurisdictional cracks of separate regulators or be the subject of ‘turf battles’ between agencies.”<sup>482</sup> Of course, overlapping agency responsibility can have some advantages, such as putting “more cops on the beat” and raising the costs for an industry that is attempting to “capture” regulators.<sup>483</sup> Still, where neither agency is given primary responsibility—which seems to be the case in connection with SOX and Dodd-Frank—a risk emerges that neither agency will be active, because both believe “that the other agency will take the lead or pick up any slack.”<sup>484</sup> Where one agency is solely responsible for enforcement “it is more likely to be diligent in pursuing that task because it knows it will be accountable for any failures.”<sup>485</sup> In some contexts, competition between agencies can also be useful, with each trying to best the other in enforcement.<sup>486</sup> Given OSHA’s historical problems in enforcing its whistleblower regulations, and the SEC’s reticence about the value of insider tips, however, there is little likelihood of virtuous competition emerging in the protection and reward of SOX/Dodd-Frank whistleblowers.

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479. Langevoort, *supra* note 421, at 904.

480. See Klock, *supra* note 421, at 835 n.371.

481. Black, *supra* note 136, at 343.

482. Eric Pan, *Structural Reform of Financial Regulation*, 19 *TRANSNAT’L L. & CONTEMP. PROBS.* 796, 819 (2011).

483. Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 *TEX. L. REV.* 15, 55 (2010).

484. *Id.* at 56.

485. *Id.*

486. Anne Joseph O’Connell, *The Architecture of Smart Intelligence: Structuring and Overseeing Agencies in the Post-9/11 World*, 94 *CALIF. L. REV.* 1655, 1677 (2006).

Third, the SEC may continue to be the victim of regulatory capture. Regulatory capture describes the tendency of regulatory agencies to suffer from a “persistent policy bias” in favor of “regulated or client interests.”<sup>487</sup> The industries subject to a particular agency’s regulation are “well-financed and well-organized, especially when compared to the general public and public interest groups.”<sup>488</sup> They can lobby agencies effectively and put pressure on the legislative committees responsible for setting agency budgets, which in turn can circumscribe agencies’ ability to engage in aggressive regulation.<sup>489</sup> Agency employees “anticipate entering or returning to employment with the regulated industry once their government service terminates” and fear making enemies in the industry that might close the proverbial “revolving door.”<sup>490</sup> The “logical (and most lucrative) job path” for SEC employees “is to move into compliance and other roles at investment banks, law firms, and large public company issuers after a few years of work at the SEC.”<sup>491</sup> Regulated industries also have an information advantage over agencies, which are dependent on industry to provide information about “how the industry works and what it is capable of doing.”<sup>492</sup>

Even after the increased attention it has received in the aftermath of the financial scandals of the past fifteen years, the SEC has not remedied policies and practices that create significant dangers of agency capture.<sup>493</sup> Although all agencies “will succumb to ‘capture’ by special’ interest groups[,] . . . [w]hat may be different about the SEC is the fact that with the Commission in recent years, this sort of behavior has not been simply random or opportunistic, but has been a defining characteristic feature of the SEC.”<sup>494</sup> Perhaps the most striking evidence of SEC capture came in connection with an investigation launched by a whistleblower tip. As noted earlier, Peter Sivere, the former analyst at JP Morgan, had provided e-mails to the

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487. Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1713 (1975).

488. Barkow, *supra* note 483, at 22.

489. *Id.* at 22–23.

490. *Id.* at 23.

491. Heminway, *supra* note 476, at 3.

492. Barkow, *supra* note 483, at 23.

493. Heminway, *supra* note 476, at 3.

494. Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 948 (1994).

SEC's New York Regional Office concerning an ongoing investigation into his investment firm's market timing.<sup>495</sup> An SEC attorney disclosed the fact that Sivere had provided information to the SEC and requested a bounty (then only available in insider trading cases) to JP Morgan's outside counsel.<sup>496</sup> This clearly reflects capture of relevant SEC employees by the regulated industry (or, to be specific, the gatekeepers of the industry, which is to say its attorneys). Future whistleblowers may also encounter SEC employees more loyal to the firms the Commission regulates than to the notion that tipsters may have valuable information about fraud.

Finally, in a sense, the emergence of a whistleblower is a challenge to the legitimacy of a regulator.<sup>497</sup> Information about fraud coming from a whistleblower can suggest that regulators are not effectively monitoring their subject industry.<sup>498</sup> Whistleblowers become competitors of the regulatory authorities; as a result, regulators tend to be unresponsive to whistleblower complaints.<sup>499</sup> A *qui tam* vehicle recognizes that whistleblowers' uneasy partnership, and sometimes outright competition, with regulators can be leveraged for policy gain.

## *2. Dodd-Frank bounties do nothing to motivate whistleblowers in nonfinancial ways*

If whistleblowers are motivated not by money, but instead by do-gooder-ism and the desire to have their voices heard, then monetary incentives may offer a less concrete additional benefit. Instead, what whistleblowers are likely seeking is a day in court. Whistleblowers "have a strong sense of injustice" and "feel victimized and often desire to have the employer make a public apology."<sup>500</sup> Whistleblowers are often reluctant to settle their cases when forced to negotiate with a team of strangers.<sup>501</sup> Working with outsiders "can increase a whistleblower's feelings of persecution and

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495. See SEC OIG, *supra* note 397, at 2.

496. *Id.*

497. Sawyer, *supra* note 302, at \*7.

498. *Id.* at \*7-8.

499. *Id.*

500. Fincher, *supra* note 157, at 67.

501. *Id.*

injustice.”<sup>502</sup> Before a case can be resolved, whistleblowers want the chance to vent their emotions.<sup>503</sup>

Dodd-Frank provides bounties, but because of the absence of a true qui tam provision, it does not guarantee a whistleblower that her allegations will ever be heard in an open forum. Indeed, since securities enforcement typically ends in settlement discussions rather than trial, whistleblowers under the Dodd-Frank scheme have no reason to expect the kind of public vindication that a successful qui tam action can provide to FCA relators. Qui tam lawsuits help restore “both moral and pragmatic legitimacy to the whistleblower.”<sup>504</sup> The lawsuit gives a whistleblower the chance to fight for her legitimacy, and successful recovery helps vindicate a whistleblower’s claims and her actions.<sup>505</sup> Litigation provides an “outlet for plaintiffs to voice their concerns” and “assert their right to be heard,”<sup>506</sup> something not provided for whistleblowers when the SEC settles or declines to pursue their claims. Plaintiffs “often feel a need to have their story told to experience the catharsis this produces.”<sup>507</sup> The decision to blow the whistle is an “important part of their lives,”<sup>508</sup> if not a singular one, and the chance to tell the story is not guaranteed in the Dodd-Frank process. There is simply “no way to heal emotionally from an injury if the story goes unheard and victims are denied their moral right to testify to their own pain.”<sup>509</sup>

Given its historical role as a roadblock to whistleblowers, the SEC is not likely to be seen as an ally for a whistleblower seeking vindication and a chance to tell her story. Whistleblowers may lack trust in the Dodd-Frank process, and promoting trust is one of the key ways to foster reporting.<sup>510</sup> A true qui tam structure would have

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502. *Id.*

503. *Id.* at 69.

504. Sawyer, *supra* note 302, at \*15.

505. *See id.* at \*12.

506. Yungsuk Karen Yoo, Note, *Tainted Milk: What Kind of Justice for Victim’s Families in China?*, 33 HASTINGS INT’L & COMP. L. REV. 555, 557 (2010).

507. Tom Galbraith, *Storytelling: The Anecdotal Antidote*, 28 LITIG. 17, 23 (2002), available at <http://tinyurl.com/7vmrphn>.

508. *Id.*

509. THANE ROSENBAUM, THE MYTH OF MORAL JUSTICE 61 (2004).

510. David Lewis, *Whistleblowing in a Changing Legal Climate: Is It Time to Revisit Our Approach to Trust and Loyalty in the Workplace?*, 20 BUS. ETHICS: EUR. REV. 71, 71–72 (2011).

fostered trust by assuring potential whistleblowers that their allegations would eventually be processed in a judicial forum.

Similarly, where whistleblowers are motivated by revenge, money is unlikely to make a significant difference. In the context of tax fraud whistleblowing, many of those reporting fraud are ex-spouses of alleged tax cheats.<sup>511</sup> While money might add some sweetness to the act of blowing the whistle, the underlying goal of such whistleblowers is to put their targets through the wringer. Qui tam provides whistleblowers a vehicle for asking questions, sometimes probing and intrusive, of their targets. For revenge-motivated whistleblowers, the new Dodd-Frank law provides no such opportunity.

Qui tam plaintiffs are also more likely than Dodd-Frank whistleblowers to remain vested in the process. To the extent that perseverance matters in measuring whether whistleblowing is effective, a qui tam structure maximizes perseverance by giving the whistleblower significant ownership of the investigation and enforcement of antifraud provisions. Qui tam whistleblowers have “a much greater stake in the claim because they must fund the litigation (unless the DOJ takes over the prosecution), they must bear the costs if unsuccessful, and they stand to reap a much greater reward if the proceeds of the action are large.”<sup>512</sup> Moreover, attorneys representing qui tam plaintiffs will target large, “deep-pocketed” defendants, and it is arguably fraud in connection with those defendants that presents the greatest risk of harm to the financial system.<sup>513</sup>

Albert O. Hirschman’s work on the sociology of dissent<sup>514</sup> provides a useful vehicle for understanding the value of qui tam actions. Dissenters have three choices with respect to failing

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511. Daily Mail Reporter, *‘Encourage Others to Squeal’: IRS Awards \$4.5m to Accountant after Tip Off in First Ever Whistleblower Award*, DAILY MAIL (LONDON), Apr. 8, 2011, <http://tinyurl.com/7z33s2r> (“Many of the tips involved mom-and-pop operations or ex-spouses.”); Robert Goulder, *Gambling on IRS Whistleblower Payouts*, TAX.COM (Jun. 10, 2010, 12:31 PM) <http://www.tax.com/taxcom/taxblog.nsf/Permalink/RGOR-85VPF5:OpenDocument> (“In other cases the informant might be a disgruntled business partner or ex-spouse.”).

512. Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 1014 (2011).

513. *Id.*

514. See ALBERT O. HIRSCHMAN, *EXIT, VOICE & LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* (1970).

institutions. They can “elect to leave that organization for another (exit),” they can “express their dissent through complaint . . . (voice),” or they can “decline to act (loyalty).”<sup>515</sup> The last option—loyalty and silence—is one that whistleblowers decline the minute they raise their complaints, either within or outside of a firm. The exit option is the one most served by the financial aspects of whistleblower bounties. Since a potential bounty offsets the costs of blowing the whistle, it allows a whistleblower to exit an organization without a significant loss in human capital investment. However, the qui tam structure provides “voice” in a way that Dodd-Frank does not. In qui tam, the whistleblower is empowered to pursue the litigation himself or herself. In that process, the whistleblower is given a chance to express her dissent against the organization’s fraudulent scheme in a very public and very real way. By contrast, under Dodd-Frank, the SEC can become a bottleneck for expression, and whistleblowers’ allegations have no guarantee that they will ever see a courtroom.

There would certainly be downsides to expanding relator actions to the financial fraud context. Expansion would produce “a significant amount of new litigation and attorney fee awards.”<sup>516</sup> A sensibly designed policy would provide moderate awards but enable at least some private pursuit of securities enforcement by whistleblowers so as to support those with nonfinancial motivations.

#### VI. ALTERNATIVES: TOWARD AN INFORMER’S ACTION FOR SOX WHISTLEBLOWERS

This Article has cast doubt on the likelihood that Dodd-Frank’s whistleblower bounty provisions will change the realities of Wall Street fraud, given that the statute fails to embrace a true qui tam structure. This section advances a two-part palliative for the flaws of Dodd-Frank. The two main flaws of the scheme revealed in this Article are (1) its limitation to enforcement actions producing at least \$1 million in sanctions and (2) the absence of a qui tam mechanism for private whistleblowers to pursue claims when the SEC declines to take any action whatsoever. Several steps could be

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515. Ronald J. Daniels et al., *The Legacy of Empire: The Common Law Inheritance and Commitments to Legality in Former British Colonies*, 59 AM. J. COMP. L. 111, 125 (2011).

516. Arnold, *supra* note 10, at 468.

taken to address these limitations of the Dodd-Frank whistleblower program.

*A. Bounties Should Be Available in Low- or No-Sanction Cases*

First, the SEC should be permitted to pay bounties even in cases in which *no* monetary sanction is imposed, such as where a cease-and-desist order, obey-the-law injunction, or therapeutic reform is employed. Similarly, the SEC's discretion should extend, as the IRS's does, to paying bounties in cases below Dodd-Frank's \$1 million threshold. Second, a *qui tam* structure should be developed for those cases in which the SEC declines (or fails) to take any action. In past work, I have argued that bounties could be paid by way of traditional *qui tam* cases brought in the securities fraud context under state whistleblower laws (based on state government investments in publically traded companies) or by using the federal FCA (in the case of companies receiving investments as part of the federal bailout programs).<sup>517</sup> In addition to providing bounties, both of those approaches would create *qui tam* structures for whistleblowers to proceed regardless of SEC inaction. Rather than revisit those proposals, this section suggests an additional model for consideration, the *qui tam* provisions of the False Marking Act.<sup>518</sup>

The first fix, giving the SEC discretion to pay bounties even in cases in which no monetary sanction is obtained or in which the \$1 million threshold is not met, is relatively straightforward. Such a change could be made in statutory text taking the following form:

DISCRETION TO PAY BOUNTIES WHERE NO OR LITTLE  
MONETARY SANCTION IS IMPOSED—

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.)  
is amended by inserting after Section 21F(a)(C)(2)

(3) DISCRETION TO PAY BOUNTIES IN JUDICIAL OR  
ADMINISTRATIVE ACTIONS THAT ARE NOT COVERED  
PROCEEDINGS. —In any action by the SEC in which the

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517. Rapp, *supra* note 21.

518. More accurately, the *qui tam* provisions of the patent False Marking Act prior to the changes effected by the America Invents Act of 2011.



monetary sanctions imposed in a covered action or related action are less than \$1 million, or in any action producing no monetary sanction but instead a nonmonetary sanction such as a cease-and-desist order, injunction, disbarment, or other civil remedy or criminal sanction, the SEC shall have discretion to pay a bounty, not to exceed \$300,000, to a whistleblower who voluntarily provided original information to the Commission that led to the successful enforcement of the action. The SEC's decision not to pay a bounty in such cases, or of the amount of the bounty, shall not be subject to appeal.

Unfortunately, there is no realistic alternative in designing a bounty reward for small- or no-sanction cases other than to vest discretion over paying such awards to the SEC. In cases where no monetary sanction or disgorgement remedy is imposed, there would be no rubric against which to apply a fixed-share bounty. The \$300,000 maximum is thirty percent of a bounty meeting the minimum enforcement sanction level of \$1 million. The proposed language here recognizes that the SEC often may choose to impose purely nonmonetary sanctions in cases that were spurred by a whistleblower, but still provides whistleblowers with a reward for bringing fraud to light.

One of the reasons to include such cases in the whistleblower bounty scheme is that corporate penalties are not appropriate in most cases unless shareholders have improperly benefitted from the violation.<sup>519</sup> Corporate fines are paid (indirectly) by shareholders, who are, perversely, the victims of most securities fraud.<sup>520</sup> For that reason, in many instances policy favors sanctions that are nonmonetary in nature. Dodd-Frank should not ignore the importance of such actions in deterring securities fraud nor the role that whistleblowers can play in promoting successful actions seeking nonmonetary sanctions.

*B. Whistleblowers Should Be Given Standing to Pursue Fraud Claims Independent of the SEC*

The second aspect of this Article's proposed fix for Dodd-Frank's

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519. Black, *supra* note 136, at 324–25.

520. *Id.*

flaws is to develop a structure allowing whistleblowers to proceed with an investigation and litigation even where the SEC takes no enforcement action at all. In Dodd-Frank, Congress directed the SEC to conduct a study evaluating whether “it would be useful for Congress to consider empowering whistleblowers . . . who have already attempted to pursue the case through the Commission, to have a private right of action . . . on behalf of the Government and themselves, against persons who have committed [sic] securities fraud.”<sup>521</sup> This Article lays the foundation for such congressional enactment.

To be sure, there would be some practical difficulties associated with crafting a *qui tam* mechanism for SOX whistleblowers. Unlike in the FCA, where an injury to the government provides the basis for calculating a relator’s award, in the Dodd-Frank whistleblower setting, the civil “fine” is not awarded as compensation for injury to the government. Nor are some other models of private enforcement of regulatory regimes all that applicable, such as those available in the environmental law setting. While fines may be levied in such actions, citizen plaintiffs are ineligible to share in those sanctions.<sup>522</sup>

Thus, I propose the creation of an “Informer’s Act” for securities fraud whistleblowers to supplement the new Dodd-Frank bounty scheme. An Informer’s Act differs from a traditional *qui tam* suit in that an Informer “may be empowered” to do more than “recover . . . sums owed the government”<sup>523</sup> by seeking fines on behalf of the government. Standing issues would likely mean that the plaintiff in an Informer’s Action would not be able to obtain injunctive relief or a declaratory judgment;<sup>524</sup> however, since the SEC has the option to pursue cases based on tips from Dodd-Frank informants, and the Informer’s Act proposed here would only be triggered when the SEC declines to do so, the loss of such remedies should not be a major concern. Moreover, the proposal here provides, as does the FCA, for subsequent intervention by the SEC should it experience a change of heart and wish to seek such remedies.

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521. Dodd-Frank Act, *supra* note 12, § 922(d)(1)(G).

522. Patti Goldman, *Public Interest Environmental Litigation in China: Lessons Learned from the U.S. Experience*, 8 VT. J. ENVTL. L. 251, 269 & n.102 (2007).

523. Heather Elliott, *Congress’s Inability to Solve Standing Problems*, 91 B.U. L. REV. 159, 198 (2011).

524. *Id.* at 199–200.

There is some recent precedent for permitting private citizens to sue for civil fines under an Informer's Act framework. Under the Patent Act, false marking of goods with counterfeit or imitation patent marks triggers a \$500 per violation fine.<sup>525</sup> A defendant must have marked a product either with an expired patent or a patent that does not actually cover the product and must have done so with the purpose of deceiving the public.<sup>526</sup>

For a time, "[a]ny person" was authorized by the Patent Act to file a lawsuit seeking statutory penalties, with one half of the proceeds going to the qui tam plaintiff and the other half to the United States.<sup>527</sup> That provision was eliminated in legislation passed by the House and Senate in the summer of 2011,<sup>528</sup> but during its existence it did offer a model for a private informer's action in the securities fraud context. Until the 2011 changes, the plaintiff did not need to be a competitor or have sustained an injury to bring an action under the statute. This form of action is "much more like an informer's action (where the plaintiff is a private prosecutor) than a qui tam action, since the plaintiff here would be suing a lawbreaker, not someone who defrauded the government."<sup>529</sup> In the 2011 Act, only the United States or an injured competitor can bring suit, and in the case of the latter, only the damages suffered would be available.<sup>530</sup>

The False Marking Statute had been on the books for more than a century and a half and "remains one of only a handful of qui tam actions left intact from a rich history of varied incentives provided by the government for private enforcement."<sup>531</sup> However, the statute

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525. 35 U.S.C. § 292 (2006). Legislation introduced in 2010, H.R. 4954, 111th Cong. (2010), and H.R. 6352, 111th Cong. (2010), would have added a requirement of individual damage and thus end the qui tam patent mismarking claim. Neither of these bills made significant legislative progress. H.R. 4954 and H.R. 6352 were referred to the House Judiciary Committee, but neither was reported by the Committee or enacted into law. *See H.R. 4954: To Amend Title 35, United States Code, to Provide Recourse Under the Patent Law*, GOVTRACK.US, <http://www.govtrack.us/congress/bill.xpd?bill=h111-4954> (last visited Nov. 10, 2011); *H.R. 6352: Patent Lawsuit Reform Act of 2010*, GOVTRACK.US, <http://www.govtrack.us/congress/bill.xpd?bill=h111-6352> (last visited Nov. 10, 2011).

526. Kirsten R. Rydstrom et al., *Burning Down the Courthouse: Qui Tam Actions Under Section 292 of the False Marking Statute*, U. PITT. J. TECH. L. & POL'Y, Spring 2011, at 1, 2.

527. 35 U.S.C. § 292(b).

528. *See Leahy-Smith America Invents Act*, Pub. L. No. 112-29, 125 Stat. 284 (2011).

529. Elliott, *supra* note 523, at 202 n.269.

530. Leahy-Smith America Invents Act § 16(b).

531. Winston, *supra* note 25, at 111.

was not widely used until the Federal Circuit recently held that the \$500 penalty applied *per article sold*.<sup>532</sup> This decision unleashed “a firestorm of patent mismatching claims.”<sup>533</sup> Some worried that this could lead to “a new ‘cottage industry’ of false-marking litigation brought by ‘marking trolls’ who have not suffered any direct harm but who stand to collect potentially massive damage awards based on the number of articles a company places into commerce with a false marking on them.”<sup>534</sup> In practice, relator-plaintiffs in the false marking context face difficulty establishing the necessary *intent to deceive*.<sup>535</sup> However, were a similar statute created in the securities fraud context, the status of whistleblowers as insiders might give them greater access to relevant information, which would make it easier to prove intent to deceive.

The False Marking Act precedent provides a basis for creating an Informer’s Action for SOX/Dodd-Frank whistleblowers. Such Informer’s Actions have a storied history—they existed in colonial and post-colonial times, when “a member of the public could sue to ensure government agent compliance with the law, and receive a bounty” when successful.<sup>536</sup> The proposal here, modeled after the FCA, provides such an Informer’s Action (referred to as a “Relator’s Enforcement Action”) to securities fraud whistleblowers:

SECURITIES WHISTLEBLOWER RELATOR’S ENFORCEMENT  
ACTION—

The Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*)  
is amended by inserting after Section 21F(e)

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532. S. Edward Sarskas & Melissa H. Burkland, *False Patent Marking*, 1037 PLI/PAT 269, 272 (2011) (citing *Forest Group, Inc. v. Bon Tool Co.*, 590 F.3d 1295, 1300 (Fed. Cir. 2009)).

533. Rydstrom et al., *supra* note 526, at 1, 3.

534. Laurence P. Colton et al., *Intellectual Property*, 61 MERCER L. REV. 1153, 1155 (2010). Other criticism lodged against § 292 of the Patent Act focuses not on the Informer’s Action it provides, but instead on its inclusion of marking patents which have *expired* among the actionable offenses. See Laura N. Arneson, Note, *Defining Unpatented Article: Why Labeling Products with Expired Patent Numbers Should Not Be False Marketing*, 94 MINN. L. REV. 650, 652–53 (2010).

535. Colton et al., *supra* note 534, at 1171.

536. Raymond H. Brescia, *On Public Plaintiffs and Private Harms: The Standing of Municipalities in Climate Change, Firearms, and Financial Crisis Litigation*, 24 NOTRE DAME J.L. ETHICS & PUB. POL’Y 7, 40 n.164 (2010).

(f) RIGHT OF WHISTLEBLOWER TO BRING RELATOR'S ENFORCEMENT ACTION IN CASES WHERE THE SEC DOES NOT PURSUE ENFORCEMENT ACTION. —Any person who has voluntarily provided original information to the Commission is permitted, where the Commission declines to take enforcement action within 180 days of the provision of such information, to pursue a claim for violation of the Securities Laws for the person and the Commission. Upon filing the action, the person will serve a copy on the Commission. The Commission may seek a stay of proceedings to continue to investigate whether it will take action in the matter.

(1) The Action shall be brought in the name of the Commission. The action may be dismissed only if the court and the SEC give written consent to the dismissal and their reasons for consenting.

(2) When a person brings an action under this subsection, no person other than the Commission or other agency of the United States Government or a state may intervene or bring a related action based on the facts underlying the pending action.

(3) The Commission may dismiss the action notwithstanding the objections of the person initiating the action if the person has been notified by the Commission of the filing of the motion, and the court has provided the person with an opportunity for a hearing on the motion.

(4) The Commission may settle the action with the defendant notwithstanding the objections of the person initiating the action if the court determines, after a hearing, that the proposed settlement is fair, adequate, and reasonable under all the circumstances. Upon a showing of good cause, such hearing may be held in camera.

(5) If the Commission requests it, the action shall be served with copies of all pleadings filed in the action and shall be supplied with copies of all deposition transcripts (at the

Commission's expense). The Court may permit the Commission to intervene at a later date upon a showing of good cause.

(6) If successful, such person shall be entitled to a payment of 10–30% of the total civil sanctions imposed in such proceeding, depending on the factors enumerated in subsection (c)(1)(B) of this section. No person ineligible for a bounty under subsection (c)(2) of this section is eligible to bring a Relator's Enforcement Action under this subsection.

As a quality-control mechanism, the Informer's Act model follows the FCA precedent in giving the government the option to seek dismissal of claims it views as meritless. This mechanism should reduce the likelihood that the Relator's Enforcement Action would trigger a significant number of frivolous or meritless claims.

Rather than adopting a sort of fixed-bounty scheme like the one in the former provisions of the False Marking Act,<sup>537</sup> the proposal here would continue to vest authority to assign an appropriate sanction to the federal courts. In current SEC actions litigated in federal court, “[o]nce a district court has found federal securities laws violations, it has ‘broad equitable power to fashion appropriate remedies.’”<sup>538</sup> Civil penalties are “determined by the court in light of the facts and circumstances.”<sup>539</sup>

The SEC's statutory authorization to seek fines limits the amount of a fine to the greater of “the gross pecuniary gain” to the wrongdoer or a “maximum statutory amount.”<sup>540</sup> The maximum statutory amount for civil penalties that can be imposed against natural persons ranges from \$5000 (for first-tier violations), to \$50,000 (for second-tier violations), to \$100,000 (for third-tier violations).<sup>541</sup> For nonnatural persons (corporations, LLCs, and the

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537. The fixed bounty scheme in the False Marking Act has been criticized for having nothing to do with the fairness of damages and the culpability of the wrongdoer. Winston, *supra* note 25, at 115.

538. SEC v. CMKM Diamonds, Inc., 635 F. Supp. 2d 1185, 1189 (D. Nev. 2009) (citing SEC v. Haligiannis, 470 F. Supp. 2d 373, 383 (S.D.N.Y. 2007)). There is relatively little appellate court guidance on the “scope, target, and amount of civil penalties except to confirm the discretionary nature of the remedy.” Black, *supra* note 136, at 325.

539. 15 U.S.C. § 77t(d)(2)(A) (2006).

540. Atkins & Bondi, *supra* note 249, at 392.

541. 15 U.S.C. § 77t(d)(2)(A)–(C).

like), the limits for first-, second-, and third-tier violations are \$50,000, \$250,000, and \$500,000 respectively.<sup>542</sup> Classification into a “tier” is made based on the severity of offense. Tier II penalties require “fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement,”<sup>543</sup> and Tier III penalties additionally require that the violation “result[] in substantial losses or create[] a significant risk of substantial losses to other persons.”<sup>544</sup> A separate schedule of fines applies to insider trading violations.<sup>545</sup> In deciding on a fine, courts will consider:

(1) the egregiousness of the violations at issue[;] (2) defendants’ scienter[;] (3) the repeated nature of the violations[;] (4) defendants’ failure to admit their wrongdoing; (5) whether defendants’ conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants’ lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to defendants’ demonstrated current and future financial condition.<sup>546</sup>

Of course, penalties are imposed *per violation*, so a particular scheme to defraud can trigger multiple fines if it involves multiple instances of fraudulent communications to shareholders or the market.<sup>547</sup> Added to the civil penalty is the amount of pecuniary gain (if any) enjoyed by a defendant—this raises the fine level, even though it also can be used as the basis for an order of disgorgement.

In practice, the calculation of a particular level of sanction is a complicated process. The SEC and “defendants each compare the misconduct to that in other cases and argue that the penalty should be more or less than in those other cases.”<sup>548</sup> This same practice could be utilized to calculate fines for Relator Enforcement Actions as proposed in this Article.

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542. *Id.*

543. *Id.* § 77t(d)(2)(B).

544. *Id.* § 77t(d)(2)(C).

545. *Id.* § 78u-1.

546. SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003).

547. SEC v. Haligiannis, 470 F. Supp. 2d 373, 386 (S.D.N.Y. 2007) (holding that “[e]ach of the quarterly statements sent to each of the investors” constitutes a separate violation).

548. Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALB. L. REV. 5, 50 (1994).

The creation of this Relator's Enforcement Action might reduce the need for the SEC to consider awarding bounties in low- or no-sanction actions as provided in the first proposed reform of Dodd-Frank suggested above.<sup>549</sup> Currently, resource limitations may lead the SEC to adopt a softer approach to target companies by accepting resolution of enforcement actions involving little (or no) monetary sanction except in the most serious of cases. Low-level sanctions may result not from any substantive determination that the fraud is not serious, but instead from the SEC's recognition that a particular case would require a relatively unwise expenditure of governmental resources. Were the Informer's Act model adopted, the SEC might be inspired to decline to involve itself at all in those difficult, but likely low-reward cases. As a result, individual whistleblowers would be empowered to bring a greater share of the potential enforcement actions, in which they would enjoy the potential for bounties provided. An ancillary advantage of freeing the SEC from pursuing investigations likely to lead to low-level enforcement awards would be that its resources could be redirected toward "big-ticket" cases.

The proposed Relator's Enforcement Action structure offers several advantages. First, it is likely to expand the scope of deterrence of securities fraud. Under the current system, the SEC brings relatively few actions but seeks significant fines.<sup>550</sup> Research on the effectiveness of sanctions indicates that milder punishments more consistently applied have a greater deterrent effect than do harsher but less certain sanctions.<sup>551</sup> Second, since informers would be bringing claims in the name of the government, they would not face some of the difficult burdens imposed on private plaintiffs in Rule 10b-5 actions.<sup>552</sup> Third, and most importantly, the Relator's Enforcement Action will prevent the SEC from continuing to function as a roadblock to leveraging whistleblower information for the enforcement of the securities laws.

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549. The Informer's Act model also reduces the need for any statutory minimum level of sanctions to trigger bounties. If the justification for such floors is a concern about frivolous claims, that concern can be addressed in an Informer's Act model since there will be little financial benefit to whistleblowers and lawyers associated with bringing extremely low-payoff claims.

550. Laby & Callcott, *supra* note 548, at 51.

551. *Id.* at 51 & n.306.

552. Black, *supra* note 136, at 335. These barriers include the requirements that private plaintiffs are purchasers or sellers who suffered a loss as a result of the misrepresentation. In some cases, private securities plaintiffs must also establish reliance.



## VII. CONCLUSION

We have certainly come a long way from the days in which would-be whistleblowers, like Enron's Sherron Watkins, in financial fraud cases had no protection under federal or state law from being terminated for objecting to fraudulent financial practices. A decade ago, federal law created a uniform protection for such tipsters. Inconsistent enforcement has hampered that statute's effectiveness. But the significant economic troubles of the past few years, along with the exposure of some massive fraudulent schemes, have renewed interest in the role of financial fraud whistleblowers.

Dodd-Frank's bounty scheme is a major shift in the direction of recognizing the role that monetary incentives can play in stimulating whistleblowers to face the tremendous personal, social, and economic costs of bringing fraud to light. However, although we have been given a good start, we cannot say mission accomplished. Dodd-Frank's limitation to those rare SEC actions producing seven-figure enforcement sanctions means that for the vast majority of whistleblowers the promise of a bounty will remain an illusion. More importantly, the absence of a vehicle by which whistleblowers themselves can pursue financial fraud claims means that nothing will be done to strengthen the nonmonetary incentives that lead people to expose fraud.

This Article has proposed two fixes to Dodd-Frank: one would allow the payment of bounties even in cases producing nonmonetary sanctions, and the other would empower whistleblowers to pursue financial fraudsters even if the SEC remains inactive. So far, legislators have shown more interest in creating even more holes in Dodd-Frank than filling in the ones already present in the statute. Wall Street may have to collapse in another bubble a decade from now before policymakers finally get around to adopting a more straightforward and effective whistleblower reward program.