

Chicago-Kent Journal of International and Comparative Law

Volume 13 | Issue 2

Article 6

1-1-2013

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Recommended Citation

Thomas C. Reynolds, *Securing Protections for Whistleblowers of Securities Fraud in the United States and the European Union*, 13 Chi.-Kent J. Int'l & Comp. Law 201 (2013).

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Student Note

Securing Protections for Whistleblowers of Securities Fraud in the United States and the European Union

Thomas C.R. Reynolds*

Abstract

The European Union is currently in the process of passing a regulation designed to strengthen protections and incentives for whistleblowers of securities fraud and other violations. Proposal for a Regulation on Insider Dealing and Market Manipulation (Market Abuse) No. 2011/0295 creates a framework that may protect whistleblowers from retaliation, incentivize them to blow the whistle, protect their confidential data and personal information, and require companies to set up compliance plans. However, almost by definition, the Regulation's language is sufficiently broad to require efficient development in accordance with the supranational purposes.

The United States has experience with whistleblower regulations and laws, and has recently implemented measures to address whistleblowers in securities cases. The purposes of this paper are to ask, discuss, and hopefully answer the question: "With what issues should the European Union be concerned, and how should the E.U. or its Member States develop laws and regulations concerning whistleblowers of securities fraud?" This paper uses two methods to analyze the issues relevant to whistleblowers of securities fraud or illegal securities transactions. The first is the comparative method, applied

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to the laws and regulations of the United States and the European Union. The second is an economic analysis of the effects of the laws, in the hopes to find the most efficient solutions.

Since the writing of this note in the summer of 2012, the Council of the European Union has debated this proposal and it is awaiting first reading in the EU Parliament, forecasted for September 10, 2013.

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Thomas C.R. Reynolds

Introduction

Whistleblowers, according to Black's Law Dictionary, are employees who report employer wrongdoing to a governmental or law-enforcement agency.¹ A more noble and idealistic description of a whistleblower is one "who no longer silently tolerate[s] illegal activities, maladministration or danger to humans, the environment and the economy, but reveal[s] those abuses within or outside their business, their company, their organization or their bureaucracy."² Of course, neither of these definitions is exactly correct. Black's definition fails because a whistleblower's legal relationship with the reported subject may include other types of horizontal or vertical relationships; whistleblowers do not necessarily need to go straight to the government, sometimes they go to the company first. Moreover, Strack's definition falls short because a whistleblower may, in fact, be motivated solely by financial rewards. Regardless, the term 'whistleblower' - used since at least 1958³ - is preferable to 'snitch,' 'rat,' or other words with negative connotations.

Whistleblowers of securities fraud face additional risks, and opportunities, due to the fluid characteristics of a security. The nature of a security allows individuals more room to commit fraud and illegal manipulation. A security is unlike a good, or even a unit of monetary currency.⁴ A company may create an infinite amount of securities with little if any cost.⁵ This is possible because securities represent a fraction of certain ownership rights tied in the company, such as the right to control, the right to seek dividends, and the right to other traditional property

¹ BLACK'S LAW DICTIONARY 1734 (9th ed. 2009).

² Guido Strack, *Whistleblowing in Germany*, in WHISTLEBLOWING 109, 110 (Marek Arsztowicz & Wojciech W. Gasparski eds., 2011).

³ "The whistleblower on that \$50,000 a month call-girl story was a witch, who tried to tap Bea Garfield, alleged madam, for \$250." Mansfield News-Journal (Ohio) (October 10, 1958), 25.

⁴ THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, 1 Law Sec. Reg. § 11, 1 (6th ed.)

⁵ *Id.* ("Securities can be issued in unlimited amounts and virtually without any costs since securities are nothing in themselves but rather represent only an interest in something else.").

rights.⁶ This intangible and amorphous concept can be rather complex, allowing for creative fraud and manipulation.⁷

The regulation of securities began in thirteenth century England, around seven hundred and twenty-five years ago.⁸ King Edward I authorized securities brokers to practice their craft in London by issuing crown-sanctioned licenses.⁹ In the United States, President Franklin Delano Roosevelt signed the first securities regulations laws in 1933, prompted by the securities fraud that contributed to the Great Depression.¹⁰ A European Economic Community (“EEC”) directive in 1968 marked the first efforts of European securities regulations.¹¹ However, the 1999 Financial Services Action Plan was the first sign of real progress.¹²

This paper will look specifically at a number of laws: 1) the Sarbanes-Oxley Act of 2002¹³ (hereafter known as “Sarbanes-Oxley” or “SOX”); 2) the Dodd-Frank Wall Street Reform And Consumer Protection Act¹⁴ (hereinafter known as “Dodd-Frank”); and 3) the Proposal for a Regulation of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse)¹⁵ (henceforth known as “COM (2011) 651” or “Proposal for Regulation No. 2011/0295”).

I. The Laws of the Lands

A. *The United States*

The United States has five main federal securities laws: 1) Securities Act of 1933,¹⁶ 2) Securities Exchange Act of 1934,¹⁷ 3) Trust Indenture Act of 1939,¹⁸ 4) Investment Company Act of 1940,¹⁹ and 5) Investment Advisers Act of 1940.²⁰ In addition to these federal securities laws,

⁶ *Id.*

⁷ *Id.* at 2.

⁸ THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, 1 Law Sec. Reg. § 12, 1 (6th ed. 2013).

⁹ Statute of Edward I, in 1285; see STEPHEN KILLIK, THE WORK OF THE STOCK EXCHANGE 12 (2nd ed. 1934).

¹⁰ Securities Act of 1933, 15 U.S.C. § 77a et seq.

¹¹ MANNING GILBERT WARREN III, EUROPEAN SECURITIES REGULATIONS 43 (1st ed. 2003).

¹² *Id.* at 5.

¹³ Sarbanes-Oxley Act, Pub.L. No. 107-204, 115 Stat. 745.

¹⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. No. 111-203, H.R. 4173 (2010).

¹⁵ COM (2011) 651 final (October 20, 2011).

¹⁶ Securities Act of 1933, 15 U.S.C. § 77a et seq.

¹⁷ Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq.

¹⁸ Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa - 77bbbb.

¹⁹ 15 U.S.C. §§ 80a-1 - 80a-64.

²⁰ 15 U.S.C. §§ 80b-1 - 80b-21.

individual states have passed securities laws. With regard to whistleblowers and securities, the United States has a comprehensive set of laws and regulations that both protect and incentivize whistleblowers. This paper will focus on two relatively younger federal laws that have amended the above statutes in favor of whistleblowers.

1. Sarbanes-Oxley (2002)

The Sarbanes-Oxley law amended all of the above statutes except for the Trust Indenture Act of 1939. It added primarily to the Securities Exchange Act of 1934, and secondarily, to the Securities Act of 1933. Congress passed this law after the revelation of accounting and securities fraud committed by multinational corporations such as Enron and WorldCom in 2001.²¹ One of the purposes of SOX is to decrease shareholder fraud by expanding criminal penalties and other preventative measures.²² By passing SOX, Congress charged the Securities and Exchange Commission (the “SEC”) and other federal agencies with implementing specific regulations to enforce the Act. The relevant sections that deal with issues facing whistleblowers are: 1) Title III, Section 301(4) on Complaints to Public Company Audit Committees; and 2) Title VIII, Section 806 on Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud.

Title III, Section 301 of SOX requires issuers of securities to use an “independent” audit committee, who happen to also be a part of the Board of Directors, when issuing securities. Section 301(4) requires these independent audit committees to set up a confidential procedure for employees to complain or express their concerns over questionable accounting or auditing matters. The issuer of securities may receive these complaints, but reserve some sort of confidentiality.

Title VIII, Section 806 of SOX amends Chapter 73 of Title 18, of the United States Code, to protect whistleblowers of securities fraud. Section 806(a) states that no publicly-traded company may “discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee.” ‘Lawful acts’ in this context include providing information or assisting the government, the SEC, the company’s compliance division, or other authoritative people or entities. Another

²¹ See Richard Moberly, *Sarbanes-Oxley’s Whistleblower Provisions: Ten Years Later*, 64 S.C. L. REV. 1, 2 (2012).

²² *Id.* at 3.

'lawful act' may be filing or complaining about alleged violations.²³ These protections are intended to prevent employer retaliation against the employee. If an employee who has "blown the whistle" believes his or her employer has retaliated against him or her, the employee may seek relief through an administrative court.²⁴ If the administrative channels are not responsive, the employee may file a complaint through the normal federal court system. Remedies can include general and special compensatory damages, and injunctive relief to reinstate the employee.

2. Dodd-Frank (2010)

The Dodd-Frank Wall Street Reform and Consumer Protection Act amended a variety of banking, company, and financial laws, including the Securities Exchange Act of 1934. Among other changes, Dodd-Frank established a whistleblower incentive program. The incentive program can be described as a bounty program, similar to one the Internal Revenue Service established where informants may collect part of their neighbor's taxes if the neighbor was committing tax fraud.²⁵ The Sections relevant to whistleblowers in Dodd-Frank are Sections 921 through 924, in Title IX on Investor Protections and Improvements to the Regulation of Securities.

Section 921 is the first section in Title IX, Subtitle B "Increasing Regulatory Enforcement and Remedies." It simply overrules any contract provision that may require binding arbitration when dealing with whistleblowers, whether made in an employment contract, a transactional contract, or any other agreement between two private parties. Only by establishing the government's inherent authority to adjudicate these matters could it reach out to incentivize and protect future whistleblowers.

Amongst others, Section 922 establishes an incentive program to encourage future whistleblowers. Whistleblowers may be eligible for a ten to thirty percent (10-30%) commission for original information that leads to a covered judicial or administrative action. In order to define what is "original information," Dodd-Frank established a three-prong test. The test defines "original information" as 1) deriving from the *independent* knowledge of the whistleblower; 2) not known to the SEC, but if it is, the SEC will make an exception if the whistleblower is the source of the information; and 3) "not exclusively derived from an allegation made in a

²³ Violations of §§ 1341, 1343, 1344, 1348, SEC regulations or rules, or any federal shareholder fraud laws.

²⁴ Through the Department of Labor. The cause of action could be based on the Occupational Safety and Health Act.

²⁵ Patrick A. Barthle, II, *Whistling Rogues: A Comparative Analysis of the Dodd-Frank Whistleblower Bounty Program*, 69 WASH. & LEE L. REV. 1201, 1214 (2012).

judicial or administrative hearing,” unless the whistleblower is the source of the information. “Covered judicial or administrative action(s)” are defined as cases brought by the SEC, whose cause(s) of action stems from US securities laws, and which result in penalties over one million dollars (\$1,000,000.00). Further subsections describe the procedures for determining the amount of the award, accepting or denying awards, the discretion of the SEC, and the legal rights of a whistleblower vis-à-vis the SEC.

Section 922 also protects whistleblowers from retaliation and accords them confidentiality rights. Retaliation, not just in Dodd-Frank, but also in employment discrimination and other areas of law, occurs when the company or employer treats the whistleblower employee worse as a result of his or her reporting of wrongdoing. Specifically, employers may not, “discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment” for “blowing the whistle.”²⁶

Section 923 simply amends the aforementioned Securities laws, as well as occasionally mentioning the Sarbanes-Oxley Act of 2002.

Section 924 directs the SEC to implement these rules into the federal regulations as Section 21F of the Securities Exchange Act of 1934 (also known as “Regulation 21F” or “Section 240.21F”). It also directs the SEC to establish a separate office for Section 21F issues.²⁷

Regulation 21F, like most regulations, simply details the general rules the legislation passed. Regulation 21F is also known as §§ 240.21F-1 through 240.21F-17 of the Securities Exchange Act of 1934. Section 240.21F-2 defines “whistleblower,” and adds to their anti-retaliation rules. Significantly, a whistleblower will be protected against retaliation even if he or she is not eligible for a monetary award. Section 240.21F-3 repeats the eligibility requirements for an award, but the SEC interpreted § 21F(a)(3)(c) to require a *voluntary* disclosure; the SEC also allows “related actions,” including state criminal cases. Section 240.21F-5 emphasizes the SEC's discretion in deciding the amount of the award. Section 240.21F-5(c) states that if there is more than one whistleblower per case, the SEC will not give away more than 30% of the award; instead, it may award 10 to 30% of the award to the aggregated whistleblowers. In § 240.21F-6, the SEC lists optional factors it may consider in determining how much to award. Sections 240.21F-9 through 240.21F-11 specify more eligibility

²⁶ Dodd-Frank Act § 922(h)(1)(A), 15 U.S.C. § 78u-6.

²⁷ Currently this office is called the Office of the Whistleblower (see U.S. SECURITIES AND EXCHANGE COMMISSION, OFFICE OF THE WHISTLEBLOWER (2013), available at <http://www.sec.gov/whistleblower>).

requirements, exceptions to eligibility, and the recommended whistleblowing procedures. Section 240.21F-8(c)(3) exempts whistleblowers if they are “convicted of a criminal violation” related to the same information or action for which they would otherwise have been eligible for an award.

The Code of Federal Regulations describes the administrative history behind each regulation and how the SEC decided to craft them.²⁸ For example, among the factors that may lower the financial award, the SEC included the culpability of the whistleblower, instead of per se excluding culpable whistleblowers.²⁹ Even though this changed very little on the issue of whistleblower culpability, the SEC stated it did not believe that Congress intended a per se exclusion of culpable whistleblowers.³⁰

B. *The European Union*

The European Union's laws and regulations concerning whistleblowers of securities violations are not as comprehensive as those of the United States. To begin, securities laws in the European Union have not yet been completely harmonized – each nation still retains some sovereignty over this area of law. Even though there is an E.U. agency called the Committee of European Securities Regulators (“CESR”), the CESR is nowhere near as authoritative or powerful as the SEC is in the United States.³¹ However, the E.U. took a big step toward unifying the securities framework in 2007 by implementing the Market in Financial Instruments Directive.³² As for whistleblowing, the E.U. has only recently protected the act itself, although statutory law still remains on the national level. To summarize, there are no supranational protections for whistleblowers, and most certainly none for whistleblowers of securities violations.

Within the past decade, however, there has been a movement toward encouraging and protecting whistleblowers within Europe – in the Council of Europe and the formal European Union. In 2007, the so-called Group of States against Corruption (“GRECO”) presented a motion for a recommendation to the Council of Europe's Parliamentary Assembly,³³ urging the Assembly to “decide[] to consider the question of

²⁸ 17 C.F.R. §§ 240, 249 (2011).

²⁹ 17 C.F.R. § 240.21F-6 (2011).

³⁰ See 17 C.F.R. §§ 21F-15, 21F-16 (2011).

³¹ Tanja Boskovic, et al., *Comparing European and U.S. Securities Regulations 2* (World Bank Working Paper No. 184, 2010).

³² See *id.*; 2004/39/EC.

³³ The Council of Europe's Parliamentary Assembly is unrelated to the European Union or the Council of the European Union.

[whistleblowers'] protection and make appropriate recommendations.”³⁴ In 2009, the Committee on Legal Affairs and Human Rights reported its study on whistleblowers to the Parliamentary Assembly.³⁵ Finally in 2010, the Council passed a resolution urging member states to review their legislation concerning the protection of whistleblowers.³⁶

In addition, from 2008 to 2011, a lawsuit was pending in the judicial channels of the European Union. Ms. Brigitte Heinisch commenced a lawsuit against the nation of Germany for unfair dismissal and denial of her freedom of expression.³⁷ Ms. Heinisch had worked for a private nursing home in Germany, which had some potentially criminal and civil liabilities.³⁸ Ms. Heinisch complained about these problems and instituted a criminal investigation.³⁹ Subsequently, she was dismissed from her job, allegedly in retaliation for “blowing the whistle.”⁴⁰ The German courts did not grant her relief, so she commenced an action against the nation in the European Court of Human Rights.⁴¹ The Court held that there had been a violation of Ms. Heinisch's right to freedom of expression found in Article 10, § 1 of the Convention for the Protection of Human Rights and Fundamental Freedoms.⁴² Based on that decision, whistleblowing is protected under the E.U.'s right of freedom of expression.

1. Proposal for Regulation No. 2011/0295

Currently, the European Parliament and the Council of the European Union, the E.U.'s two legislative bodies, are considering adopting a Regulation on insider dealing, market manipulation, and market abuse.⁴³ This Regulation would repeal Directive 2003/6/EC or the Market Abuse Directive (MAD).⁴⁴ The proposed Regulation enhances the limited market abuse framework in the E.U., protects whistleblowers from retaliation, introduces an incentive system, and strengthens the confidentiality of the

³⁴ Eur. Parl. Ass., *Protection of “whistle-blowers,”* Doc. 11269 (2007) (Referring to Resolution 1507 (2006), where the Parliamentary Assembly called member states to protect whistleblowers who disclose illegal activities within national governments.).

³⁵ Pieter Omtzigt, Report to the Committee on Legal Affairs and Human Rights, THE PROTECTION OF “WHISTLE-BLOWERS,” Doc. 12006 (2009).

³⁶ Eur. Parl. Ass., Res. 1729 (2010).

³⁷ *Heinisch v. Germany*, App. No. 28274/08, Eur. Ct. H.R. 1 (2011).

³⁸ *Id.* at 3.

³⁹ *Id.*

⁴⁰ *Id.* at 4.

⁴¹ *Id.* at 5, 2.

⁴² *Id.* at 19.

⁴³ COM (2011) 651.

⁴⁴ *See*

[http://www.europarl.europa.eu/oecil/popups/ficheprocedure.do?lang=en&reference=2011/0295\(COD\)](http://www.europarl.europa.eu/oecil/popups/ficheprocedure.do?lang=en&reference=2011/0295(COD)).

reporting system.⁴⁵ Article 11 requires businesses to adopt a system to detect and prevent insider dealing and market manipulation; it also charges the European Securities and Markets Authority (“ESMA”) with developing regulations to ensure compliance.⁴⁶ Article 21 protects the secrecy of “any confidential information received, exchanged or transmitted pursuant to this Regulation.”⁴⁷ Article 22 similarly protects the personal information of the communicant, ensuring that authorities will comply with another data privacy Regulation.⁴⁸ The information shall, at most, be deleted after five years.

Until Article 29, Proposal for Regulation No. 2011/0295 has only addressed issues tangentially related to whistleblowers and whistleblowing. Article 29, § 1 delegates the responsibility to Member States to institute “effective mechanisms” and provides a list of minimum components. Those include a process that acknowledges complaints and their follow-up, appropriate legal protections, protection of personal data, and a right to due process for the alleged wrongdoer. Article 29, § 2 proposes a financial incentive program similar to that of Dodd-Frank. It recommends that financial incentives be available for eligible people who offer new and “salient information” about “potential breaches” and leads to an imposition of administrative or criminal sanctions. Unlike in Dodd-Frank, there is no requirement of a minimum amount of legal or administrative sanctions.⁴⁹ The European Regulation also does not require “independent knowledge” or the element of good will.⁵⁰

II. How Should the E.U. Construct its Legal Framework?

Before determining how the E.U. should construct its legal framework, the first question to ask is, “Why should the government protect whistleblowers of securities violations?” The answer is, whistleblowers are in the best position to reduce the transactional costs and provide the most information.⁵¹ Protections and incentives for whistleblowers are necessary to prevent and address securities violations.⁵²

⁴⁵ COM (2011) 651, at § 3.4.5.2.

⁴⁶ COM (2011) 651, art. 11.

⁴⁷ COM (2011) 651, art. 21.

⁴⁸ COM (2011) 651, art. 22.

⁴⁹ See Sec. 21F(a)(1).

⁵⁰ *Contra* 17 C.F.R. § 240.21F(a)(3).

⁵¹ See *Proposal for a Regulation of the European Parliament and Of the Council on Insider Dealing and Market Manipulation (Market Abuse)*, COM (2011) 651 final, ¶ 36 (Oct. 29, 2011) [hereinafter *COM (2011)*]; Alexander Dyck, Adair Morse, Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, LXV J. Fin. 2213, 2251 (2010) (“Employees, industry regulators, and analysts gather a lot of relevant information as a byproduct of their normal work . . . and are in a much better position to

An alternative may be to give the shareholders and recipients of fraudulent securities a strong cause of action or a right to bring a private lawsuit to court such as a shareholder derivative suit. After all, shareholders are the owners of the company, have access to company information, and are owed fiduciary duties from its agents. However, this causes collective action problems. With possibly hundreds or thousands of shareholders, any one individual will not feel responsible for investigating and preventing fraud. Those individuals or companies defrauded will, *ex post*, likely have the initiative to investigate, but possibly not the necessary resources or ability. This may, in turn, cause an increase in litigation, predatory hunting of smaller and unsophisticated investors in securities, and individuals who take advantage of investors, like Bernie Madoff.

Even if the shareholders were to appoint agents such as the Board of Directors or an Auditing Committee, a whistleblower incentive program led by government could be in many cases a more efficient system. In addition, this incentive system is less invasive in company affairs than a possible Regulation that would require even privately-held companies to appoint Auditing Committees.

Proponents of the Coase Theorem may argue that the market should equal out inefficiencies.⁵³ However, there are significant transactional costs for companies to acquire the necessary information. The Coase Theorem relies on the assumptions that the parties have no transactional costs and have perfect knowledge. Those assumptions being impossible, the Coase Theorem cannot stand. Therefore, without an acceptable alternative, governments and legal systems must continue to rely on whistleblowers.

A. *The Issue of Data Protection and Procedural Safeguards*

To create an effective whistleblower system, the European Union must establish legal and technological systems to protect the data and personal information of a whistleblower. The E.U. already has a directive and a committee within the European Commission designed to protect the personal data of individuals.⁵⁴ The new whistleblower law must comply with this E.U. directive, and the new law should consider the agency's

identify fraud than short sellers, security sellers, or lawyers, for whom detecting fraud is like looking for a needle in the haystack.").

⁵² COM (2011), *supra* note 51, ¶ 39.

⁵³ The Coase Theorem posits that if there are no transactional costs (such as no taxes, perfect information, and other barriers to trade), a transaction will be efficient, regardless of the externalities, or unintended effects.

⁵⁴ Council Directive 95/46, 1995 O.J. (L 281) 1 (EC).

suggestions, the most important of which are found in Working Paper 117.⁵⁵ Without safe and stable procedures, a whistleblower will be more hesitant to come forward with valuable information because of the higher risks involved. However, in crafting a system, the E.U. must take into account that some systems have already run into legal problems in member states such as Germany and France. In Germany, a state court called into question the legal validity of a whistleblower telephone hotline and the onerous duties imposed on company employees.⁵⁶

Aside from technologically advanced computer systems, there are at least three basic structures the E.U. can institute or require companies to institute.⁵⁷ First, the E.U. can create an anonymous message reception through telephone or email.⁵⁸ This would be beneficial to society because it would likely increase the number of whistleblowers and identify possibly unlawful situations. However, a French court in 2005 declared similar systems to be unlawful because anonymous collection could increase the risk of false information, and violate an employee's fundamental freedoms if that employee is the subject of the complaint.⁵⁹ This type of system would also limit the government or the company's ability to follow-up and obtain more information. Whistleblowers may know of important information that they consider irrelevant, or they may be unaware of the significance of their information.

Furthermore, this system presents evidentiary problems. Courts would be unlikely to admit a piece of information that has been anonymously submitted if the government cannot establish a foundation for the evidence through testimony or other means.

A second type of system that addresses the problem of follow-up would be a system with a backchannel.⁶⁰ Backchannels let two parties communicate in real-time, and an individual may set up a mailbox for the reception of messages (i.e. think of Facebook, Gmail Chat, or Skype). The benefit of this system is that it protects the identity of the whistleblower while allowing the government or company to obtain further information, if the whistleblower continues to follow-up. The cost, however, is in the whistleblower not complying further. Courts and companies may still not

⁵⁵ See Cooper & Marttila, *infra* note 59.

⁵⁶ Judgment of Jun. 15, 2005, 5 BV 20/05, NZA-RR 2005, 476 (Arbeitsgericht Wuppertal [Labor Court in Wuppertal]).

⁵⁷ Strack, *supra* note 2, ¶ 26.

⁵⁸ *Id.*

⁵⁹ McDonald's, CNIL Délibération No 2005-110 (May 26 2005); Exide Techs., CNIL Decision No 2005-111 (May 26 2005); see also Daniel P. Cooper and Helena Marttila, *Corporate Whistleblowing Hotlines and EU data Protection Laws*, PRACTICAL LAW COMPANY (June 14, 2012, 16:53), <http://us.practicallaw.com/1-366-2987?q=whistleblowing>.

⁶⁰ Strack, *supra* note 2, ¶ 26.

take the information seriously because it has been submitted anonymously. This also creates the moral hazard mentioned in the first system: An anonymous system may be abused by individuals who lie about or invent the information they submit. The two anonymous systems mentioned also deprive others from the chance of examining the whistleblower and determining whether he or she is a credible witness. Once again, an anonymous system may run into similar legal troubles as mentioned above.

The third system that Strack identifies is an ombudsman system.⁶¹ An ombudsman system involves the whistleblower meeting with an independent third party who receives the information. The third party may be a lawyer, sometimes in-house counsel, a journalist, a bureaucrat, or other individual. A benefit of this system is that it allows for the examination of whistleblowers, along with his or her credibility. However, this would certainly discourage some whistleblowers for fear of reprisal and mistrust of the ombudsman. The ombudsman may also be vulnerable to corruption or regulatory “capture” by large companies and special interest groups.

The United States established a hybrid system in Sarbanes-Oxley.⁶² SOX charges an Audit Committee, which is part of the Board of Directors, with the safekeeping of whistleblower complaints.⁶³ As such, this possibly fourth system is like an ombudsman system, but without the crucial independence of the third party. The Audit Committee is also a way to receive anonymous messages because the SEC establishes this as a minimum standard for public companies and some private companies. Indeed, SOX also imposed a legal duty on the company's Board of Directors to keep the submissions confidential and anonymous.⁶⁴ The benefit of the Audit Committee is that it reduces costs by delegating the responsibility to the company, thereby saving and optimizing the most efficient use of judicial and governmental resources. On the downside, a conflict of interest exists because the primary duties of both the Audit Committee and the Board of Directors belong to the company, not to the whistleblowers. A strong cause of action against employer retaliation may reduce this problem, but this system will nevertheless discourage some whistleblowers and raise the risk of greater conspiracies involving the former whistleblower(s), digging the grave even deeper.

Considering the pros and cons of each system, no single system clearly stands out from the rest. Europe had legal problems with SOX's

⁶¹ *Id.*

⁶² *See* § 301.

⁶³ *See* Securities Exchange Act of 1934, § 10A(m)(4); 14 U.S.C.A. § 78 (West 2012).

⁶⁴ *Id.* § 10A(m)(4)(B).

requirement of an anonymous reception of complaints because of the potential for infringing the fundamental freedoms of the person being discussed.⁶⁵ However, the E.U.'s Article 29 Working Party may have reconciled these contradicting requirements by suggesting that corporations only need to *encourage* employees to identify themselves on a confidential basis when submitting reports.⁶⁶

Europe may wish to adopt a mixed system tailored to their needs, which delegates certain responsibilities to nations and corporations. Each member state's culture is slightly different, and cultural attitudes to whistleblowing may "lead us to suspect some diversity in optimal whistleblower-policy."⁶⁷ Indeed, nations that have histories with dictatorships and secret police are much more hesitant to accept the whistleblower as noble. Legal systems must account for this when designing the procedural and substantive provisions of a whistleblower system. In the next section, the incentive system, which may encourage a hesitant whistleblower to overcome his cultural prejudices, will be discussed.

Nevertheless, an ombudsman system (the third system presented) may be a good beginning because it allows for the confidentiality of whistleblowers across Europe. This system allows for an examination of the whistleblower, provides an efficient centralized resource, and is more likely to pass legal rigor in nations such as France and Germany. The E.U. has an established securities agency, called the European Securities and Markets Authority ("ESMA"), which could serve as a platform for enforcement, similar to the SEC's role in the United States. However, the European Commission⁶⁸ or its Internal Market and Services Directorate General ("DG MARKT")⁶⁹ are more likely to serve as regulators.

B. *The Issue of an Incentive System*

The second major issue this paper will discuss is that of the incentive system. Incentive or bounty systems, like the False Claims Act *qui tam* actions,⁷⁰ encourage whistleblowers to blow the whistle by offering an

⁶⁵ Cooper & Marttila, *supra* note 59, at 10.

⁶⁶ *Id.*

⁶⁷ Anthony Heyes & Sandeep Kapur, *An Economic Model of Whistle-Blower Policy*, 25 J. L. ECON. & ORG. 157, 159 (2009).

⁶⁸ EUROPEAN COMMISSION, THE EU SINGLE MARKET: SECURITIES (2013), available at http://ec.europa.eu/internal_market/securities/index_en.htm.

⁶⁹ *Id.*

⁷⁰ *Qui tam* is short for the Latin phrase "*qui tam pro domino rege quam pro se ipso in hac parte sequitur*," which means, "who as well for the king as for himself sues in this matter." BLACK'S LAW DICTIONARY 1368 (9th ed. 2009).

award, usually financial, for the successful completion of a judicial action. In the carrot-stick approach, these awards are the quintessential carrots. These systems bring in the benefits of private justice because insiders possess more and better information, but they allow the government to prosecute and prevent vigilantism. The United States implemented an incentive system for securities fraud in 2010 as part of the Dodd-Frank Act.⁷¹

The Dodd-Frank incentive system was partially based on similar programs hosted by the Internal Revenue Service (“IRS”)⁷² and it strengthens the whistleblower protections under the False Claims Act.⁷³ In comparison, the E.U. Regulation delegates the responsibility to set up this system nationally. However, the E.U. may wish to consider a supranational incentive system not only to further integrate, but also to pool the financial resources and incentivize more whistleblowers.⁷⁴

Psychologically, a whistleblower is driven to blow the whistle on his/her employer(s), partner(s), or business associate(s) for a variety of reasons.⁷⁵ Chief amongst them, one may presume, is a potential financial award.⁷⁶ “There is no question that human beings do react to the carrot and the stick. However, people are not blindly mechanical cost-benefit machines.”⁷⁷ Of course, people are not influenced solely by financial rewards; in fact, some whistleblowers are also motivated by the elements of duty⁷⁸ and legitimacy.⁷⁹ Even though incentive or bounty programs primarily motivate whistleblowers' financial interests, non-financial and psychological elements have a bearing on the economic analysis, and the legal consequences.

⁷¹ 15 U.S.C. § 78u-6 (2010).

⁷² 26 U.S.C. § 7623(a) began as a potential award in 1867, at the discretion of the IRS. In 2006, the Tax Relief and Health Care Act of 2006 fundamentally changed the provision, taking away the discretionary power of the IRS. Thomas J. Oulin, and Richard R. Zabel, *IRS Whistleblower Provision*, ROBINS, KAPLAN, MILLER & CIRESI L.L.P. (Dec. 2007/Jan. 2008), <http://www.rkmc.com/~media/PDFs/IRS%20Whistleblower%20Provision.pdf>.

⁷³ *Id.*

⁷⁴ The downside to that is that the some nations will inevitably attempt to take advantage of this financial pool, in the author's opinion.

⁷⁵ Dave Ebersole, *Blowing the Whistle on the Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPREN. BUS. L.J. 123, 124 (2011).

⁷⁶ See Geoffrey C. Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 113 (2007) (“Presumably, a large enough financial benefit in favour of blowing the whistle could outweigh any social or psychological factors.”).

⁷⁷ Lawrence M. Friedman, *Coming of Age: Law and Society Enters an Exclusive Club*, 1 ANN. REV. LAW SOC. SCI. 1, 14 (2005).

⁷⁸ Ebersole even argues that laws imposing an affirmative duty on people will create more whistleblowers. Ebersole, *supra* note 75, at 135.

⁷⁹ Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1184 (2010).

1. Prerequisites and Eligibility

In order to receive an award, the European Union's proposal requires the whistleblower to first provide salient and new information.⁸⁰ But the U.S.'s Dodd-Frank Act requires only "original information."⁸¹ Original information is further defined as: 1) "independent knowledge or analysis," 2) not known to the commission, and 3) not derived from a hearing, audit, investigation, etc.; the definition also makes an exception for the original sources of the information.⁸²

The E.U. and U.S. definitions are similar, but have two major differences. First, the E.U.'s use of the word "salient" suggests significant and useful information, but the U.S. wording has no such requirement.^{83,84} The E.U.'s requirement raises the bar for whistleblowers to receive an award, perhaps deterring innocent whistleblowers with insignificant information because they may not consider their information to be "salient." The bigger concern, however, is that it may deter whistleblowers with some fault in the matter being reported. But, a whistleblower is unlikely to expose himself or herself by reporting insignificant information and hoping for an award. If a whistleblower comes forward, they do so either accepting the SEC's legitimacy (in the U.S.), from a sense of duty, or with a determination to win that award. A reasonable person would not believe that providing insignificant information will payoff.

The second major difference is an exception to the general rule that the U.S. and the E.U. prefer information they do not already possess. The U.S. makes an exception for the second whistleblower who comes forth to them (or third, fourth, etc.) if he or she is the original source of the information they give. This is a clever incentive to encourage those committing fraud to defect, even if some whistleblowers have already come clean. The effects of the rest of Dodd-Frank are unclear,⁸⁵ but the incentive divides itself as more whistleblowers come forward.⁸⁶

⁸⁰ *COM (2011)*, *supra* note 51, art. 29, § 2.

⁸¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5301 § 922 (2010) (amending The Securities Exchange Act of 1934, 15 U.S.C. 78a § 21).

⁸² *Id.*

⁸³ The SEC did not add this requirement under "original information." Original Information, 76 Fed. Reg. 34300, 34310 (Jun. 13, 2011) (amending 17 C.F.R §§ 240 and 249).

⁸⁴ Further research may uncover that courts have narrowed the definition to include substantial or important information.

⁸⁵ "The United States experience with the Dodd-Frank Act is too nascent to allow for many lessons to be drawn. However, it will be worthwhile to monitor how the bounty provisions work." Nicholas Mavrakis & Michael Legg, *Whistleblower Bounties a Novel Financial Reform*, 40 *AUS. BUS. L. REV.* 26, 41 (2012).

⁸⁶ *See* Amount of Award, 76 Fed. Reg. at 34329-31 (June 13, 2011).

A similar provision may deter European whistleblowers if they thought they may have to share the award (it would change their cost/benefit analysis); however, this is less likely to be significant when the E.U. Regulation does not give any numbers which can help a whistleblower calculate his potential monetary benefits if he or she chooses to blow the whistle. Therefore, the E.U.'s specific language is probably insignificant, and perhaps the E.U. does not want to adopt the U.S.'s exception if it does not adopt some formula for the award. But even if the E.U. does adopt a financial cost/benefit calculus, the U.S. exception may not have such a significant effect on the quantity or quality of whistleblowers.

In addition, the E.U. specifies that the information must be about potential breaches, but the U.S. has no such explicit requirement. The SEC's action, however, must be brought under "the securities laws" and must cause a successful result. There is no obvious difference to the language and practices here.

The E.U.'s third requirement is that the information, "result[] in the imposition of an administrative sanction," administrative measure, or criminal sanction.⁸⁷ The SEC must also use the information in a judicial, administrative, or related action for a whistleblower to receive an award.⁸⁸ Beyond that, a court must sanction the fraud participants at least \$1,000,000.⁸⁹ It is foreseeable that the U.S.'s glass floor may deter whistleblowers of smaller fraud to allow the amount to increase over time. After all, if the conspiracy is for \$800,000, the whistleblower may wait until it goes above \$1,000,000 to report the fraud. On the other hand, ESMA may not even wish to be burdened by such small schemes. EMSA may wish to consider a minimum money award, depending on the workload to enforce the Regulation. However, as it stands, this should encourage more whistleblowers and discourage the growth of individual conspiracies.

The E.U. Regulation explicitly prohibits the whistleblower from having a pre-existing legal or contractual duty to report information. The U.S. does not explicitly prohibit this, but Dodd-Frank exempts certain information found in situations such as during audits or investigations.⁹⁰ The Dodd-Frank list leaves the possibility of being under-inclusive. The ideal statutory language would include a list, like that of Dodd-Frank, but with open-ended language, like the E.U. Regulation.

⁸⁷ Further research will address the Regulation's criminal sanctions as a "stick" versus Dodd-Frank's notable lack of criminal sanctions.

⁸⁸ 12 U.S.C. 5301 § 922 (2010) (amending 15 U.S.C. 78a §§ 21F(a)(1) and 21F(a)(5)).

⁸⁹ *Id.*

⁹⁰ 12 U.S.C. 5301 § 922 (2010) (amending 15 U.S.C. 78a § 21F(a)(3)(C)).

2. Awards

For a whistleblower motivated by financial interests, the award is perhaps the most important element. Feldman and Lobel found that some whistleblowers are motivated by duty and legitimacy.⁹¹ This is revealing when one considers the history of much of Europe. Germany, for example, has been plagued by two dictatorships that used spies and informants to repress the nation. Guido Strack identifies one obstacle that needs to be overcome: the “psychological hurdles and the culture of silence, non-interference and misunderstood loyalty.”⁹² A change in culture is a long-term solution, but a short-term one is through financial incentives. No matter the culture, financial incentives work.⁹³

To tap into this short-term solution, Europe's regulations should be tested until finding the optimal setting. Currently, COM (2011) 651 makes awards a discretionary power of the proper authority.⁹⁴ Furthermore, COM (2011) 651 does not give any clue or suggestions as to how the authorities may determine the award amount. Because of this uncertainty in award amount, whistleblowers motivated by monetary incentives will likely be discouraged from coming forward. Radically, Dodd-Frank requires the SEC pay an award if the criteria discussed above are met.⁹⁵ Furthermore, the award to the whistleblower or group of whistleblowers will be between ten and thirty percent of the monetary sanction under Dodd-Frank.⁹⁶

Under the American system, whistleblowers may calculate their costs and benefits. Assuming the award is lucrative enough, this is a better system to attract more financially-minded whistleblowers. Considering the cultural hurdles in Europe, the E.U. and/or its member states may wish to rely on these kinds of whistleblowers and make the necessary changes.

Another running concern of whistleblowers is the legitimacy of the award and the agency. Guido Strack argues that German whistleblowers may not report indiscretions because Germans generally believe that harm will not be eliminated even if he or she sends a message.⁹⁷ Similarly, businessmen in general may naturally mistrust the government and worry

⁹¹ See Feldman & Lobel, *supra* note 79, at 1202.

⁹² Strack, *supra* note 2, ¶ 27.

⁹³ See Feldman & Lobel, *supra* note 79, at 1202; Justin R. Blount & Spencer Markel, *The End of the Internal Compliance World as We Know It, or an Enhancement of the Effectiveness of Securities Law Enforcement? Bounty Hunting Under the Dodd-Frank Act's Whistleblower Provisions*, 17 FORDHAM J. CORP. & FIN. L. 1023, 1028 (2012) (“... bounty schemes ... survive for one reason- they work. The bounty model is a win-win-model.”).

⁹⁴ COM (2011), *supra* note 51, art. 29, § 2.

⁹⁵ 12 U.S.C. 5301 § 922 (2010) (amending 15 U.S.C. 78a § 21F(b)).

⁹⁶ 12 U.S.C. 5301 § 922 (2010) (amending 15 U.S.C. 78a § 21F(b)(1)).

⁹⁷ Strack, *supra* note 2, ¶ 27.

that the award may not be duly granted. Therefore, it is imperative in both the E.U. and the U.S. that the agencies: 1) address suspicions, messages, and complaints, and 2) rightfully award deserving whistleblowers.

C. *The Issue of Whistleblower Immunity*

The final legal issue deals more with the government's use of a 'stick,' rather than a 'carrot.' Whistleblowing is not a one-time event, because oftentimes, the whistleblower wishes to continue working for the same company. However, this may present difficulties, as employers will likely resent the whistleblower for his or her actions. "Moreover, whistleblower[s] may fear blacklisting from future employers who suspect disloyalty, as well as social ostracism from their coworkers."⁹⁸ At this point, government should intervene to protect whistleblowers who not only accurately divulged securities violations, but also may have mistakenly reported a violation.

If the E.U. wants to encourage whistleblowers, it will have to protect them *ex post facto*. Proposal for Regulation No. 2011/0295's retaliation protection is left wanting.⁹⁹ Member states should institute "[a]ppropriate protection[s] for persons who report potential or actual breaches."¹⁰⁰ Dodd-Frank's protection of whistleblowers is more comprehensive, but restricts only actions of the employer "in the terms and conditions of employment."^{101, 102, 103} These provisions in effect establish a protection against employer retaliation. However, due to the nature of retaliation, it is very difficult to prove. A crucial element is to prove that the employer was motivated to discriminate against the employee because the employee had blown the whistle. Thus, a simple private right of action may not be sufficient to protect the whistleblower.

The E.U. could solve this problem if it were to adopt stronger legal protections against retaliation. In fact, the E.U. may have already bound itself to strong protections against retaliation, and perhaps stronger protections against securities retaliation. In *Heinisch v. Germany*, the European Court of Human Rights recognized whistleblowing as part of a

⁹⁸ Rapp, *supra* note 76, at 95.

⁹⁹ See *COM (2011)*, *supra* note 51, art. 29, § 2.

¹⁰⁰ *Id.*

¹⁰¹ 12 U.S.C. 5301 § 922 (2010) (amending 15 U.S.C. 78a § 21F(h)(1)(A)).

¹⁰² Similar protections and almost identical language can be found in the United States' Title VII protections against employment discrimination based on fundamental characteristics such as race, gender, national origin, religion. The Civil Rights Act of 1964, 42 U.S.C. 21 (1964).

¹⁰³ For various cultural and constitutional reasons, the United States adopted a relatively restrained protection that relies mainly on the individual's capabilities to survive the potential retaliation, in the author's opinion.

European's fundamental freedom of expression found in the Convention for the Protection of Human Rights and Fundamental Freedoms.¹⁰⁴ The Court paid particular attention to the Council of Europe's recommendations and the Revised European Social Charter's provisions protecting against employer/employment retaliation.¹⁰⁵ Thus, we see here statutory protections within an eventual judicial protection. And even though the Court primarily held that whistle blowing is a fundamental freedom, it may have said in dicta (or even in a secondary holding) that the public is certainly concerned with information on crimes that take advantage of people who, "may not be in a position to draw attention to shortcomings."¹⁰⁶ Therefore, the complex nature of securities fraud may be prime ground for legislative initiatives and legal suits if not properly addressed.

Conclusion

The European Union has some hurdles to overcome in order to effectively encourage and protect whistleblowers. Chief amongst them are: 1) legal, logistical, and political barriers to data privacy and transmission; 2) cultural biases against 'informants'; 3) financial accounting and experimentation; and 4) *ex post facto* legal protections for those who have already blown the whistle. These challenges, however, provide opportunities for the E.U. to further consolidate and integrate by developing its securities laws and agencies, pooling financial resources, and generally developing together in one direction, around one common idea. The E.U. should not necessarily emulate the United States, but should learn from the U.S.'s experiences and borrow from its strengths while avoiding its weaknesses. In order to reach this goal, further research could concentrate on the effective use of criminal sanctions against white-collar criminals, the U.S.'s *qui tam* programs of the False Claims Act and the IRS, anti-retaliation measures related to Title VII employment discrimination, and whistleblowers in anti-trust regulation in the United States and the European Union.

¹⁰⁴ Heinsich v. Germany, 2011 Eur. Ct. H.R. at ¶¶ 94-95.

¹⁰⁵ *Id.* at ¶¶ 37, 38.

¹⁰⁶ *Id.* at ¶ 71.