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Outsourcing Fraud Detection: The Analyst as Dodd-Frank Whistleblower

ABSTRACT

The Dodd-Frank Act ushers in a new era of whistleblower law. Congress, for the first time, is rewarding the providers of “independent analysis” that helps the Securities and Exchange Commission (SEC) prosecute fraud. To receive a bounty under section 922(a) of the Dodd-Frank Act, “independent knowledge” of fraud is not required. While the statute recognizes the importance of securities analysts in identifying violations, the rules interpreting this language fall short in considering and accounting for the costs to whistleblowers in the financial services industry.

This Article first argues that if SEC bounties are intended to compensate whistleblowers, the SEC’s decisions as to the size of the bounty should reflect not only the intrinsic value of the information to the SEC, but also the whistleblower’s cost of providing that information. Specifically, Rule 21F-6, which allows the SEC to consider whistleblower costs in determining the size of the award, should be changed to require the SEC to consider those costs.

Second, this Article considers the recent economic research about whistleblowers and concludes that the SEC cannot afford to discourage hedge fund managers and other buy side analysts from participating in the SEC program. To avoid that outcome, the SEC should allow these actors to “double-dip,” or collect bounties despite profiting on short positions. Finally, the SEC should clarify when “independent analysis” qualifies for a bounty.

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I. INTRODUCTION

BERNARD MADOFF’S PONZI SCHEME AND THE SCANDALS THAT AROSE during the 2008–2009 financial crisis exposed weaknesses in the financial regulatory system.¹ The market crash, followed by the scathing testimony of derivatives expert Harry Markopolos² about his nearly decade long effort to alert the government about Ma-

1. Statement by Timothy F. Geithner, U.S. Secretary of the Treasury, before the Committee on Financial Services U.S. House of Representatives 7–8 (Mar. 26, 2009), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf.

2. Harry M. Markopolos, CFA, was the 2002–2003 President of the Boston Security Analysts Society. *Past Presidents*, BOSTON SEC. ANALYSTS SOC’Y, http://www.bsas.org/BSAS_About/A03.asp (last visited Mar. 6, 2011). Membership in the Society currently includes 5,325 investment professionals. *Demographics*, BOSTON SEC. ANALYSTS SOC’Y, http://www.bsas.org/BSAS_Membership/Mship03.asp (last visited May 1, 2011). “BSAS is a founding society of the CFA Institute which has over 90,000 members globally.” *Id.* According to the CFA Institute website, there are currently 103,712 CFA Institute members globally. *Constituent Statistics*, CFA INST.,

doff, publicly embarrassed the Securities and Exchange Commission (SEC).³ These events spurred the most significant financial reform since the Great Depression.⁴ Congress realized that parts of the regulatory structure, including the SEC Enforcement Division and examiners within the Office of Compliance Inspections and Examinations (OCIE)⁵ and the Financial Industry Regulatory Authority (FINRA),⁶ need help in identifying financial fraud.⁷ If history is any guide, SEC officials will have a difficult time keeping up with innovative fraud.⁸ The government's decision to expand financial compensation for whistleblowers amounts to an admission that it needs help.⁹ Since Congress passed the first federal securities laws in 1933 and

http://www.cfainstitute.org/ethics/conduct/Pages/about_pcs.aspx (last visited May 27, 2011). Of those, 92,953 are CFA charterholders. *Id.*

3. See *Madoff Ponzi Scheme: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 10 (2009) (statement of Harry Markopolos, CFA, CFE), available at <http://online.wsj.com/public/resources/documents/MarkopolosTestimony20090203.pdf>; see also Nancy Pelosi, *Markopolos: I Gift Wrapped and Delivered the Largest Ponzi Scheme in History to the SEC*, YOUTUBE (Feb. 4, 2009), http://www.youtube.com/watch?v=uw_Tgu0txS0 (video recording of C-Span 3 live broadcast of Harry Markopolos testimony to U.S. House of Representatives Committee on Financial Services); *60 Minutes: The Man Who Knew*, (CBS television broadcast June 14, 2009), available at <http://www.cbsnews.com/video/watch/?id=5088137n&tag=mncol;lst;2>.

4. See Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J., July 16, 2010, at A1 (describing the Act as “the biggest expansion of government power over banking and markets since the Depression.”); see also U.S. Securities & Exchange Commission, In Brief FY 2011 Congressional Justification 2 (Feb. 2010), available at <http://www.sec.gov/about/secfy11congbudgjust.pdf> (“The financial crisis that began in 2008 and continues to resonate through the markets today is . . . the most serious economic and regulatory crisis this country has faced since the Great Depression.”).

5. The OCIE is the SEC's exam arm for broker-dealers, transfer agents, investment advisers, investment companies, the national securities exchanges, clearing agencies, the nationally recognized statistical rating organizations (NRSROs), self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB), and the Public Company Accounting Oversight Board (PCAOB). *Office of Compliance, Inspections, and Examinations*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/offices/ocie.shtml> (last modified Feb. 12, 2011). It is important to note that the OCIE does not examine issuers. See *id.*

6. FINRA conducts many, if not most broker-dealer exams. See *About the Financial Industry Regulatory Authority*, FIN. INDUS. REG. AUTH., <http://www.finra.org/AboutFINRA/> (last visited Feb. 12, 2011) (“FINRA oversees nearly 4,570 brokerage firms, about 163,325 branch offices and approximately 630,850 registered securities representatives.”).

7. See 156 CONG. REC. S4066 (daily ed. May 20, 2010) (Statement of Sen. Kaufman) (“Whistleblowers provide a vital early warning system to detect and expose fraud in the financial system. With the right protections, whistleblowers can help root out the kinds of massive Wall Street fraud that contributed to the current financial crisis.”).

8. See generally HARRY MARKOPOLOS, *NO ONE WOULD LISTEN: A TRUE FINANCIAL THRILLER* (2010); see also H. DAVID KOTZ, *INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME* 457 (2009).

9. See Statement of Sen. Kaufman, *supra* note 7. Between fiscal years 2005 and 2007, the SEC budget stayed flat or declined, and the agency lost 10 percent of its employees. *FY 2011 Congressional Justification*, *supra* note 4, at 2. This hampered several key areas including enforcement and examination programs. *Id.*

1934, the industry has become vastly more complex.¹⁰ The industry “has not merely mushroomed; it has exploded in size, scope and globality.”¹¹ And, in less than a generation, the number of equity issues outstanding has grown from about three to over seven thousand.¹² The SEC currently oversees more than thirty-five thousand registrants, including ten thousand public companies, seventy-eight hundred mutual funds, fifty-four hundred broker-dealers, and six hundred transfer agents.¹³ One of Markopolos’s key recommendations for dealing with the complexity is for the SEC to hire experienced brokers, traders, and back-office personnel to conduct investigations.¹⁴ “Let lawyers prosecute, not investigate,” he says.¹⁵

But should the SEC hire experts from the industry to identify fraud, or should it outsource this function?¹⁶ On July 21, 2010, Congress answered that question when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which included a new kind of whistleblower program.¹⁷

The clear legislative intent of the program is to “create incentives to report wrongdoing and protect whistleblowers.”¹⁸ But who should be rewarded for blowing the whistle? As noted earlier, due to limited resources, OCIE and FINRA examiners cannot give full attention to the complete range of regulated entities.¹⁹ On the other

10. Cornelius Hurley, *Paying the Price for Too Big to Fail*, 4 ENTREPRENEURIAL BUS. L.J. 351, 352–56 (2010) (discussing the increasing complexity in the financial services industry).

11. Clark Winter, *Tuesdays with Bernie—Some Life (and Investing) Lessons from the Madoff Affair* (2009), http://www.clarkwinter.com/wr_tings_tuesdayswithbernie.php.

12. *Id.*

13. *FY 2011 Congressional Justification*, *supra* note 4, at 2.

14. MARKOPOLOS, *supra* note 8, at 269–70.

15. *Id.* at 269.

16. Although some agencies have successfully outsourced core functions to concerned citizens, *see e.g.*, LCDR Michael Billeaudeau, *The Citizen’s Action Network: How the U.S. Coast Guard Put the “Home” in Homeland Security*, PROCEEDINGS, Spring 2009, at 33, available at <http://www.uscg.mil/proceedings/spring2009/spring2009.pdf> (The U.S. Coast Guard, for example, uses a “Citizen’s Action Network” to monitor the coastline.), unrestricted private enforcement of the securities laws under Rule 10b-5 rarely results in optimal deterrence. *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301, 1303–05 (2008) (“Law and economics scholarship teaches that it is especially difficult to achieve optimal deterrence when private parties are granted the right to enforce overbroad liability rules for financial reward.”).

17. Dodd-Frank Financial Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

18. Shruti Shah & Robert N. Walton, *The SEC’s Tricky Balancing Act*, FCPA BLOG (Nov. 8, 2010, 7:28 AM), <http://fcpablog.squarespace.com/blog/2010/11/8/the-secs-tricky-balancing-act.html>.

19. Louis A. Aguilar, Commissioner, Sec. & Exch. Comm’n, A Shared Responsibility: Preserving the Fiduciary Standard (Mar. 26, 2010), <http://www.sec.gov/news/speech/2010/spch032610laa.htm> (“Clearly, OCIE has been seriously challenged over the last decade—a time during which the number of regulated entities grew significantly, while OCIE faced declining staff and budgets.”); Lori Richards, Director, Office of Compliance In-

hand, securities analysts taken together can follow more entities: each analyst can focus his practice narrowly, leading to increased specialization. Examiners also may not know where to look for fraud within each of the entities they investigate.²⁰ Even if the examiners know where to look, they may not have the expertise necessary to interpret the data as suspicious.²¹ They may lack the formal financial training that analysts often possess.

In determining which groups to rely upon, the SEC can consider the difference between “general” and “firm specific” knowledge about how to detect fraud.²² To increase its level of “general” expertise, OCIE could hire examiners that are more competent. These examiners would be less likely to miss relatively easy cases where specialized expertise is not required. But when access to highly specialized “specific” financial expertise is required, the SEC will likely need to depend on experienced and sophisticated securities professionals. By providing financial incentives to outsiders with unique skills, the SEC could access and analyze valuable information about fraud more efficiently. With superior information, the SEC would be able to better deploy its examiners and enforcement attorneys.

Some functions cannot be outsourced. The Enforcement Division of the SEC needs attorneys to prosecute cases.²³ However, investment analysts and other fraud

spections and Examinations, Sec. & Exch. Comm’n, Speech by SEC Staff: Frequently-Asked Questions About SEC Examinations, (Jan. 17, 2008), <http://www.sec.gov/news/speech/2008/spch011708lar.htm> (“In our work as examiners, we are challenged by oversight of 5,800 broker-dealers (with more than 173,000 branch offices!), almost 11,000 investment advisers, and about 950 mutual fund complexes with more than 8,000 portfolios, and 450 transfer agents. . . . [G]overnment resources are limited, [and] we cannot examine every firm, every branch office, or every issue.”). See accompanying text at *supra* notes 12–13 for the updated numbers.

20. Common sense dictates that if OCIE could detect fraud effectively, the SEC would not need to reward whistleblowers. *Office of Compliance Inspections and Examinations*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/offices/ocie.shtml> (last modified Feb. 14, 2011) (“OCIE’s mission is to protect investors, ensure market integrity and support responsible capital formation through risk-focused strategies that: . . . prevent fraud; . . .”).

21. See David J. Baum & Maureen Whalen, *Back to the Future: Is Disbanding OCIE the Answer?*, LAW 360 (Jan. 5, 2010), <http://www.alston.com/files/Publication/bd839511-08d5-48a9-ac91-99a06488804c/Presen%20tation/PublicationAttachment/ad3115fb-debb-4ca0-851d-a0d9f5e33286/BackFuture.pdf> (arguing for the re-integration of examiners back into policymaking divisions in order to “immerse them in the subject matter with which they deal during inspections and examinations”).

22. Cf. Michael C. Jensen & William H. Meckling, *Specific and General Knowledge, and Organizational Structure*, at 1, in MICHAEL C. JENSON, FOUNDATIONS OF ORGANIZATIONAL STRATEGY (1998), available at <http://business.illinois.edu/aibrahim/readings/Specific%20and%20General%20Knowledge.pdf> (“We define *specific knowledge* as knowledge that is costly to transfer among agents and *general knowledge* as knowledge that is inexpensive to transmit. Because it is costly to transfer, getting specific knowledge used in decision-making requires decentralizing many decision rights in both the economy and in firms.”).

23. *About the Division of Enforcement*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/enforce/about.htm> (last visited Mar. 4, 2011).

detection specialists²⁴ that the SEC could hire to detect fraud might not only lack the specialized knowledge of their peers in the industry, they may lack motivating financial incentives. Although hiring experts can help the SEC in some areas,²⁵ it is often better for the SEC to work with experts on the outside. Financial rewards for government employees are difficult to assign and disburse.²⁶ SEC officials are public servants.²⁷ Thus, it would be politically impossible to lavishly reward SEC officials for doing their jobs well.²⁸ And it would seem to make sense to outsource a considerable part of the fraud identification apparatus to expert whistleblowers.

However, regulators must ensure that the benefits of whistleblower incentives exceed any negative consequences. Part II of this Article will outline the statutory whistleblower program and Rule 21F (“Rule 21F” or “the Rule,”), which governs its implementation.²⁹ Part III will analyze whistleblower incentives, define the term “whistleblower,” and examine the factors that drive whistleblowing.³⁰ It will then explain why financial incentives are more effective than non-financial incentives.³¹ Part IV will examine the consequences analysts suffer when they blow the whistle, and argue that the SEC should encourage analysts (especially on the buy side)³² to

24. Perhaps the best known professional designation for fraud detection specialists is the Chartered Fraud Examiner designation. See *Become a CFE*, ASS’N OF CERTIFIED FRAUD EXAMINERS, <http://www.acfe.com/membership/becoming-cfe.asp> (last visited Mar. 5, 2011) (“Globally preferred by employers, the Certified Fraud Examiner (CFE) credential denotes proven expertise in fraud prevention, detection, and deterrence.”).

25. See, e.g., Zachary A. Goldfarb, *At SEC, an Unconventional New Team; Agency Hiring More Experts, Professionals to Help Assess Complex Financial Systems*, WASH. POST, June 15, 2010, at A10 (stating that the SEC hired a nuclear physicist to draw conclusions from “chaotic information”).

26. HOWARD RISHER & CHARLES H. FAY, *NEW STRATEGIES FOR PUBLIC PAY: RETHINKING GOVERNMENT COMPENSATION PROGRAMS 1* (1997) (describing the growing consensus that compensation programs for public sector employees do not work and hinder reinvention of government).

27. Luis A. Aguilar, Commissioner, Sec. & Exch. Comm’n, *Speech by SEC Commissioner: Answering the Call to Public Service on Behalf of Investors* (Feb. 22, 2010), <http://www.sec.gov/news/speech/2010/spch022210laa.htm> (last visited Mar. 8, 2011).

28. SEC employees are already among the highest paid in federal government. Danielle Kurtzleben, *The Top Paid Federal Employees*, U.S. NEWS AND WORLD REPORT (Nov. 30, 2010), <http://www.usnews.com/news/articles/2010/11/30/the-top-paid-federal-employees> (according to the U.S. Office of Personnel Management, the average SEC employee earns \$147,475 per year; the average federal civilian employee earns \$74,311).

29. See *infra* Part II.

30. See *infra* Parts III.A–B.

31. See *infra* Parts III.C–D.

32. *Buy Side*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/buyside.asp> (last visited Apr. 13, 2011) (The “buy side” is “[t]he side of Wall Street comprising the investing institutions such as mutual funds, pension funds and insurance firms that tend to buy large portions of securities for money-management purposes. The buy side is the opposite of the sell side entities, which provide recommendations for upgrades, downgrades, target prices and opinions to the public market. Together, the buy side and sell side make up both sides of Wall Street.”). For reasons given below in the last paragraph of section III, *infra*, this author believes that the SEC

participate in the program by not penalizing them for “double-dipping” by taking a short position and then seeking a bounty.³³ Part V will conclude briefly.

II. THE SEC WHISTLEBLOWER PROGRAM

A. *The Statute*

Section 922(a) of the Dodd-Frank Act, to be codified at section 21F of the Securities Exchange Act of 1934 (“Exchange Act”), provides that:

In any covered judicial or administrative action, or related action, the [SEC], under regulations prescribed by the [SEC] . . . shall pay an award or awards to 1 or more whistleblowers who voluntarily provided original information to the [SEC] that led to the successful enforcement of the covered judicial or administrative action, or related action, in an aggregate amount equal to—(A) not less than 10 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions; and (B) not more than 30 percent [of the same].³⁴

Section 922(a) defines a “covered judicial or administrative action” as “any judicial or administrative action brought by the [SEC] under the securities laws that results in monetary sanctions exceeding \$1,000,000.”³⁵

Section 922(a) marks the first time the SEC has offered financial incentives to whistleblowers for information leading to the successful enforcement of securities law violations other than insider trading.³⁶ Before Dodd-Frank, the Insider Trading and Securities Fraud Act of 1988 (“Insider Trading Act of 1988” or “1988 Act”) permitted the SEC to reward individuals who provided the SEC with information on insider trading.³⁷ But the SEC made few awards. Prior to a July 23, 2010 award for \$1,000,000, the SEC had “awarded a total of \$160,000 to five claimants in the

should be cognizant that buy side analysts will be more likely to provide viable leads than their sell side counterparts.

33. See *infra* Part IV.

34. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 124 Stat. 1376, 1842 (2010) (to be codified at 15 U.S.C. § 78u-6(b)(1)). For a discussion of the term “whistleblower,” see *infra* Part III.A.

35. Dodd-Frank Act § 922(a).

36. See Phyllis Diamond, *Regulatory Reform: Whistleblower Bounty Provision Will Have Large Impact, Washington Lawyer Predicts*, BNA SEC. LAW DAILY, Sept. 21, 2010. Section 922(a) provides for awarding bounties for information about violations of “the securities laws.” Dodd-Frank Act § 922(a). The “securities laws” include the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002, and, presumably, the Dodd-Frank Act of 2010. See *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/laws.shtml> (last visited Mar. 5, 2011).

37. The 1988 Act expanded on the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

twenty years since it received the statutory authority to award bounties in insider trading cases.”³⁸ Indeed, on March 29, 2010, the SEC Inspector General had issued a report criticizing the SEC for making too few bounty awards.³⁹

Also, section 922(a), unlike the Insider Trading Act of 1988, *guarantees* a bounty for eligible whistleblowers.⁴⁰ And it says that the bounty shall be “not less than 10 percent” of the money recovered.⁴¹ Although the SEC retains discretion to award less than 10 percent to a particular whistleblower in cases where information leading to a single enforcement action comes from multiple original sources (“the [SEC] . . . shall pay an award . . . to 1 or more whistleblowers”),⁴² it is significant that Congress set a floor. The “award” can never be less than \$100,000, whether shared between multiple whistleblowers or not.⁴³ By contrast, the Insider Trading Act of 1988 only provided for a bounty “not to exceed 10 percent,”⁴⁴ meaning that the SEC has discretion *not* to award a bounty at all, even when the whistleblower technically qualifies.⁴⁵

Moreover, the bounty in section 922(a) is calculated from “monetary sanctions,” defined as including “any monies, including penalties, disgorgement[s] and interest,”⁴⁶ and “any monies deposited into a disgorgement fund . . . pursuant to section 308(b) of the Sarbanes-Oxley Act of 2002.”⁴⁷ Under the Insider Trading Act of 1988, the bounty was calculated from *penalties* imposed and recovered by the SEC or Attorney General.⁴⁸ Under the 1988 Act, all discretion as to whether or not to award a bounty remained with the SEC.⁴⁹ Thus, section 922(a) describes the eligible monetary sanctions from which the bounty can be calculated in more sweep-

38. *U.S. SEC Awards \$1 Million Bounty for Information Leading to an Insider Trading Action*, GIBSON DUNN (July 27, 2010), <http://www.gibsondunn.com/publications/pages/SECAwards1MillionDollarBounty-InsiderTradingAction.aspx> (stating that the SEC paid a \$1,000,000 bounty for information leading to the May 2010 action against Pequot Capital Management, Inc. (“Pequot”), its chairman and CEO, Arthur J. Samberg, and David Zilkha, an employee of Microsoft and later, Pequot.).

39. OFFICE OF AUDITS, U.S. SEC. & EXCH. COMM’N, REPORT NO. 474, ASSESSMENT OF THE SEC’S BOUNTY PROGRAM (2010), available at <http://www.sec-oig.gov/reports/auditsinspections/2010/474.pdf>

40. Dodd-Frank Act § 922(a).

41. *Id.*

42. *Id.* (emphasis added).

43. *Id.*

44. 15 U.S.C. § 78u-1(e) (2006). The Dodd-Frank Act struck this section from the Code. Dodd-Frank Act § 923(b)(2)(B).

45. 15 U.S.C. § 78u-1(e) (2006).

46. Dodd-Frank Act § 922(a).

47. *Id.* (to be codified at 15 U.S.C. § 78u-6(a)(4)(B)).

48. 15 U.S.C. § 78u-1(e) (2006). The Dodd-Frank Act struck this section from the Code. Dodd-Frank Act § 923(b)(2)(B).

49. Application for Bounty Awards on Civil Penalties Imposed in Insider Trading Litigation, Exchange Act Release No. 26,994, 43 SEC Docket 1964 (June 30, 1989).

ing terms than its statutory predecessor.⁵⁰ One consequence of the expansive language is that under section 922(a), part of the whistleblower's award is carved out from the amounts collected to compensate fraud victims.⁵¹

Finally, if the SEC determines that the whistleblower is eligible for an award, the agency must decide the size of the award within the boundaries of the statute and implementing Rule.⁵² Section 922(a) requires that the SEC consider the following factors:

(I) [T]he significance of the information provided by the whistleblower to the success of the covered judicial or administrative action; (II) the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action; (III) the programmatic interest of the [SEC] in deterring violations of the securities laws by making awards to whistleblowers who provide information that lead to the successful enforcement of such laws; and (IV) such additional relevant factors as the [SEC] may establish by rule or regulation. . . .⁵³

Unfortunately, these statutory factors do not consider the costs to whistleblowers and the dangers they face.⁵⁴ Congress, in enacting the statute, appeared focused on the value of the information provided, while ignoring the costs. For instance, under the Dodd-Frank Act, the benchmark from which the SEC will calculate a whistleblower's reward is the agency's monetary recovery.⁵⁵ Thus, if the SEC does

50. Compare 15 U.S.C. § 78u-1(e) (2006) (calculation of eligible bounty from monetary sanctions collected from penalties), with Dodd-Frank Act § 922(a) (calculation of eligible bounty from monies including penalties, interest, and disgorgement).

51. Under section 308 of The Sarbanes-Oxley Act of 2002, civil penalties are added to a fund for the benefit of fraud victims. 15 U.S.C. § 7246(a) (2006). The language of section 922(a) includes these funds in the term "monetary sanctions" eligible to calculate a bounty. Dodd-Frank Act § 922(a). Matthew Lee, former Senior Vice President Financial Control for Lehman Brothers and Repo 105 whistleblower, argues that "the prime purpose of whistle blowing is to protect the Public from loss." Letter from Matthew Lee, Former Senior Vice President Financial Control, Lehman Brother, to Sec. & Exch. Comm'n. (Dec. 13, 2010), <http://www.sec.gov/comments/s7-33-10/s73310-119.pdf> (last visited Apr. 19, 2011). If protecting the public from public loss is the highest priority, then one must be careful not to give whistleblowers windfalls at the expense of fraud victims. For an explanation of Repo 105, see *infra* note 279.

52. See Dodd-Frank Act § 922(a); see also *infra* Part II.B.2.

53. Dodd-Frank Act § 922(a).

54. It did, however, occur to the SEC to consider costs to whistleblowers. Proposed Rule 21F-6 includes eleven "permissible factors" the SEC may consider in determining the size of the award. *Proposed Rules, infra* note 61, at 70,499-500. One of these factors is whether the whistleblower experienced "[a]ny unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action." *Id.* at 70,500. Unfortunately, because of the SEC's characterization of this factor as merely a "permissible" factor, the SEC is not required to consider it. See *id.*

55. See Dodd-Frank Act § 922(a).

not recover money, then the whistleblower receives nothing, even though she may have taken a costly risk in sharing her “original information” with the SEC.⁵⁶ This problem is acute when the SEC uses the whistleblower’s information to obtain equitable relief, such as an injunction or a declaration, but fails to recover any funds.⁵⁷ The Dodd-Frank Act leaves the whistleblower completely unrewarded in this situation, reducing the effectiveness of the program.⁵⁸

A better approach would be for the SEC to always base a bounty on both the information’s value to the SEC and the costs to the whistleblower. When the costs to the whistleblower are high, the bounty would be higher. And when the costs are low, as would be the case if the SEC responded immediately to the whistleblower’s concerns, the bounty would be lower. Ultimately, if financial incentives are intended to offset costs to the whistleblower, the SEC should consider them when deciding the size of the award.⁵⁹

B. Rule 21F⁶⁰

To understand the whistleblower program, it is essential to take into account the rules for implementing section 922(a) of the Dodd-Frank Act.⁶¹ To be credible in the Dodd-Frank era, the SEC must exercise discretion in a reasonable manner. If the SEC fails to pay sufficient bounties to deserving whistleblowers, or if it fails to award bounties consistently in similar cases or unreasonably discriminates against

56. Lori Pizzani, *Blowing It*, CFA MAG., Jan.–Feb. 2011, at 32, 35–37.

57. See *supra* notes 37–39 and accompanying text (discussing the SEC’s reluctance under the Insider Trading Act of 1988 to make monetary awards, which totaled only \$160,000 in the more than twenty years following passage of the bill, notwithstanding a \$1,000,000 award in 2010).

58. See Pizzani, *supra* note 56, at 36–37. From an economics perspective, that might not be a bad result. Arguably, the value of the information to the SEC is zero when no monetary sanction is recovered. However, the information does have value because it enables the SEC to bring enforcement actions and enjoin securities violations. See Press Release, Sec. & Exch. Comm’n, *SEC Proposes New Whistleblower Program Under Dodd-Frank Act* (Nov. 3, 2010), <http://www.sec.gov/news/press/2010/2010-213.htm>.

59. In deciding how to measure costs to whistleblowers, the SEC could study the methodology Kenneth Feinberg used to compensate the victims of the 9/11 World Trade Center attacks. See Brendan I. Koerner, *How Are 9/11 Victims Paid*, SLATE (Dec. 23, 2003, 6:17 PM), <http://www.slate.com/id/2093166/> for a description of that methodology.

60. The SEC issued final Rule 21F just a few days before this Article went to print. The issuance of the final Rule does not change the analysis or thesis of this Article.

61. Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 64545, <http://www.sec.gov/rules/final/2011/34-64545.pdf> (to be codified at 17 C.F.R. pts. 240, 249) (May 25, 2011) [hereinafter *Final Rules*]; see also Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 63237, 75 Fed. Reg. 70,488 (Nov. 3, 2010) [hereinafter *Proposed Rules*]. This section does not pretend to summarize Rule 21F in all its aspects. Rather, it focuses on the elements of the rule that will likely be of greatest concern to analyst whistleblowers.

certain groups, the agency could lose credibility. However, if the SEC manages the program evenhandedly, it will gain in influence and effectiveness.

1. *Payment of a Bounty*

The incentive structures of the whistleblower program are complex.⁶² Rule 21F defines who qualifies as a whistleblower eligible for an award.⁶³ Most fundamentally, the whistleblower must provide “original information.”⁶⁴ Rule 21F-4(b)(1) defines “original information” as information derived from the whistleblower’s independent knowledge or analysis; is not already known to the SEC from any other source, unless the whistleblower is the original source of the information; is not exclusively derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information; and is provided to the SEC for the first time after July 21, 2010 (the date of enactment of the Dodd-Frank Act).⁶⁵

Paragraph (2) of Rule 21F-4(b) defines “independent knowledge” as “factual information in the whistleblower’s possession that is not obtained from publicly available sources.”⁶⁶ Publicly available sources include “both sources that are widely disseminated . . . and sources that, though not widely disseminated, are generally available to the public . . .”⁶⁷ Significantly, the definition of “independent knowledge” does not require “direct, first-hand knowledge of potential violations.”⁶⁸ Thus, under Rule 21F-4(b)(2), a whistleblower could qualify as having “independent knowledge” even if she obtained it “from any of [her] experiences, observations, or communications . . .”⁶⁹ However, a whistleblower who only reports mere

62. See generally Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1157–73 (2010) (arguing it is possible to break down the incentives governments inject into their regulatory structures into three categories: anti-retaliation protections, affirmative reporting duties and liability for failure to report, and monetary incentives).

63. See *Final Rules*, *supra* note 61, at 7–203; see also *Proposed Rules*, *supra* note 61, at 70,489.

64. *Proposed Rules*, *supra* note 61, at 70,491–92 (Proposed Rule 21F-4(b)). For the statutory language, see Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376, 1841–42 (2010) (to be codified at 15 U.S.C. § 78u-6(a)(3)(B)).

65. *Final Rules*, *supra* note 61, at 39. “The first three requirements recited the definition of “original information” found in Section 21F(a)(3) of the Exchange Act.” *Id.* at 39–40. Rule 21F-4(b)(1) is adopted as proposed. *Id.* at 41; see also *Proposed Rules*, *supra* note 61, at 70,491.

66. *Final Rules*, *supra* note 61, at 43–44. Rule 21F-4(b)(2) is adopted as proposed. *Id.* at 43; see also *Proposed Rules*, *supra* note 61, at 70,492.

67. *Final Rules*, *supra* note 61, at 44, 46.

68. *Id.*

69. *Id.* The definition for independent knowledge “is subject to the exclusion for knowledge from public sources, and subject further to the exclusions set forth in Rule 21F-4(b)(4).” *Id.*

“factual information” contained in public SEC filings would not be deemed to have “independent knowledge.”⁷⁰

Under section 922(a) of the Dodd-Frank Act, the whistleblower’s “independent analysis” can be original information.⁷¹ Rule 21F-4(b)(3) defines ‘independent analysis’ to mean the whistleblower’s “own examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public.”⁷² The SEC further stated that “there are circumstances where individuals can review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to the [SEC] staff in understanding complex schemes and identifying securities violations.”⁷³ Information gathered from public sources can often be analyzed in a new way. The *In re Merck & Co., Inc. Securities Litigation*⁷⁴ case, discussed below in Part IV.C, illustrates this point.⁷⁵

For public policy reasons, Rule 21F-4(b)(4) provides six exclusions where information cannot qualify as original information.⁷⁶ The exclusions that apply to attorneys,⁷⁷ certain responsible personnel, compliance officers, and independent pub-

70. See *Final Rules*, *supra* note 61, at 44, 46; see also *Filings & Forms*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/edgar.shtml> (last visited Apr. 19, 2011) (“All companies, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through EDGAR. Anyone can access and download this information for free.”).

71. Dodd-Frank Act § 922(a).

72. *Final Rules*, *supra* note 61, at 48; see also *Proposed Rules*, *supra* note 61, at 70,492. “Independent analysis means your own analysis, whether done alone or in combination with others.” *Final Rules*, *supra* note 61, at 248. Rule 21F-4(b)(3) is adopted as proposed, “with a slight modification to clarify that ‘independent analysis’ can be based upon the whistleblower’s evaluation of publicly available sources.” *Id.* at 50. The final Rule clarifies that an award “will primarily depend . . . on an evaluation of whether the analysis is of such high quality that it either causes the staff to open an investigation, or significantly contributes to a successful enforcement action.” *Id.* See *infra* notes 260–90 and accompanying text for a discussion of agency problems.

73. *Final Rules*, *supra* note 61, at 48; see also *Proposed Rules*, *supra* note 61, at 70,492.

74. 432 F.3d 261 (3d Cir. 2005).

75. See *infra* Part IV.C.

76. *Final Rules*, *supra* note 61, at 53 (the exclusions are set forth in Rules 21F-4(b)(4)(i–vi)). The exclusions were an area of significant revision from the proposed rules. See *id.*

77. Proposed Rules 21F-4(b)(4)(i–ii) are adopted with several modifications. *Final Rules*, *supra* note 61, at 59–60 (“First, we have modified the language to clarify that both exclusions apply to non-attorneys Second, we have modified [the second exclusion] to clarify that it applies to attorneys who work in-house for an entity and provide legal services”); see also *Proposed Rules*, *supra* note 61, at 70,492–93 (“The first proposed exclusion is for information that was obtained through a communication that is subject to the attorney-client privilege. . . . The second [proposed] exclusion applies when a would-be whistleblower obtains information as a result of the legal representation of a client on whose behalf the whistleblower’s services . . . have been retained, and the person seeks to make a whistleblower submission for his or her own benefit. . .”).

lic accountants,⁷⁸ are “narrowly-focused, and promote the goal of ensuring that the persons most responsible for an entity’s conduct and compliance with law are not incentivized to promote their own self-interest at the possible expense of the entity’s ability to detect, address, and self-report violations.”⁷⁹ As adopted, the Rule “permits such individuals to become whistleblowers under certain circumstances.”⁸⁰

In its exclusions, the SEC is responding to corporate concerns that the law would undermine anonymous hotlines set up under the 2002 Sarbanes-Oxley Act to encourage internal reporting of wrongdoing.⁸¹ Companies worry that whistleblowers will bypass those programs and report directly to the SEC.⁸² Under the proposed rules, the exclusions are broad and would cease to apply if the entity fails to disclose the information received from the whistleblower to the SEC within a “reasonable

78. The proposed rules covering responsible personnel, compliance officers, and independent public accountants proposed exclusions that would make it difficult for these employees to collect awards. *Proposed Rules*, *supra* note 61, at 70,493–94. Under the proposed rules, employees for an entity with legal, compliance, audit, supervisory or governance responsibility, and persons who receive information from those employees, were excluded from receiving an award “unless the entity does not disclose the information to the [SEC] within a reasonable time or if the entity proceeds in bad faith,” *Id.* at 70,493. The final Rule significantly revised the proposed rule to create a better balance and make it possible for some of these employees to receive an award under certain circumstances. *Final Rules*, *supra* note 61, at 53; *see id.* at 69 (“we do not think it serves the purpose of Section 21F to apply this principle in a manner that creates expansive new exclusions for broad categories of company personnel”); *see also infra* notes 88–92 and accompanying text (creating exceptions to the exclusions).

79. *Final Rules*, *supra* note 61, at 54–55.

80. *See supra* note 78; *see also infra* notes 88–92 and accompanying text.

81. Jessica Holzer & Ashby Jones, *SEC Proposes Rules for Bounties*, WALL ST. J., Nov. 4, 2010, at B4.

82. Bruce Carton, *Pitfalls Emerge in Dodd-Frank Whistleblower Bounty Provision*, SEC. DOCKET (Sept. 9, 2010, 3:37 PM), <http://www.securitiesdocket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision/> (“Most often heard is the complaint that the law provides a huge incentive for employees to race to the SEC’s door, so they can be the first to provide the agency with ‘original information’ leading to an enforcement action.”); Steve Quinlivan, *SEC’s Proposed Whistleblower Rules—The Good, Bad and Ugly*, DODD-FRANK.COM (Nov. 3, 2010), <http://dodd-frank.com/sec%E2%80%99s-proposed-whistleblower-rules%E2%80%94the-good-bad-and-ugly/> (“The concern is employees will run to the SEC to report violations instead of advising the employer of the misconduct and permitting the employer to take appropriate action.”). However, according to whistleblower attorney Eric Havian (and this author agrees), “the internal reporting argument is bogus.” Melanie Rodier, *Wall Street Fights New Whistleblower Law*, WALL ST. & TECH. (Feb. 11, 2011), http://www.wallstreetandtech.com/articles/229218465?cid=nl_wallstreettech_daily. According to Havian, “[It] is the new corporate line to kill the SEC whistleblower law. And it’s absolutely baseless.” *Id.* Another whistleblower attorney addressed the internal reporting argument: “The essence of their argument is that big corporations can police themselves and provide adequate forums for employees to report wrongdoing. This position may be true, for say, a report of an employee who is stealing from the cash register of a big-box store. But this does not make sense where the company is following a corporate policy of stealing from consumers or cheating shareholders or investors. A corporation simply cannot police itself when its senior officials are the culprits.” Reuben Guttman, *Fraudsters Lobby to Muzzle Whistleblowers*, MARKETWATCH (Feb. 8, 2011, 11:49 AM), <http://www.marketwatch.com/story/fraudsters-lobby-to-muzzle-whistleblowers-2011-02-08>. Nonetheless, whether the whistleblower program discourages employees from reporting internally before going to the SEC may be a good topic for future research.

time” or if it proceeds in “bad faith.”⁸³ The revised rules take a markedly different approach. Rules 21F-4(b)(4)(iii)(A–C) identify “by title or function specific categories of personnel to whom the rules apply.”⁸⁴ The exclusions apply to officers, directors, trustees, partners, compliance officers, auditors, and investigators.⁸⁵ For officers, directors, trustees, and partners, the Rule applies “whenever one of the designated persons is “informed . . . of allegations of misconduct,” regardless of whether the communication was made “with the reasonable expectation [the recipient] would take steps to cause the entity to respond appropriately to the violation.”⁸⁶ Paragraph (D) of Rule 21F-4(b)(4)(iii) “excludes information that is learned by employees of . . . a public accounting firm through and audit . . . or other engagement required under the federal securities laws”⁸⁷

Rule 21F-4(b)(4)(v) sets forth three exceptions to the application of Rule 21F-4(b)(4)(iii).⁸⁸ Satisfaction of any of these exceptions allows the designated person to receive an award.⁸⁹ The first exception applies “when the designated person has a reasonable basis to believe that disclosure of the information to the [SEC] is necessary to prevent . . . substantial injury to the financial interest or property of the entity or investors.”⁹⁰ The second exception applies “when the designated person has a reasonable basis to believe that the entity is engaging in conduct that will impede an investigation of the misconduct.”⁹¹ The third exception takes effect after at least 120 days have elapsed since the whistleblower reported the information to the audit committee, chief legal officer, chief compliance officer, or to the whistleblower’s supervisor, if the whistleblower received it under circumstances indicating that the relevant person was already aware of the information.⁹²

Rule 21F-4(b)(iv) as adopted slightly weakens the proposed rule that would have excluded from the definition of “independent knowledge” information obtained unlawfully.⁹³ The Rule as adopted modifies the proposed rule by requiring a domestic court to determine that the information was obtained in a manner that violated applicable state or federal law.⁹⁴ Likewise, Rule 21F-4(b)(4)(vi) modifies the

83. *Proposed Rules*, *supra* note 61, at 70,493.

84. *Final Rules*, *supra* note 61, at 69–72.

85. *Id.*

86. *Id.* at 70.

87. *Id.* at 72–73.

88. *Id.* at 73–75.

89. *Id.* at 73–74.

90. *Id.* at 74.

91. *Id.* at 75.

92. *Id.* at 75–77.

93. *See id.* at 79–80.

94. *Id.*

proposed rule that would have excluded all information if the whistleblower obtained the information from a person subject to another exclusion.⁹⁵ The Rule as adopted creates an exception to the exclusion: if “the information is not excluded from that person’s use,⁹⁶ or the whistleblower is providing the [SEC] with information about potential violations involving that person,” then the whistleblower can receive an award.⁹⁷

2. Size of the Bounty

If the SEC determines that a bounty is due, the agency must determine its size. In addition to the mandatory factors Congress set forth in the statute for determining the ultimate size of the award within the 10 to 30 percent range,⁹⁸ Rule 21F-6 allows for eleven “permissible considerations” in determining the size of the award.⁹⁹ For our purposes, the most important consideration is the sixth one listed, namely that the SEC *may* consider “any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action.”¹⁰⁰

The Rule gives wholly too much discretion to the SEC. This Article argues that because of the undeniable costs that whistleblowers experience,¹⁰¹ and the historical failure to compensate for those costs,¹⁰² the SEC should *always* consider costs to whistleblowers when considering the size of awards. Further, the word “unique” in the phrase “unique hardships” allows the SEC to interpret some grave costs as commonplace and therefore not deserving of consideration.

C. Reaction

On May 25, 2011, the SEC issued final Rule 21F¹⁰³ in a 3-2 vote split along ideological lines.¹⁰⁴ Whistleblower advocates were pleased, largely because the SEC sided

95. *Id.* at 81.

96. This phrase “is intended to be purely derivative; i.e., if the person from whom the information is free to use the information in a submission . . . then this rule does not bar use of the information.” *Id.* at 82.

97. *Id.*

98. See *supra* note 53 and accompanying text for the statutory factors. For the statutory language giving the range of potential awards, see *supra* note 34 and accompanying text. In addition to the statutory factors, Rule 21F-6 also requires the SEC to consider “whether an award otherwise enhances the [SEC’s] ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers.” *Final Rules, supra* note 61, at 119.

99. *Final Rules, supra* note 61, at 119; *Proposed Rules, supra* note 61, at 70,499–500.

100. *Final Rules, supra* note 61, at 119; *Proposed Rules, supra* note 61, at 70,500.

101. See *infra* Part IV.A.

102. See *infra* Part III.C.

103. *Final Rules, supra* note 61.

with whistleblowers over business interests on the critical issue of whether corporate whistleblowers would be required to report internally before reporting to the SEC.¹⁰⁵ Tom Devine of the Government Accountability Project said: “Yesterday the SEC took the high road to strengthen the role of whistleblowers against corporate fraud. It rejected demands by a big business ‘fraud lobby’ and House Republicans to twist whistleblowing into obstruction of justice.”¹⁰⁶

On the other side of the spectrum, David Hirschmann of the U.S. Chamber of Commerce’s Center for Capital Markets said in a statement that “[n]ot informing a company of a potential fraud and waiting for the SEC to act is the equivalent of not calling the firefighters down the street to put out a raging fire.”¹⁰⁷

III. WHISTLEBLOWER INCENTIVES

The United States has a long history of encouraging whistleblowers.¹⁰⁸ In fact, U.S. citizens “blow the whistle on waste, fraud, and abuse more than anywhere else in the world.”¹⁰⁹ This section reviews the reasons why whistleblowing is so prevalent, and examines two strategies the U.S. government has used to encourage whistleblowers to come forward, namely protection from employer retaliation, and financial incentives.

A. Definition of “Whistleblower”

The Dodd-Frank Act formally defines a whistleblower as “any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the [SEC], in a manner established, by rule or reg-

104. Edward Wyatt, *S.E.C. Adopts Its Revised Rules for Whistle-Blowers*, DEALBOOK (May, 25, 2011, 7:52 PM), <http://dealbook.nytimes.com/2011/05/25/s-e-c-adopts-final-rules-for-whistle-blowers/> (“The changes from the original proposals, which attracted 240 comments and more than 1,300 form letters, were not enough for the S.E.C.’s two Republican commissioners, Kathleen L. Casey and Troy E. Paredes, who both voted against the rules.”).

105. Dylan Blaylock, *SEC Whistleblower Rules a Win-Win*, GOV’T ACCOUNTABILITY PROJECT (May 26, 2011), <http://www.whistleblower.org/blog/31-2010/1135-sec-whistleblower-rules-a-win-win>; *see also supra* note 82.

106. *Id.* “Whistleblowers will have the choice of where to bring their evidence to maximize their effectiveness.” *Id.* The good news for whistleblowers did not end there. *See id.* The SEC revised the proposed rules to permit disclosures by auditors, compliance officers and others with similar duties. *Id.*; *see also supra*, notes 88–92.

107. Ashby Jones, *Corporate America Not Totally Thrilled With New Whistleblower Rules*, LAW BLOG (May 25, 2011, 11:50 AM), <http://blogs.wsj.com/law/2011/05/25/corporate-america-not-totally-thrilled-with-new-whistleblower-rules/>.

108. ROBERTA ANN JOHNSON, WHISTLEBLOWING: WHEN IT WORKS—AND WHY 3–23 (2003) (describing how and why whistleblowing is a part of the cultural landscape).

109. *Id.* at 3, 19.

ulation, by the [SEC].”¹¹⁰ This definition is both broader and narrower than previous academic definitions.

According to whistleblower researcher Roberta Ann Johnson, “an agreed upon definition” of the term “whistleblower” includes four parts:

*(1) An individual acts with the intention of making information public; (2) the information is conveyed to parties outside the organization who make it public and a part of the public record; (3) the information has to do with possible or actual nontrivial wrongdoing in an organization; and (4) the person exposing the agency is not a journalist or ordinary citizen, but a member or former member of the organization.*¹¹¹

As discussed above, for information to be “original,” section 922(a) requires that it be based upon “independent knowledge” or “independent analysis.”¹¹² There is no requirement that a whistleblower be “a member or former member of the organization.”¹¹³ As such, although a whistleblower is unlikely to be a journalist because of the “original information” requirement, a whistleblower under the Rule may be a private citizen with no formal present or past affiliation with the organization.¹¹⁴ In this scenario, the “original information” is likely to be based on “independent analysis” rather than “independent knowledge.” Of course, an analyst can perform “independent analysis” on an entity other than the analyst’s employer. Thus, Johnson’s first and third factors, but not the second and fourth, are consistent with the definition set forth in section 922(a) for an eligible whistleblower.¹¹⁵ And consequently, the new definition of “whistleblower” in the Dodd-Frank era modifies the definition for the securities context: (1) An individual acts with the intention of making information public; (2) the information relates to possible or actual nontrivial wrongdoing in an organization; and (3) the information provided pertains to possible securities violations.¹¹⁶

110. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376, 1842 (2010) (to be codified at 15 U.S.C. § 78u-6(a)(6)).

111. JOHNSON, *supra* note 108, at 3–4. Professor Brian Martin has another definition: “Whistleblowing is an open disclosure about significant wrongdoing made by a concerned citizen, totally or predominantly motivated by . . . wrongdoing in a particular role and initiates the disclosure of her or his own free will to a person or agency capable of investigating the complaint and facilitating the correction of wrongdoing.” Pizzani, *supra* note 56, at 35 (quoting BRIAN MARTIN, *THE WHISTLEBLOWER’S HANDBOOK: HOW TO BE AN EFFECTIVE RESISTER* (1999)).

112. See *supra* note 65 and accompanying text.

113. See *supra* notes 71–73 and accompanying text.

114. *Id.*

115. Compare JOHNSON, *supra* note 108, at 3–4 with Dodd-Frank § 922(a).

116. *Id.*

B. Whistleblowing in the United States

According to Johnson, five factors explain the prevalence of whistleblowing in the United States: “(1) changes in the bureaucracy, (2) the wide range of laws encouraging whistleblowing, (3) the federal and state whistleblower protections, (4) institutional support for whistleblowers, and (5) a culture that often values whistleblowing.”¹¹⁷ This Part will cover the first, fourth, and fifth factors, and the second and third factors will be discussed below.

Does the professionalization of bureaucracies contribute to the rising number of whistleblowers?¹¹⁸ This theory suggests “[s]pecially trained experts may feel that they have a distinct perspective on public problems . . . , one that may be nonnegotiable.”¹¹⁹ The theory applies most directly to the hiring of scientists and engineers to staff federal health, safety, and environmental protection programs.¹²⁰ However, securities industry professionals may feel just as compelled to report wrongdoing as engineers and scientists working for energy or pharmaceutical companies.¹²¹

Do institutions in the United States encourage whistleblowing?¹²² News organizations, for example, help whistleblowers reach their audience.¹²³ Johnson highlights two other factors that are specific to the United States: “(1) the system of divided government (checks and balances), and (2) the American propensity to form or-

117. See JOHNSON, *supra* note 108, at 4.

118. *Id.* at 5.

119. *Id.*

120. *Id.*

121. Analysts who view themselves as professionals (in the true sense of the word) are more likely to report misconduct. See Marshall D. Ketchum, *Is Financial Analysis a Profession?*, FINANCIAL ANALYSTS J., Nov.–Dec. 1967, at 33, 33 (“(a) A profession is a higher-grade, non-manual occupation. . . implies that the intellectual, or practical, technique involved depends on a substantial theoretical foundation.”) (quoting a table in GEOFFREY MILLERSON, *THE QUALIFYING ASSOCIATION, A STUDY IN PROFESSIONALISM* (1964)). “Presence, or absence, of a code of professional conduct” is not a determinative factor in determining professionalization, but it bears mentioning that in 1967 CFA charterholders were bound to a code of professional conduct. *Id.* at 34; see also *Code of Ethics and Standard of Professional Conduct*, CFA INST., <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx> (last visited May 1, 2011) (CFA charterholders are still bound by a code of ethics and standards of professional conduct). For a different iteration of what it means to be a professional, see C. Stewart Sheppard, *The Professionalization of the Financial Analyst*, FINANCIAL ANALYSTS J., Nov.–Dec. 1967, at 39, 39 (“Webster defines a profession [as a] ‘calling requiring specialized knowledge and often long and intensive preparation including instruction in skills and methods as well as in the scientific, historical, or scholarly principles underlying such skills and methods. . . .’”). For a more recent description of professional and ethical standards, see John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685, 709–11 (2007) (describing the professional and ethical standards of Certified Financial Planners, CFA charterholders, and Certified Public Accountants).

122. JOHNSON, *supra* note 108 at 10–14.

123. *Id.* at 10.

ganizations.”¹²⁴ Johnson argues that “[a]n important way the legislative branch can flex its muscles vis-à-vis the executive branch is through congressional oversight of the executive agencies.”¹²⁵ Whistleblowers often play an important role in congressional hearings.¹²⁶ Also amplifying the reach of whistleblowers is the flourishing of non-profit whistleblower groups in the United States.¹²⁷ Some focus on the work of individual agencies,¹²⁸ others on specific services.¹²⁹ For instance, Taxpayers Against Fraud, established in 1986, specializes in False Claims Act lawsuits.¹³⁰ The National Whistleblower Center, which emerged in the mid-1990s, offers training seminars, an attorney referral service, and a help line.¹³¹ The Government Accountability Project, created in 1977, according to Johnson, “is the most impressive whistleblower organization because of its long track record and its participation as a witness in congressional hearings and as an expert in General Accounting Office reports.”¹³² Johnson also believes that a cultural shift has taken place where society, which once saw whistleblowers as disloyal, now respects them as representative of the traditional American value of individualism.¹³³

C. Protection from Retaliation: The Failed Remedy

As whistleblowers became more accepted in society, efforts were made to protect them from retribution and encourage them to come forward.¹³⁴ First, lawmakers thought that if the government protected whistleblowers from employer retaliation, more whistleblowers would come forward.¹³⁵

124. *Id.*

125. *Id.* at 11.

126. *Id.*

127. *Id.* (citing the U.S. Navy Price Fighter Detachment as an example of a non-profit organization that serves whistleblowers).

128. *Id.* (referencing the Forest Service Employees for Environmental Ethics, the Public Employees for Environmental Responsibility, and the National Association of Treasury Agents).

129. *Id.* at 13 (referencing Taxpayers Against Fraud, Project on Government Oversight, and Integrity International as example of groups specializing in particular services).

130. *Id.*; see *infra* Part III.D for additional information on the False Claims Act.

131. JOHNSON, *supra* note 108, at 13.

132. *Id.*; see also *About, GOV'T ACCOUNTABILITY PROJECT*, <http://www.whistleblower.org/about> (last visited Apr. 19, 2011) (discussing the group's history).

133. JOHNSON, *supra* note 108, at 14, 16.

134. See Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 273, 275–83 (1992) (discussing legislative efforts in the 1980s).

135. See *id.* at 275–76 (stating that most laws focused on a remedy for when retaliation occurs).

The strategy failed.¹³⁶ Early state statutes, mostly enacted in the 1980s, inadequately protected employees against retaliation.¹³⁷ The remedy for the successful litigant was “recovery of lost benefits and wages, and a return to the job.”¹³⁸ Two assumptions underlay the statutes. Lawmakers assumed that “because most whistleblowers suffer retaliation, potential whistleblowers are deterred from reporting wrongdoing.”¹³⁹ And they assumed that removing that risk would encourage employees to blow the whistle.¹⁴⁰ Unfortunately, that was not the case.¹⁴¹ Implementation was flawed. A 1987 study indicated that early state statutes were unsuccessful because of “legislative drafting errors and ineffective judicial interpretation.”¹⁴²

In view of the failure of previous laws, the Sarbanes-Oxley Act of 2002 (“SOX”) attempted to better protect employees.¹⁴³ First, SOX included the standard anti-retaliation provision through which employees could recover damages.¹⁴⁴ And lawmakers strengthened that provision by making retaliation against whistleblowers a criminal offense.¹⁴⁵ Second, SOX “require[d] that corporations provide employees with a standardized channel to report organizational misconduct internally within the corporation.”¹⁴⁶

But the SOX provisions failed to protect whistleblowers.¹⁴⁷ Professor Richard E. Moberly studied over 700 Department of Labor administrative decisions and found that only 3.6 percent of SOX whistleblowers won relief through the initial administrative process, and only 6.5 percent won appeals.¹⁴⁸ Professor Geoffrey Christopher

136. See *id.* at 277–78 (discussing the results of a study of the effectiveness of state anti-retaliation statutes).

137. *Id.* In addition to the state statutes, a number of federal regulatory statutes protect whistleblowers against retaliation. See, e.g., Whistleblower Protection Act of 1989, Pub. L. No. 101-12 § 2, 103 Stat. 16 (codified at 5 U.S.C. § 1201 (2006)) (protecting employees who disclose government illegalities).

138. Callahan & Dworkin, *supra* note 134, at 276.

139. *Id.*

140. *Id.*

141. *Id.* at 277.

142. *Id.* at 277 n.13 (citing Terry Morehead Dworkin & Janet P. Near, *Whistleblowing Statutes: Are They Working?*, 25 AM. BUS. L.J. 241 (1987)).

143. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 806(a), 116 Stat. 745, 802–04 (codified at 18 U.S.C. § 1514A (2006)).

144. *Id.* (codified at 18 U.S.C. § 1514A(c) (2006)).

145. See *id.* § 1107 (codified at 18 U.S.C. § 1513(e) (2006)).

146. Richard E. Moberly, *Sarbanes-Oxley's Structural Model To Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107, 1109; see generally *id.* at 1131–61 (discussing the “structural model”).

147. See Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 91–99 (2007) (discussing low employee win rates); see also Pizzani, *supra* note 56, at 35 (“According to the Center for Public Integrity, since the enactment of the Sarbanes-Oxley Act whistleblower provisions through 30 June 2010, the Department of Labor has tossed out 1,066 claims while upholding only 25. In other words, only 2.3 percent of the claims have been successful.”).

148. Moberly, *supra* note 147 at 91.

Rapp describes the dire consequences whistleblowers face, including industry blacklisting, harm to future employment prospects, and social ostracism from co-workers.¹⁴⁹ Whistleblowers can also suffer psychological consequences, as they are often subject to public criticism, and they often must endure lengthy, acrimonious trials.¹⁵⁰

In the financial industry, blacklisting can be devastating.¹⁵¹ Securities professionals are often highly paid¹⁵² and their specialized skill sets may not transfer well to other industries.¹⁵³ A successful money manager, for example, can make a high salary and bonus at a financial institution, but is generally unqualified for comparably paid work outside the industry.¹⁵⁴ Conversely, professionals in brick and mortar businesses often have generally applicable skills.¹⁵⁵ For example, a blacklisted pharmaceutical sales representative might find a job selling other scientific products, or even automobiles.

In some cases, however, protection from retaliation may be sufficient. Those who see it as a professional duty to report the information may only need the assurance that they will not lose their jobs. A public accountant, upon discovering questionable revenue recognition practices during an audit, may have a professional obligation to change some language, resign the account, or under some circumstances make a report to the government.¹⁵⁶ For her, blowing the whistle may be a career-enhancing move.

149. Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 95 (2007).

150. *Id.* at 95–96.

151. See, e.g., Louise Story, *A Former Moody's Executive, in Suing Firm, Claims He Was Blacklisted*, N.Y. TIMES, Sept. 14, 2010, at B4 (illustrating that whistleblowing on Wall Street can result in severe blacklisting).

152. See Marcus Baram, *Wall Street Bonuses vs. Normal Wages: A Disturbing Trend*, HUFFINGTON POST (Oct. 20, 2009), http://www.huffingtonpost.com/2009/10/20/wall-street-bonuses-vs-no_n_324281.html (noting that in 2006 the average financial industry professional's annual bonus was fourteen times what it was twenty-five years ago).

153. See *Financial Analysts*, BUREAU OF LABOR STATS. 1, <http://www.bls.gov/oco/pdf/ocos301.pdf> (last visited Apr. 19, 2011) (describing that financial analysts often focus their work on a specific industry, region, or type of product and obtain professional designations specific to financial services).

154. See *Personal Financial Advisors*, BUREAU OF LABOR STATS. 2, <http://www.bls.gov/oco/pdf/ocos302.pdf> (last visited Apr. 19, 2011) (identifying the salary range for the middle 50 percent of employees as up to \$119,290 before bonuses); see also David F. Traver, *Transferability of Skills: Principles and Cross Examination*, http://jamespublishing.com/articles_forms/SocialSecurity/transfer_skills_principles_cross-exam.htm (last visited Apr. 19, 2011) (identifying jobs with transferable skills, such as clerical, administrative, and managerial jobs).

155. See Traver, *supra* note 154.

156. See generally Mark Grothe & Thomas R. Weirich, *Analyzing Auditor Changes: Lack of Disclosure Hinders Accountability to Investors*, CPA J. ONLINE, Dec. 2007, at <http://www.nysscpa.org/cpajournal/2007/1207/infocus/p14.htm> (discussing instances where auditors resigned from an account and where auditors required restatements of financials); Lynn E. Turner et al., *An Inside Look at Auditor Changes*, CPA J. ONLINE, Nov. 2005

D. Financial Incentives to the Rescue

Historically, financial incentives have worked well as a tool to get whistleblowers to come forward.¹⁵⁷ The first such law was the False Claims Act (“FCA”),¹⁵⁸ enacted at the insistence of President Lincoln in response to procurement fraud against the Union Army.¹⁵⁹ The 1863 law authorized private citizens, via a *qui tam*¹⁶⁰ provision, to sue on behalf of the government, and, if successful, collect a bounty.¹⁶¹ Although the law weakened over time, defense procurement scandals led to a strengthening of the FCA in 1986, when new amendments increased the chance of recovery by a *qui tam* plaintiff.¹⁶² First, they set a compensation floor to be awarded to plaintiffs in successful cases.¹⁶³ Second, they made it easier for a plaintiff to make a successful claim.¹⁶⁴ Third, they expanded the class of people who could bring claims.¹⁶⁵ Since the 1986 amendments, the federal government has recovered billions under the FCA, with whistleblowers collecting large bounties.¹⁶⁶

supp., at http://www.nysscpa.org/cpajournal/2005/1105/special_issue/essentials/p12.htm (discussing resignations and restatements). This may help explain the SEC’s stance towards public accountants as whistleblowers. See *supra* notes 78, 87 and accompanying text.

157. See Geoffrey Christopher Rapp, *False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers*, 15 NEXUS J. OP. 55, 62 (2009), available at LexisNexis.

158. Act of Mar. 2, 1863, ch. 67, 12 Stat. 696 (1863) (codified as amended at 31 U.S.C. §§ 3729–33).

159. Callahan & Dworkin, *supra* note 134, at 302 & n. 112.

160. BLACK’S LAW DICTIONARY 1368 (9th ed. 2009) (“Latin *qui tam pro domino rege quam pro se ipso in hac parte sequitur* ‘who as well for the king as for himself sues in this matter’”).

161. Act of Mar. 2, 1863, ch. 67, §§ 4, 6 (providing for a *qui tam* suit and a bounty of one half of the forfeiture and one half of the amount of damages collected).

162. Callahan & Dworkin, *supra* note 134, at 303, 305 & nn. 115 & 117.

163. See *id.* at 305–07.

164. See *id.* at 305, 308–10.

165. *Id.* at 305, 310–14.

166. See Rapp, *supra* note 157, at 62. Under the FCA, “although files are sealed in U.S. federal court for seven years,” the whistleblower’s identity is eventually made public. Pizzani, *supra* note 56, at 37. *But see* Posting of Mark Kleiman, Law Office of Mark Allen Kleiman, to whistleblowerlawlistserv@list.voicesforcorporate responsibility.com (May 2, 2011, 9:46 AM PDT) (“The files are not sealed for seven years. There is an initial 60-day seal period (see 31 U.S.C. § 3730(b)(2)). After that, the Department of Justice may, at its discretion, apply for extensions of the seal. It invariably asks for extensions until it decides to either join the case (intervention) or decline the case. Some cases take seven years, but those are the outliers. The vast majority are resolved in 3–4 years.”) (on file with author and reprinted with permission); Under Dodd-Frank § 922(a), the whistleblower may remain anonymous if represented by counsel. Dodd-Frank Act §922(a), Pub. L. No. 111-203, 123 Stat. 1376 (2010) (to be codified at 15 U.S.C. § 78u-6(d)(2)(A)). However, for a whistleblower to receive an award under the SEC program, a whistleblower or his counsel must disclose the whistleblower’s identity to the SEC. *Id.* It is unclear when the SEC would then disclose the whistleblower’s identity to the public. See *Proposed Rules*, *supra* note 61, at 70,500 (describing the SEC’s duty of confidentiality with respect to whistleblower submissions under Proposed Rule 21F-7 and stating that “there may be circumstances in which disclosure of information that identifies a whistleblower will be legally required or will be necessary for the protection of investors”). Proposed Rule 21F-7 is adopted largely as proposed. *Final Rules*, *supra* note 61, at 131.

The Insider Trading Act of 1988 was less successful than the FCA because the SEC awarded few bounties under the law.¹⁶⁷ It remains to be seen whether, if the SEC begins awarding more bounties, more whistleblowers will come forward with information on insider trading. Recently, the SEC has stepped up enforcement of insider trading.¹⁶⁸ However, it is unclear whether the increased enforcement is due to better information from whistleblowers, due to whistleblowers perceiving that compensation is more likely, or due to some other factor.

Financial incentives for whistleblowers can be structured in different ways.¹⁶⁹ They can be fixed or contingent, large or small.¹⁷⁰ Large incentives are significantly more effective than small incentives,¹⁷¹ and section 922(a) promises highly variable, and potentially enormous financial rewards.¹⁷² As noted above, at a minimum, if the SEC succeeds in obtaining a monetary recovery, the whistleblower is guaranteed at least \$100,000.¹⁷³ There is no dollar cap on the size of the award.¹⁷⁴ In theory, the award could be in the tens of millions of dollars. Thus, there is reason to believe that the response under section 922(a) will be strong.

However, the brute force of the financial incentive could be problematic if it leads to excessive reporting of unworthy claims. Such reporting could tax the resources of the SEC, excessively burden the businesses that must respond to the claims, and result in a political backlash that could jeopardize agency support. Two

167. See OFFICE OF AUDITS, *supra* note 39, at iii, 4–8 (noting that very few payments were made under the SEC's bounty program); see also *id.* at 5 (identifying seven payments to only five claimants).

168. See *Insider Trading*, N.Y. TIMES (Mar. 10, 2011), http://topics.nytimes.com/topics/reference/timestopics/subjects/i/insider_trading/index.html (discussing the expansion of insider trading arrests in 2010 and how the case against Galleon Group hedge fund manager Raj Rajaratnam mushroomed into a much broader investigation); see also Roben Farzad & Theo Francis, *The SEC's Tough New Offensive on Insider Trading*, BLOOMBERG BUSINESSWEEK (Oct. 21, 2009), http://www.businessweek.com/magazine/content/09_44/b4153000978323.htm (noting a recent action against Galleon Group and signaling a bolder stance from the SEC on insider trading and an increased use of technology). On May 11, 2011, a jury convicted Rajaratnam on all fourteen counts of insider trading. Peter Lattman & Azam Ahmed, *Galleon's Rajaratnam Found Guilty*, DEALBOOK (May 11, 2011, 10:50 AM), <http://dealbook.nytimes.com/2011/05/11/rajaratnam-found-guilty/>. Rajaratnam is to be sentenced on July 29, 2011, when he could receive up to twenty-five years in prison. *Id.*

169. See Feldman & Lobel, *supra* note 62, at 1168–72 (discussing financial incentives designed to encourage increased reporting of organizational illegality).

170. *Id.* (differentiating between rewards available to whistleblowers).

171. See *id.*; see also *infra* text accompanying notes 178–95 (discussing the results of a study analyzing the effect of large financial rewards).

172. See *infra* notes 173–74 and text accompanying (describing the potential financial rewards available to whistleblowers under § 922(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act); see also *supra* Part II.A (giving a general outline of the contents of § 922(a)).

173. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376, 1841–49 (2010) (to be codified at scattered sections of U.S.C.) (noting that the SEC is required to pay a whistleblower at least 10 percent of monetary sanctions that exceed \$1,000,000).

174. *Id.* There is, however, a percentage cap at 30 percent. *Id.*

procedural tools are designed to deter false submissions.¹⁷⁵ First, the information must be submitted to the SEC under penalty of perjury.¹⁷⁶ Second, a whistleblower who wishes to remain anonymous must be represented by an attorney who certifies to the SEC that she has verified the whistleblower's identity.¹⁷⁷ It remains to be seen whether those safeguards are adequate. If not, more can be put in place.

As to the effect of large financial rewards, a study by Professor Luigi Zingales and co-authors found that financial incentives motivate whistleblowers.¹⁷⁸ Zingales examined fraud cases between 1996 and 2004 in U.S. companies with more than \$750 million in assets.¹⁷⁹ The sample included 216 cases of alleged corporate fraud, including Enron, HealthSouth, and WorldCom.¹⁸⁰ Zingales found that in healthcare (an industry where the government is a significant source of revenue, thus making whistleblower suits more likely) employees brought 41 percent of the frauds to light.¹⁸¹ In other industries, employees detected only 14 percent of fraud cases.¹⁸² The study concluded that there is strong circumstantial evidence that significant monetary incentives motivate whistleblowers.¹⁸³

Also relevant is Zingales' evaluation of who actually detects fraud.¹⁸⁴ Of the 216 cases examined, employees uncovered the highest number of frauds (26, 18.3 percent) followed by analysts (24, 16.9 percent).¹⁸⁵ The media also did well (22, 15.5 percent), as did industry regulators, government agencies (excluding the SEC), and self-regulatory organizations (20, 14.1 percent (one category)).¹⁸⁶ Auditors detected sixteen frauds (11.3 percent).¹⁸⁷ The SEC did poorly, finding only ten frauds (7 percent).¹⁸⁸

175. *Proposed Rules*, *supra* note 61, at 70,489, 70,502–04 (discussing the procedural requirements of Proposed Rule 21F-9 designed to enhance the efficiency and effectiveness of the SEC's enforcement program).

176. *Id.* at 70,489, 70,502–03.

177. *Id.* at 70,489, 70,503–04.

178. Luigi Zingales et al., *Who Blows the Whistle on Corporate Fraud?* 1 (Univ. of Chicago Booth Sch. of Bus., Working Paper No. 08-22, 2008), available at <http://ssrn.com/abstract=891482>.

179. *Id.* at 2.

180. *Id.*

181. *Id.* at 4.

182. *Id.*

183. *Id.*

184. *See id.* at 9 (“[O]ur aim is to identify the initial force that starts the landslide of a scandal coming to light.”).

185. *Id.* at 38 (referring to Table 2: Who Detects Corporate Fraud?).

186. *Id.*

187. *Id.*

188. *Id.* However, this poor showing may be partially because OCIE does not examine issuers. *See supra* note 5. The ranking of whistleblowers by size of fraud varies dramatically depending on what statistical measure is used (median, mean, or winsorized mean). Zingales, *supra* note 178, at 38–39. A winsorized mean is “[a] me-

Zingales' work indicates that analysts, on balance, are competent fraud detectors.¹⁸⁹ They may not identify all the largest frauds,¹⁹⁰ but that does not mean that they are not capable of discovering them. One problem may be that accomplished analysts often work for high-tier Wall Street investment banks.¹⁹¹ At these banks, blowing the whistle to the SEC may be seen as distracting and against shareholders' interest.¹⁹² And the banks certainly do not want their analysts blowing the whistle on their clients.¹⁹³ The large banks remain extremely conflicted due to perennial tension between the research and investment-banking functions.¹⁹⁴ There is also the question of whether analysts are successful in detecting fraud because of insider tips, or analytical prowess.¹⁹⁵ In any case, if big bank analysts wish to participate in the SEC program, they may have to leave their banks for smaller, opportunistic hedge funds that encourage entrepreneurial activity such as bounty hunting. They could potentially even organize bounty-hunting firms devoted exclusively to detecting fraud. However, this would amount to a privatization of an essential SEC function.

thod of averaging that initially replaces the smallest and largest values with the observations closest to them. After replacing the values, a simple arithmetic averaging formula is used to calculate the winsorized mean." *Winsorized Mean*, INVESTOPEDIA, http://www.investopedia.com/terms/w/winsorized_mean.asp (last visited Mar. 16, 2011). Out of the eleven categories of whistleblowers, analysts ranked third using the median measure, eighth using the mean measure, and second using the winsorized mean measure. Zingales, *supra* note 178, at 38–39. Only employees did consistently better than analysts. *Id.*

189. Zingales, *supra* note 178, at 38 (noting that analysts make up a large percentage of fraud detectors in comparison with the others).

190. *Id.* at 39. The mean fraud the SEC uncovered resulted in more than \$720 million more in settlements and fines than those uncovered by analysts. *Id.* Of course, the SEC, as a regulator, has more leverage to extract large settlements than private parties in securities litigation.

191. See *id.* at 20, 44 (describing how values were generated for Table 6 on page 44).

192. See *id.* at 24 ("Not only is . . . honest behavior not rewarded by the market, . . . it is penalized."). Banks may also retaliate against analysts for issuing negative reports on the companies they cover. Jesse Eisinger, *For One Whistle-Blower, No Good Deed Goes Unpunished*, PROPUBLICA (June 1, 2011, 3:19 PM), http://www.propublica.org/thetrade/item/for-one-whistle-blower-no-good-deed-goes-unpunished/?utm_source=socmed&utm_medium=twitter&utm_content=tweet4&utm_campaign=jesse. When star analyst David Maris "put out a sell report on Biovail, a Canadian drug company," Bank of America fired him after coming under pressure from multiple sources. *Id.* "For his success, [Maris] was sued, fired and stripped of compensation . . ." *Id.* "[Maris] also lost access to the world of bulge-bracket Wall Street, [and] was shunned by some institutional investors." *Id.* ("Investors think they want unvarnished advice, but many don't truly appreciate it. Most banks don't want employees to play detective.").

193. See, e.g., *id.* at 23–24 (finding that in 82 percent of the cases studied where an employee was the whistleblower, the whistleblower either quit under duress, was fired, or had altered responsibilities at work).

194. See Erik Sirri, *Investment Banks, Scope, and Unavoidable Conflicts of Interest*, FED. RES. BANK OF ATLANTA ECON. REV., Fourth Quarter 2004, at 23, 23–29, available at http://www.frbatlanta.org/filelegacydocs/erq404_sirri.pdf.

195. See Zingales, *supra* note 178, at 20, 44 (noting that the differences seen in Table 6 may suggest that analyst revelations are credible only when coming from a reputable analyst; an alternative theory could be that reputable analysts receive insider tips).

IV. THE ANALYST AS BOUNTY HUNTER

Whistleblowers who expose fraud inside their own company may suffer from different pressures from whistleblowers who reveal illegality at another company.¹⁹⁶ Part A of this section discusses the substantial costs analysts can face when they blow the whistle. Part B argues that the SEC should encourage analyst participation in the program. Part C suggests that the SEC clarify when independent analysis qualifies as original information.¹⁹⁷

A. Harry Markopolos and the Price Analysts Pay

In the securities industry, experienced professionals, due to their expertise, are often best able to identify securities law violations from the outside.¹⁹⁸ Unfortunately, these whistleblowers often have much to lose when revealing financial misconduct.¹⁹⁹ The Bernard Madoff scandal illustrates this dynamic.

Harry Markopolos, a derivatives portfolio manager, identified Madoff's multi-billion dollar fraud eight years before it became public.²⁰⁰ From 2000 to 2008, the SEC ignored all five of Markopolos's detailed submissions on Madoff's investment management business (separated from the legitimate broker-dealer business).²⁰¹ The narrative in the media focused on how the SEC failed to do its job.²⁰² Markopolos's

196. Of course, both types of whistleblowers may fear blacklisting and ostracism, depending on the culture of the industry. However, many of the negative connotations that haunt whistleblowers involve feelings of disloyalty. See Paul E. Rossler, Comment, *Running for Cover Under Sarbanes-Oxley*, 41 TULSA L. REV. 573, 574 (2006) ("Corporate cultures . . . do not tolerate dissent well, in part because of the premium placed on loyalty"). A whistleblower who blows the whistle on an organization other than his employer is clearly less susceptible to those attacks. This whistleblower also may have less to fear in the way of potential termination (though this author does recognize that Markopolos feared termination for his continued investigation of Madoff). See MARKOPOLOS, *supra* note 8, at 61.

197. This Article focuses on the experiences of outside whistleblowers (analysts) because in this author's opinion the principal innovation of § 922(a) is the allowance for independent analysis. Further, other authors have extensively covered the experience of inside whistleblowing employees. See, e.g., MARCIA P. MICELI & JANET P. NEAR, *BLOWING THE WHISTLE: THE ORGANIZATIONAL AND LEGAL IMPLICATIONS FOR COMPANIES AND EMPLOYEES* (1992).

198. See, e.g., MARKOPOLOS, *supra* note 8, at 35–41 (describing how Markopolos, having thirteen years of experience within the financial industry, began to uncover Madoff's scheme through attempts to reverse engineer Madoff's strategy). At first, Markopolos's bosses pushed him to market a product that could deliver returns similar to those alleged by Madoff. *Id.* at 37.

199. See, e.g., Zingales, *supra* note 178, at 23–24; see also *supra* notes 193, 196.

200. MARKOPOLOS, *supra* note 8, at 1–3.

201. *Id.* at 1, 3, 7 (noting the repeated warnings given to the SEC over a nine-year period and identifying Madoff's separate business dealings).

202. See, e.g., *SEC Dropped Ball on Madoff, Watchdog Finds*, CBSNEWS (Sept. 2, 2009), <http://www.cbsnews.com/stories/2009/09/02/business/main5282193.shtml> ("The watchdog of the Securities and

story is a textbook example of how costs for whistleblowers can quickly multiply when regulators fail to listen.²⁰³

Markopolos was uniquely situated to become the Madoff whistleblower. In the late 1990's, he worked for Rampart Investment Management, a Boston asset management firm with nearly nine billion dollars under management.²⁰⁴ He was a quantitative analyst, applying mathematical methods to investing.²⁰⁵ Markopolos first heard about Madoff's investment activities in 1999 from his marketing colleague Frank Casey.²⁰⁶ Markopolos had introduced Casey to his old friend, Tim Ng, a junior partner at Access International Advisors ("Access Group"), a hedge fund of funds.²⁰⁷ Ng informed Casey that he found a manager returning 1 to 2 percent a month or more net of fees.²⁰⁸ When Ng revealed Madoff as the manager, "[a]nyone who . . . worked in the stock market even for a short period of time knew that name. . . ."²⁰⁹ His company, Madoff Investment Securities LLC, was "[one of the] most successful broker-dealers on Wall Street."²¹⁰ Neither Casey nor Markopolos, however, had ever heard that Madoff also managed money.²¹¹

Markopolos began investigating Madoff out of curiosity, as well as for professional reasons.²¹² He knew that if he could create a derivatives product to compete with Madoff, Access Group could raise a lot of money for Rampart.²¹³ It quickly became clear to him that Madoff was running the largest Ponzi scheme in history.²¹⁴ Rampart, however, was not convinced.²¹⁵ As his bosses pushed him to create a

Exchange Commission has found that three agency exams and two investigations of Bernard Madoff's business were incompetent, despite ample warnings of the multibillion-dollar fraud.").

203. See, e.g., MARKOPOLOS, *supra* note 8, at 3, 7 (illustrating the costs to Markopolos, his family, and his co-workers during the period they investigated Madoff).

204. *Id.* at 16 (noting Markopolos's position as a derivatives portfolio manager).

205. *Id.* at 9 (explaining a quantitative analyst's skill set).

206. See *id.* at 3, 20–21 (detailing Madoff's investment activities).

207. A hedge fund of funds is a fund that does not make direct investments, but rather invests in other hedge funds. The purpose of such a fund (and extra layer of fees) is to smooth out returns, engage in due diligence on behalf of investors, and provide diversification. See *Fund of Funds*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fundsoffunds.asp> (last visited Apr. 19, 2011).

208. MARKOPOLOS, *supra* note 8, at 24–25.

209. *Id.* at 26.

210. *Id.*

211. *Id.*

212. See *id.* at 33–36 (discussing Markopolos's curiosity of Madoff and his attempts to model his strategy in order to understand Madoff's success).

213. *Id.* at 36–37 (noting the pressure from his bosses to reverse engineer Madoff's strategy to develop a product to deliver returns similar to Madoff's).

214. See *id.* at 36–40 (concluding from his research that the largest hedge fund in history appeared to be a fraud).

215. *Id.* at 36 (describing his boss's disbelief of Madoff running a Ponzi scheme).

product to compete with Madoff, Markopolos grew more frustrated.²¹⁶ In the course of his digging, Markopolos discovered marketing material from feeder funds.²¹⁷ In these materials, which made no mention of Madoff, Markopolos recognized Madoff's investment strategy.²¹⁸

In one pamphlet, a feeder fund described how Madoff was supposedly executing his option trades: "To provide the desired hedge the manager then sells out of the money OEX index call options and buys out of the money OEX index put options. The amount of calls that are sold and puts that are bought represent a dollar amount equal to the basket of shares purchased."²¹⁹ To an ordinary person, this is not a smoking gun. But to experienced options traders such as Harry Markopolos and his partner Neil Chelo, it was obvious that those trades would move the market: "You can't do trades of that size and not be noticed."²²⁰ Markopolos knew "there was in existence a total of \$9 billion of OEX index put options²²¹ on the Chicago Board Options Exchange . . . [and] [y]ou can realistically purchase only \$1 billion of these, and at various times Madoff needed \$3 billion to \$65 billion of these options to protect his investments—far more than existed."²²² This "breathtaking discovery" was one that only a derivatives expert could readily make.²²³

In the spring of 2000, Markopolos went to the SEC because he knew that Madoff was "a dirty player," and wanted him "thrown out of the game."²²⁴ Ed Manion, a Markopolos ally in the SEC's Boston Regional Office, arranged the meeting.²²⁵ Markopolos suspected that if Rampart found out about this meeting, he would have

216. *Id.* at 36–37 (describing his frustration with his boss's insistence on creating a product to compete with Madoff).

217. *Id.* at 40–42. A feeder fund is a fund "that conducts virtually all of its investing through another fund (called the master fund)." *Feeder Fund*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/feederfund.asp> (last visited Apr. 19, 2011).

218. MARKOPOLOS, *supra* note 8, at 42.

219. *Id.* at 41.

220. *Id.*

221. *Id.* at 41–42. OEX put options are options to sell the S&P 100[®] index with American-style exercise. CHICAGO BOARD OPTIONS EXCHANGE, OEX[®] & XEO[®]: S&P 100[®] INDEX OPTIONS (2001). An option with American-style exercise can be exercised at any point in the option's life. BARBARA J. ETZEL, WEBSTER'S NEW WORLD FINANCE AND INVESTMENT DICTIONARY 12 (1st ed. 2003); *see also American Option*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/americanoption.asp> (last visited Mar. 6, 2011). These are unlike European-style options, which an investor can only exercise at maturity. *Id.*

222. MARKOPOLOS, *supra* note 8, at 41–42.

223. *See id.* at 42.

224. *Id.* at 55. Markopolos originally did *not* seek a reward from the SEC. *Id.*

225. *Id.* at xiii–xiv, 61.

been asked to drop the investigation, and if he had persisted, it might have cost him his job.²²⁶

Had the SEC merely checked whether there insufficient “options in existence to delta hedge²²⁷ Madoff’s long stock position,²²⁸ the costs to Markopolos as a whistleblower would have been minimal. Unfortunately, the costs to Markopolos multiplied.²²⁹ The “most chilling discovery” was that Europeans invested billions through offshore funds.²³⁰ To Markopolos, it “indicated that at least some of these funds were handling dirty . . . , untaxed money.”²³¹ Markopolos knew that it is “common knowledge that offshore funds are used by . . . organized crime and the drug cartels that have billions of dollars and no legitimate place to invest them.”²³² Markopolos “realized that [his] life was in danger.”²³³ After returning from Europe, he “began seriously upgrading [his] home security.”²³⁴

On December 22, 2005, at Manion’s urging, Markopolos submitted a comprehensive report to the SEC on Madoff, including thirty red flags.²³⁵ A Branch Chief (Meghan Cheung) in SEC’s New York Regional Office read the report, but failed to act.²³⁶ It was then that Markopolos began “carrying an airweight Model 642 Smith and Wesson everywhere [he] went.”²³⁷ Panicked, he applied for a firearms permit.²³⁸ Although Markopolos was never physically injured or killed, his fear was nonetheless real.²³⁹

226. *Id.* at 61.

227. *Delta Hedging*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/deltahedging.asp> (last visited May 18, 2011) (“An option strategy that aims to reduce (hedge) the risk associated with price movements in the underlying asset by offsetting long and short positions. For example, a long call position may be delta hedged by shorting the underlying stock. This strategy is based on the change in the premium (price of option) caused by a change in the price of the underlying security. The change in premium for each basis-point change in price of the underlying is the delta and the relationship between the two movements is the hedge ratio.”).

228. MARKOPOLOS, *supra* note 8 at 60.

229. *Id.* at 104–09.

230. *Id.* at 104.

231. *Id.* at 105.

232. *Id.*

233. *Id.*

234. *Id.* at 109.

235. *See id.* at 298–332.

236. *See id.* at 138–40.

237. *Id.* at 142.

238. *Id.* at 143.

239. *Id.* at 145 (“If [Madoff] contacted me and threatened me, I was going to drive down to New York and take him out. At that point it would have come down to him or me In that situation I felt I had no other options. I was going to kill him.”); *see also id.* at 6 (Markopolos relieved [and unharmed] when Madoff is caught).

The SEC should consider such costs when exercising its discretion under section 922(a). And, when dealing with external whistleblowers of Markopolos's caliber, the SEC should broadly interpret the terms "analysis" and "original information." Investment analysts are accustomed to using mosaic theory²⁴⁰ in their investment decisions, even when most of the information they use is public.²⁴¹ It may be appropriate to use a stricter definition of "analysis" with whistleblowers who are not bona-fide professional analysts. But in determining who qualifies for the broader use of the term, the SEC can look to professional designations, such as the CFA²⁴² and CAIA²⁴³ charters. The SEC should also consider whether the whistleblower is engaged in the type of activity that she is investigating. For instance, Markopolos was a derivatives portfolio manager, and therefore uniquely qualified to use mosaic theory to draw conclusions about another derivatives manager.²⁴⁴

Finally, when the SEC ignores whistleblowers that are later vindicated, the agency should consider giving such whistleblowers the highest possible financial reward. As seen from Markopolos's story, the consequences can escalate exponentially when the whistleblower loses faith in the system after being ignored. The experience of SOX has shown that protection against retaliation from employers is not enough to offset the cost of whistleblowing.²⁴⁵ Some may argue that Markopolos

240. *Mosaic Theory*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mosaictheory.asp> (last visited Apr. 19, 2011) ("A method of analysis used by security analysts to gather information about a corporation. Mosaic theory involves collecting public, non-public and non-material information about a company in order to determine the underlying value of the company's securities and to enable the analyst to make recommendations to clients based on that information. . . . Some see this style of analysis as a misuse of insider information, but the CFA Institute (formerly known as AIMR) has recognized mosaic theory as a valid method of analysis. However, analysts using this method should disclose the details of the information and methodology they used to arrive at their recommendation.").

241. See MARKOPOLOS, *supra* note 8, at 298; see also *id.* at 306–21.

242. CFA Institute awards the Chartered Financial Analyst (CFA) designation to those who pass three levels of examinations and have four years of qualifying work experience. *Becoming a Member*, CFA INST., <http://www.cfainstitute.org/about/membership/process/Pages/index.aspx> (last visited Mar. 5, 2011).

243. "The Chartered Alternative Investment Analyst program provides individuals with the core competencies required to create, manage, and monitor an institutional-quality portfolio consisting of both traditional and alternative investments." *CAIA Program*, CHARTERED ALTERNATIVE INVESTMENT ANALYST ASSOC., <http://caia.org/caia-program> (last visited Mar. 5, 2011).

244. MARKOPOLOS, *supra* note 8, at 298.

245. See Nina Schichor, *Does Sarbanes-Oxley Force Whistleblowers to Sacrifice Their Reputations? An Argument for Granting Whistleblowers Non-Pecuniary Damages*, 8 U.C. DAVIS BUS. L.J. 272, 293–95 (2008) (noting that SOX provides insufficient incentives as shown by the regret felt by the majority of whistleblowers for blowing the whistle as well as the emotional and financial losses whistleblowers have suffered due to their civic actions); see 18 U.S.C. § 1514A(c) (2006) for the SOX anti-retaliation remedies.

received a windfall from his celebrity status after testifying before the U.S. Senate.²⁴⁶ But that view does not account for the fact that he suffered for nine years, sacrificed his career, and feared for the welfare of his family.

When whistleblowers are taken seriously, the costs are less severe. The implementation does not take these costs seriously enough. The factor in final Rule 21F-6 that permits the SEC to consider these costs is buried among many other factors that the SEC may or may not use to determine the size of the award.²⁴⁷ If the financial benefit is to *compensate* the whistleblower, the government should consider all surrounding circumstances, including the perspective and experience of the whistleblower.

In determining the total costs to the whistleblower, the SEC should consider both monetary and non-monetary consequences.²⁴⁸ If Wall Street blackballs an analyst for exposing a fraud to the SEC, the analyst will have suffered quantifiable damages by the time the bounty is awarded. The analyst could decide to pursue less remunerative (albeit possibly less stressful) work in the future that could increase his cost over the long term. The analyst may also suffer fear, loss of reputation, loss of self-esteem, and loss of social status. Some of these non-monetary costs, particularly loss of reputation, can be monetized.²⁴⁹ The act of whistleblowing can deprive the analyst of his most valuable asset—reputation. Further, the analyst may need mental health services to recuperate from the trauma of losing colleagues, friends, social status, and self esteem. If the SEC is required to weigh these costs, it will make a better-informed decision as to the appropriate size of a bounty.

Although Markopolos's experience illustrates the need to consider whistleblower experiences, his case is unique. Normally, when an investment analyst uncovers wrongdoing in a company, she will recommend investors sell shares of the company (or sell short²⁵⁰ if the investor wishes to create a short position and shares are

246. See Andrew Clark, *The Man Who Blew the Whistle on Bernard Madoff*, GUARDIAN (Mar. 24, 2010), <http://www.guardian.co.uk/business/2010/mar/24/bernard-madoff-whistleblower-harry-markopolos> (stating that Markopolos is "clearly relishing elements of his new-found notoriety").

247. See *supra* Part II.B.2.

248. At least one author has made this argument on behalf of whistleblowers. See, e.g., Schichor, *supra* note 245, at 292–95 (arguing that SOX whistleblowers should receive non-pecuniary damages).

249. See Bryan Eisenberg & Jeffrey Eisenberg, *Is Your Reputation Worth \$15 Billion?*, FORBES (Feb. 6, 2008), http://www.forbes.com/2008/02/06/facebook-marketing-reputation-oped-cx_bje_0206facebook.html (stating that individuals' reputations as customers who can recommend products and services through word-of-mouth can be monetized); see also *What Price Reputation?*, BLOOMBERG BUSINESSWEEK (July 9, 2007), http://www.businessweek.com/magazine/content/07_28/b4042050.htm (stating that both corporate reputation and image changes in specific areas can be used to predict the effect on share prices).

250. "[A] short sale is the sale of a security that isn't owned by the seller, but that is promised to be delivered." *Short Selling*, INVESTOPEDIA, <http://www.investopedia.com/university/shortselling/shortselling1.asp> (last visited Mar. 5, 2011).

available to borrow).²⁵¹ Here, because there is no way to take a short position in a Ponzi scheme, Markopolos could not use the market to correct the imbalance.²⁵² Section 922(a) of the Dodd-Frank Act takes a step in the right direction by recognizing that “independent analysis” can be just as valuable to the SEC in prosecuting securities violations as “independent knowledge.” However, the agency needs to take this thinking a step further and fully embrace the role of analysts in ferreting out wrongdoing.

B. The SEC Should Encourage Analyst Participation

Politicians, investors, and business executives make a sport of criticizing short sellers, contending that they disrupt the market.²⁵³ However, short selling “is a legitimate economic activity that enhances market efficiency and liquidity and shapes prices to reflect the investment views of investors that do not own the stock in question.”²⁵⁴ Although the United States and United Kingdom have generally been careful not to impose restrictions that go beyond the purpose of avoiding market manipulation,²⁵⁵ the SEC has occasionally scapegoated short-sellers.²⁵⁶ For instance, the SEC recently imposed circuit breakers on stocks that fall 10 percent in one day.²⁵⁷ When that happened, short sellers can only execute a transaction at a price above the best bid.²⁵⁸ By contrast, long-only institutional investors, who often have more power to move markets downwards or upwards, were exempted from any sales restrictions.²⁵⁹

251. See, e.g., Christopher Mayer, *Stock Market Scams*, MISES DAILY (June 6, 2001), <http://mises.org/daily/696/Stock-Market-Scams> (book review of MANUEL P. ASENSIO, *SOLD SHORT: UNCOVERING DECEPTION IN THE MARKETS* (2001) (describing short selling process and associated scams)).

252. MARKOPOLOS, *supra* note 8, at 89.

253. Sadakazu Osaki, *The Folly of Demonizing Short-selling*, LAKYARA, Jan. 10, 2009, at 1, 3, available at <http://www.nri.co.jp/english/opinion/lakyara/2009/pdf/lkr200948.pdf>.

254. *Id.* at 2.

255. See *id.*

256. Christopher A. Stanley, *The Panic Effect: Possible Unintended Consequences of the Temporary Bans on Short Selling Enacted During the 2008 Financial Crisis*, 4 ENTREPRENEURIAL BUS. L.J. 267, 282–83 (2010); Michael Comeau, *SEC's New Restrictions Scapegoat Short Sellers*, MINYANVILLE (Feb. 24, 2010, 1:35 PM), <http://www.minyanville.com/articles/print.php?a=26998>.

257. Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Speech by SEC Chairman: Statement at SEC Open Meeting—Short Sale Restrictions, (Feb. 24, 2010), <http://www.sec.gov/news/speech/2010/spch022410mls-shortsales.htm>.

258. *Id.*

259. *Id.*

But some short sellers see themselves as the “de facto enforcement division of the SEC.”²⁶⁰ And why shouldn’t the SEC embrace market players, including short sellers, as fraud finders? Mostly, investment managers engaged in these activities will have “skin in the game,”²⁶¹ which is the way it should be. However, the question arises whether the SEC should penalize these individuals simply because they are professional investors. The fear is that awarding bounties to investment managers amounts to ‘double dipping’ because they would benefit not only from the government award, but also from market movement in their portfolios.²⁶² Most analysts looking for fraud are also engaged in some professional capacity within the financial industry and owe certain duties to their clients.²⁶³ However, if analysts are honest and recommend that investors sell shares when they uncover irregularities, and if they report their findings to the SEC, their interests are aligned with, rather than in opposition to, their clients’ interests.²⁶⁴ Just because many potential outside whistleblowers are employed as analysts, the SEC should not disqualify these individuals on a technicality in the rules. The SEC should enlist smart analysts on Wall Street by offering them the prospect of a bounty under section 922(a).

Despite some obstacles, the text of section 922(a) does not preclude such a result. The section defines whistleblower as “any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the [SEC]. . . .”²⁶⁵ The Act even provides a list of those precluded from collecting an award: hedge funds and short sellers are not on the list.²⁶⁶ If the whistleblower of the future is not Markopolos, but rather a “boring hedge fund money-making machine looking to collect a government reward,” the policy could yield substantial enforcement dividends.²⁶⁷ Nonetheless, the SEC will have to con-

260. Jesse R. Morton, (*Commentary*) *Whistleblower Bounties: Can Hedge Funds Double Dip Under Dodd-Frank?*, WESTLAW BUS. CURRENTS (Jan. 11, 2011) (citing DAVID EINHORN, FOOLING SOME OF THE PEOPLE ALL OF THE TIME: A LONG SHORT STORY 355 (2009)).

261. “Skin in the game” is a term renowned investor Warren Buffett coined “referring to a situation in which high-ranking insiders use their own money to buy stock in the company they are running.” *Skin in the Game*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/skininthegame.asp> (last visited Mar. 5, 2011). In the investment management industry, the term is used when a money manager invests his own money with the fund he manages. *See id.*

262. *See id.*

263. *See generally* Amy Y. Yeung & Kristen J. Freeman, *Gartenberg, Jones, and the Meaning of Fiduciary: A Legislative Investigation of Section 36(B)*, 35 DEL. J. CORP. L. 483 (2010) (examining the history of the fiduciary duty standard as applied to investment advisers).

264. *Id.*

265. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376, 1843 (2010) (to be codified at 15 U.S.C. § 78u-6(a)(6)).

266. *Id.*

267. Morton, *supra* note 260.

front the risk that the public will see such bounties as evidence of the agency's collusion with Wall Street.²⁶⁸ The SEC can only overcome this risk if it harnesses the market's power to uncover large frauds.

To understand the obstacles an analyst or hedge fund may face in collecting a government bounty, it is helpful to consider the Einhorn case. On March 15, 2002, David Einhorn, the Founder and President of the hedge fund Greenlight Capital ("Greenlight"), gave a speech at a charity event in which he disclosed potential accounting irregularities and fraud²⁶⁹ at the company Allied Capital Corporation ("Allied").²⁷⁰ After the speech, there was a large market sell-off, and Greenlight, which held a substantial short position in Allied, stood to profit immensely.²⁷¹ Could Einhorn have collected a bounty under section 922(a)? We must consider several issues.

The main obstacle an analyst or hedge fund will face in qualifying for a bounty is whether the SEC deems the information original.²⁷² In this case, Einhorn based his analysis on "independent analysis of publicly available information."²⁷³ The SEC definition of "original information" explicitly allows for "independent analysis."²⁷⁴ Less clear is how the SEC will interpret the phrase "not known to the [SEC] from any other source."²⁷⁵ As discussed above, the SEC conceded that there are circumstances where individuals analyzing public information can assist the SEC and be eligible for a bounty.²⁷⁶ Unfortunately, the SEC provided no more detail.²⁷⁷ Thus, the

268. *Id.* (suggesting that some market players feel short sellers are the "de facto enforcement division of the SEC").

269. The substance of the allegations were the following: (1) "Allied did not mark its investments to fair value . . . which was in direct disagreement with SEC requirements . . .;" (2) "Allied refused to provide adequate disclosure over the performance of several of its controlled investments;" (3) Allied's largest investment was similar to one of Enron's questionable investments; (4) "Allied regularly issued fresh equity, which appeared to finance its dividend payout;" and (5) "Allied's external auditor . . . changed some of the language in its opinion. . . ." *Id.*

270. *Id.*

271. *Id.* Allied was an investment company regulated under the Investment Advisors Act of 1940. *Id.* In 2007, Allied settled a four year investigation into its valuation practices. *Allied Capital Settles S.E.C. Inquiry*, N.Y. TIMES, June, 21, 2007, at C10. In 2010, Ares Capital merged with Allied and Ares became the surviving entity. Press Release, Ares Capital Corp., Ares Capital Corporation Merges with Allied Capital Corporation (Apr. 1, 2010), <http://www.snl.com/IRWebLinkX/file.aspx?IID=4092627&FID=9298100>.

272. See Morton, *supra* note 260.

273. *Id.*

274. *Supra* note 65 and accompanying text.

275. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376, 1841-42 (2010) (to be codified at 15 U.S.C. § 78u-6(a)(3)(B)).

276. See *supra* Part II.B.1; see also *supra* notes 71-75 and accompanying text.

277. See *supra* notes 71-75 and accompanying text.

potential analyst whistleblower is uncertain as to when she is entitled to a payout. Analysts may perceive the deck unfairly stacked against them in making a claim.

Securities law violations, like deceptive accounting practices, are often difficult for non-experts to identify.²⁷⁸ Even Dick Fuld, the former Chief Executive Officer of Lehman Brothers, claimed that he did not know about Repo 105,²⁷⁹ an accounting maneuver that allowed Lehman to appear as if it were borrowing less than it was.²⁸⁰

The law does not expressly favor those who have “knowledge” of violations over those who apply analysis.²⁸¹ But without more specificity, the uncertainty remains as to when an analyst using public information will qualify for an award. This lack of certainty amounts to a built-in disadvantage for the analyst. It is also noteworthy that much of the hedge-fund-generated whistleblower allegations will likely be based on information in SEC filings, which by definition are known to the agency.²⁸² Thus, analysts in this situation will not be able to claim they were using public information unknown to the SEC. That may hurt the analyst’s case on the margins.

Another obstacle an analyst may face lies under Rule 21F-2, Definition of a Whistleblower: “[a] whistleblower must be a natural person; a company or another entity is not eligible to receive a whistleblower award.”²⁸³ Although this requirement appears to be relatively straightforward, it may not be strictly applied.²⁸⁴ First, section 922(a) “was modeled on the FCA, which does not narrow a whistleblower to only a natural person.”²⁸⁵ Second, the Act provides that “a whistleblower can appeal an SEC determination regarding payment of an award. The section . . . states that ‘[a]ny determination . . . including whether, *to whom*, or in what amount to make

278. See, e.g., Zachery Kouwe, *Dick Fuld Has Never Heard of Repo 105*, DEALBREAKER (Apr. 16, 2010, 4:15 PM), <http://dealbreaker.com/2010/04/dick-fuld-has-never-heard-of-repo-105/>.

279. *Id.* Repo 105 was a transaction where Lehman put assets over to client companies in exchange for cash. The bank and the company agreed that Lehman would buy back the asset at a later date with interest. The number “105” came from the accounting treatment. If Lehman’s asset was worth more than 105 percent of the consideration received from the company, the transaction would be treated as sale of assets instead of as a loan. Jacob Goldstein, *Repo 105: Lehman’s ‘Accounting Gimmick’ Explained*, PLANET MONEY BLOG (Mar. 12, 2010, 11:55 AM), http://www.npr.org/blogs/money/2010/03/repo_105_lehmans_accounting_gi.html.

280. Goldstein, *supra* note 279.

281. Dodd-Frank Act § 922(a), Pub. L. No. 111-203, 123 Stat. 1376 (2010) (defining “original information” as information “derived from the independent knowledge or analysis of a whistleblower”).

282. Morton, *supra* note 260.

283. *Final Rules*, *supra* note 61, at 9, 14–15; see also *Proposed Rules*, *supra* note 61, at 70,489; Morton, *supra* note 260.

284. See Morton, *supra* note 260 (stating that “a hedge fund could theoretically succeed in spite of the proposed rule”). But see *Final Rules*, *supra* note 61, at 14 (“We have decided not to extend the definition of whistleblower beyond natural persons because we believe that this is consistent with the statutory definition which provides that a whistleblower must be an individual.”).

285. Morton, *supra* note 260.

awards, shall be in the discretion of the [SEC]”²⁸⁶ Further, “such determination, except the determination of the amount of an award . . . may be appealed to the appropriate court of appeals . . . [.]”²⁸⁷ Thus, it may be possible to sidestep the requirement if the manager acts as the whistleblower in his personal capacity to collect the award.²⁸⁸ The manager and the shareholders of the fund could have an agreement governing how much of the award the manager would pay into the fund for the benefit of the shareholders. In the end, the fund could benefit from the manager’s whistleblowing activity. Such a maneuver would empower fund managers to report wrongdoing to the SEC without worrying about the perception that the bounty constituted secret profits, possibly in violation of the corporate opportunity doctrine.²⁸⁹

C. The SEC Should Clarify When “Independent Analysis” Qualifies for a Bounty

Section 922(a), by allowing for the possibility of “independent analysis” as a basis for “original information,” took the correct first step in recognizing that whistleblower cases are not always clear cut.²⁹⁰ Although one can hope that the next great financial fraud will be uncovered by someone with perfect knowledge, it is more likely that someone like Harry Markopolos or David Einhorn will detect the first signs and put the puzzle together using a smattering of public and non-public sources.

The SEC has an opportunity to administer section 922(a) in a way that aligns the interests of Wall Street and society. Unfortunately, while Rule 21F recognizes that there are circumstances where independent analysis of public documents would warrant an award, it also details six exclusions where the SEC would *not* deem the information original.²⁹¹ By writing the rules in this way, the SEC lost an opportunity to specify fact patterns when “independent analysis” *would* qualify.²⁹²

286. *Id.*; Dodd-Frank Act § 922(a).

287. Dodd-Frank Act § 922(a); *see also Proposed Rules, supra* note 61, at 70,508 (describing the procedure for administrative appeals).

288. There may be laws or regulations that would prevent investment advisers from receiving a bounty from the SEC. Future research may be warranted to determine which rules, if any, would need to be changed.

289. A corporate opportunity exists if the corporation is financial able to take advantage of the opportunity, the opportunity is in the corporation’s line of business, and the corporation has an interest or expectancy in the opportunity. *Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939); *see also Gen. Auto. Mfg. Co. v. Singer*, 120 N.W.2d 659, 663 (1963) (application in Wisconsin).

290. Dodd-Frank Act § 922(a); *see also Morton, supra* note 260 (suggesting that adding the word “analysis” to the definition may make whistleblowers who compile publicly available information and relate it to fraudulent transactions eligible for reward collection).

291. *Final Rules, supra* note 61, at 53; *see also supra* notes 76–97 and accompanying text.

292. *Final Rules, supra* note 61, at 50 (suggesting that analysis of “such high quality that it either causes the staff to open an investigation, or significantly contributes to a successful enforcement action,” would qualify, but not giving any specific examples); *Proposed Rules, supra* note 61, at 70,492 (merely stating that “independent

Greater clarity is necessary. First, any whistleblower program that pays bounties to employees of regulated entities will be subject to a high level of media scrutiny.²⁹³ If the SEC is seen as capricious or inconsistent in its awards, the agency will be exposed to charges of industry capture. The SEC is already highly vulnerable to such criticism because of the perception that it offers a revolving door to employees eager to work for a regulated entity.²⁹⁴

Second, it is well known that many financial industry professionals show little respect for the SEC.²⁹⁵ The SEC needs credibility not only with the public, but also with the rank-and-file of regulated entities.²⁹⁶ If there is widespread buy-in from hedge fund and bank analysts on the fairness and effectiveness of the whistleblower program, analysts will likely come forward with valuable information.

Third, to the extent that information in public SEC filings is not fully incorporated into prices by the market,²⁹⁷ section 922(a) can encourage analysts to use their talents to more energetically sift through filings and uncover deceptive practices. The case of *In re Merck & Co., Inc. Securities Litigation*²⁹⁸ suggests that markets often do not digest information in SEC filings, even when analysts are supposedly perus-

analysis” can be, alone or in collaboration with others, the product of academic or professional studies, or even the evaluation of publicly available information, without providing any specific examples of when these situations may apply).

293. Michael N. Levy & Vincenza Rabenn, *SEC Reveals Proposed Dodd-Frank Whistleblower Rules*, BINGHAM (Nov. 12, 2010), <http://www.bingham.com/Media.aspx?MediaID=11515> (“Incapable of competing with the prospect of an enormous bounty award, even those companies with robust internal compliance programs now seem destined to face substantially increased scrutiny and costs.”).

294. Tom McGinty, *SEC ‘Revolving Door’ Under Review*, WALL ST. J., June 16, 2010, at C1; see also *Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door*, PROJECT ON GOV’T OVERSIGHT (May 13, 2011), <http://pogo.org/pogo-files/reports/financial-oversight/revolving-regulators/fo-fra-20110513.html> (“Between 2006 and 2010, 219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the [SEC].”).

295. See, e.g., *Testimony of Harry Markopolos*, *supra* note 3, at 1–2.

296. See Tracy Coenen, *Fraud Files: As the SEC ‘Gets Tough’ on Goldman, Remember Madoff*, DAILYFINANCE (Apr. 22, 2010, 3:50 PM), <http://www.dailyfinance.com/story/investing/fraud-files-as-the-sec-gets-tough-on-goldman-remember-madoff/19432484/> (noting the SEC’s bad track record and the need for the agency to restore its own credibility); Joe Weisenthal, *Harvey Pitt Thinks the SEC is About to Destroy Itself with Goldman, And We’re Starting to Agree*, BUSINESSINSIDER (Apr. 21, 2010, 10:23 AM), <http://www.businessinsider.com/harvey-pitt-sec-goldman-charges-2010-4> (suggesting that the SEC brought a case against Goldman Sachs to regain credibility and make itself look tough).

297. The markets are not necessarily “inefficient.” Information can be in the public domain, but not public for the purpose of securities pricing. See, e.g., Morton, *supra* note 260 (arguing that whistleblower allegations will most likely be based on information contained in SEC filings or other publicly available information); see also *infra* notes 298–316 and accompanying text.

298. 432 F.3d 262 (3d Cir. 2005).

ing them.²⁹⁹ In that case, Merck had planned an initial public offering of its wholly owned subsidiary Medco Health Solutions (“Medco”), a pharmacy benefits manager.³⁰⁰ Issues arose with Medco’s revenue recognition practices.³⁰¹ Even though Medco never handled co-payments, “it interpreted the accounting standards to allow it to recognize the co-payments as revenue.”³⁰² Merck disclosed for the first time on its April 17, 2002 Form S-1 that Medco “had recognized as revenue the co-payments paid by consumers, but it did not disclose the total amount of co-payments recognized.”³⁰³ The stock price stayed stable until June 21, 2002, when *The Wall Street Journal* estimated that in 2001 Medco wrongly recognized \$4.6 billion³⁰⁴ in co-payments as revenue.³⁰⁵ The market immediately reacted: “that day Merck’s stock lost \$2.22—dropping from \$52.20 to \$49.98.”³⁰⁶ Then “[s]ix days later, Merck announced the postponement of the Medco IPO and indicated that it would drop Medco’s offering price.”³⁰⁷ Merck filed its fourth S-1 on July 5, 2002, finally disclosing that Medco had recognized over \$12.4 billion in co-payments as revenue from 1999 to 2001.³⁰⁸

How did the reporter arrive at the \$4.6 billion estimate for 2001? She made one assumption and performed “one subtraction and one multiplication on the information contained in the April S-1.”³⁰⁹ She then “determined the number of retail prescriptions filled (462 million) by subtracting home-delivery prescriptions filled (75 million) from total prescriptions filled (537 million).”³¹⁰ She then multiplied the number of prescriptions by \$10 to get \$4.6 billion.³¹¹

The issue in *Merck* was whether the mathematics the reporter performed to understand the disclosure rendered it void.³¹² In holding that it did not, the court re-

299. *Id.* at 270 (explaining that, in this case, many analysts were following Merck, including analysts from “J.P. Morgan, Morgan Stanley, and Solomon Smith Barney, who ‘closely examine a company’s revenue and revenue growth when valuing a company’s stock’”).

300. *Id.* at 264.

301. *Id.* at 264–65.

302. *Id.* at 264.

303. *Id.*

304. Later disclosure would show the actual number to be \$5.54 billion. *Id.* at 265.

305. *Id.*; see also Barbara Martinez, *Merck Included Co-Payments Among Revenue*, WALL ST. J., June 21, 2002, at C1.

306. *Merck*, 432 F.3d at 265.

307. *Id.*

308. *Id.*

309. *Id.* at 270.

310. *Id.*

311. *Id.*

312. *Id.*

lied on its opinion in *Ash v. LFE Corp.*,³¹³ where a proxy statement disclosed directors' current pension amounts, and in another section the newly proposed amounts, but did not disclose the sum of the increase.³¹⁴ In that case, the court held that as long as the "facts [were] disclosed prominently and candidly," requiring readers to make a simple subtraction does not constitute a material omission.³¹⁵ Because the calculation necessary to make the *Merck* disclosure meaningful involved an assumption and multiplication, instead of simple subtraction, the case can be read as extending the holding in *Ash* that companies are not required to spoon feed analysts with answers, as long as the disclosures are clear.

In both of these cases, the United States Court of Appeals for the Third Circuit showed a willingness to allow companies to make "clear" disclosures that still hide their true significance.³¹⁶ Had the court taken the opposite view, requiring companies to make those calculations explicit, the SEC might be justified in believing that the market would digest the information in SEC filings. If the market absorbs the full import of the information, then it is truly "public" and analysts are less valuable in the information gathering process and as whistleblowers. Notwithstanding the court's faith in efficient markets, analysts still play a vital role.

V. CONCLUSION

The SEC has an opportunity to improve its efficiency.³¹⁷ To do so, the agency must harness the potential of analysts and money managers on Wall Street by compensating them fairly through the whistleblower program.³¹⁸ In reality, Wall Street employees will often lack "independent knowledge" of securities violations.³¹⁹ However, they can often deduce fraud through "independent analysis" of SEC filings and other public sources.³²⁰

The rules governing when "independent analysis" constitutes "original information" are imperfect. Although the SEC does not categorically exclude analysis (and analysts) from qualifying under the program, it is unfortunate that the agency focuses on the value of the information to the government, while not adequately

313. 525 F.2d 215 (3d Cir. 1975).

314. *Id.* at 218.

315. *Id.* at 219.

316. *Merck*, 432 F.3d at 270 (holding that when numbers were clearly disclosed in company statements, it was not unreasonable to expect analysts to do simple calculations on those numbers on their own); *Ash*, 525 F.2d at 219 (same).

317. *See supra* Part I.

318. *See supra* Part I.

319. *See supra* notes 64–66, 301–11 and accompanying text.

320. *See supra* notes 64–66, 301–11 and accompanying text.

considering the real costs to whistleblowers.³²¹ Securities professionals who become whistleblowers are likely to experience severe costs and consequences, as the Markopolos story indicates.³²² Unfortunately, the SEC issued final Rule 21F-6 without a requirement to consider costs to whistleblowers in bounty-size analyses.³²³ The SEC, of course, is free to place as much weight on those costs as it desires.³²⁴ Hopefully, the SEC will recognize that uncompensated costs are the principal reason whistleblowers do not come forward.³²⁵ This reality calls for a greater focus on those costs.

Research indicates that analysts are highly competent fraud detectors.³²⁶ The SEC should recognize their expertise and refrain from applying the regulations in a way that unfairly burdens them.³²⁷ The agency needs allies in the fight against fraud.³²⁸ When analysts are willing to risk their careers for justice, the SEC should make every attempt to compensate them for their trouble.

Further, the SEC should not discourage money managers who short stocks and then seek to collect a bounty.³²⁹ The agency should permit these managers to enter into agreements with their shareholders governing the distribution of bounties, and to collect them as “natural persons.”³³⁰ Last, the SEC should clarify the circumstances where “analysis” is deemed “original information,” and take a liberal approach that values analysis as much, or nearly as much, as actual knowledge.³³¹ Thus, the SEC could go a long way towards convincing stakeholders that the whistleblower program is credible and beneficial to the financial system.³³²

321. See *supra* notes 52–58 and accompanying text; see also *supra* Part II.B.2.

322. See *supra* Part IV.A.

323. See *supra* Part II.B.2.

324. See *id.*

325. See *supra* Part III.C.

326. See *supra* Part IV.A.

327. See *supra* notes 253–64 and accompanying text (distrust of short sellers).

328. See *supra* notes 260–64 and accompanying text (analysts and short sellers can help the SEC fight fraud).

329. See *supra* Part IV.B.

330. See *supra* notes 283–89 and accompanying text; see also *supra* notes 301–11 and accompanying text (although a journalist performed the analysis in the *Merck* case, it could have easily been a money manager).

331. See *supra* Part IV.C.

332. See *supra* Parts II–IV.