

THE DODD-FRANK WHISTLEBLOWER PROGRAM: A BLOWN OPPORTUNITY

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“The SEC has been set up for failure...Congress was eager to say, ‘We’ve addressed the financial crisis,’ and they didn’t worry about how effectively they had addressed the crisis. We needed smarter regulatory reform than we got.”¹

I. INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or Act)² was passed on 21 July 2010 in response to the global financial crisis that began in 2008 and still lingers today. The majority of the Act expands the scope of regulatory responsibilities to enhance monitoring of market players and complex financial instruments created on Wall Street. Buried among the over 2,000 pages lies 24 pages that create a new whistleblower program to be implemented by the Securities and Exchange Commission (SEC). The program provides typical anti-retaliatory protection for whistleblowers providing tips related to federal securities violations. The Act more notably provides for significant financial awards, commonly referred to as a “bounty,” of up to 30% of any related recovery by the SEC.³ Section 21F of the Act sets forth a basic framework: (1) a whistleblower; (2) who voluntarily provides the SEC; (3) with original information; (4) that leads to successful enforcement by the SEC resulting in monetary sanctions of more than \$1 million; (5) may be awarded 10% to 30% of any amounts recovered by the SEC. Congress left to the SEC the task of developing and issuing detailed rules to implement this program.

Proposed rules published by the SEC in November 2010 for public comment raised the ire of all affected parties. Corporations predicted a flood of frivolous SEC complaints by employees lured by the prospect of substantial bounties. Lawyers representing potential whistleblowers

¹ Harvey Pitt, former SEC Chairman, see J.J. Curran and J. Hamilton, “Schapiro SEC Seen Ineffectual Amid Dodd-Frank Funding Curbs,” *Bloomberg*, 31 March 2011, <http://www.bloomberg.com/news/2011-03-31/schapiro-sec-seen-ineffectual-amid-dodd-frank-funding-curbs.html>, last accessed on 7 April 2011.

² Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, H.R. 4173, 21 July 2010.

³ By way of example, a whistleblower in the recent \$550 million Goldman Sachs settlement with the SEC could have collected as much as \$165 million.

criticized the proposed rules for lacking sufficient whistleblower protections. The thrust of the objections dealt with one divisive issue: whether employees should be required to initially report internally to their employer using procedures mandated by the Sarbanes-Oxley Act in order to qualify for a bounty.

Such a requirement for internal reporting was not a feature of Dodd-Frank or the proposed rules, but the SEC asked for comment on how internal reporting might be encouraged. Corporations argued that costly internal reporting procedures would be rendered ineffective unless awards were contingent on prior internal reporting. The US Chamber of Commerce issued the following statement: “Not informing the 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 and instead calling the lawyers from the next town to sue over the fire instead.”⁴ On the other side, the whistleblower lobby argued just as strenuously that a requirement for internal reporting would have a chilling effect on the program.

On 25 May 2011, the SEC finally adopted rules implementing the whistleblower program, effective 12 August 2011 (Final Rules). In the Final Rules, the SEC declined to make awards contingent on internal reporting. Instead, the SEC made a number of amendments that purport to encourage internal reporting. Unfortunately, the half measures adopted by the SEC will do very little to overcome the enticement of multi-million dollar bounties. The SEC, in failing to require internal reporting, missed a golden opportunity to create a highly efficient whistleblower program. Requiring internal reporting would: (1) promote two effective and complementary regulatory mechanisms (whistleblowing and internal reporting); (2) allow the SEC to better allocate its strained resources; and (3) allow corporations to realize increased benefits from the significant investments

⁴ US Chamber of Commerce, Press Release, “U.S. Chamber Warns New SEC Whistleblower Rule Will Undermine Corporate Compliance Programs,” 25 May 2011, <http://www.uschamber.com/press/releases/2011/may/us-chamber-warns-new-sec-whistleblower-rule-will-undermine-corporate-compliance>, last accessed on 25 July 2011.

already made in creating Sarbanes-Oxley-mandated reporting procedures. Instead, the whistleblower program, as created by the SEC, will cause internal reporting programs to deteriorate, inundate the SEC with thousands of meritless tips, and expose corporations to additional inefficient regulatory costs.

This Article proposes that the SEC require whistleblowers to report internally except when they: (1) do not have access to an effective and good-faith compliance program; (2) are aware that the violation is already known by their employer but no remedial action has been taken within a reasonable timeframe; and/or (3) reasonably fear physical harm as a result of disclosure. Such a framework would allow the SEC to utilize internal corporate reporting as a screening process leading to proper allocation of its admittedly strained resources. In addition, the proposed program would give corporations the opportunity to further develop already mandated internal reporting mechanisms. Section II of this paper will examine the traditional rationales of whistleblower programs and their expansion into the private sector with financial incentives. In Section III the Article will scrutinize the pertinent provisions of the Dodd-Frank Act. Section IV will set forth the SEC's rules implementing the new whistleblower program. Finally, Section V will critically examine the failures of the newly created whistleblower program and provide the case for mandatory internal reporting.

II. WHISTLEBLOWER PROTECTION AND INCENTIVES IN THE US

Whistleblowing is “the disclosure by organization members (former or current) of illegal, immoral or illegitimate practices under the control of their employers, to persons or organizations that may be able to effect action.”⁵ Whistleblowers were once easily silenced by employers and viewed as turncoats by their co-workers. While statutes protecting whistleblowers from retaliation

⁵ J.P. Near & M.P. Miceli, “Organizational Dissidence: The Case of Whistle-Blowing,” 4 *Journal of Business Ethics* 1, 4 (1985).

have been in effect since the Civil War,⁶ the transformation of whistleblowers from scorned rats to public saviors did not gain momentum until the 1970s and 80s when whistleblowers were fundamental in combating fraud within the federal government. In recent years the low cost of gaining access to inside information through whistleblowers coupled with the collapses of public corporations has led to an increase in the use of whistleblower programs by the federal government.⁷ Today, whistleblowers are seen as courageous risk-takers willing to stand up to the public's new perceived enemy – Wall Street.⁸

Whistleblower programs play a separate and distinct role in the public and private sectors. Initially, whistleblower protection was created to expose waste within the federal government. These laws only provided protection after the fact, through legal sanctions.⁹ The gains in reporting from these programs led to the statutory creation of whistleblower programs in the private sector. These programs provided regulators with access to inside information, which is otherwise difficult to obtain because of a lack of transparency among private companies.¹⁰

The two federal whistleblowing programs that are the archetypes for modern programs are the False Claims Act (FCA)¹¹ and the Whistleblower Protection Act of 1989 (WPA).¹² The WPA protects federal employees from adverse action by the federal government for disclosing

⁶ J.R. Beck, "The False Claims Act and the English Eradication of Qui Tam Legislation," 78 *N.C. L. Rev.* 539, 555 n 12 (2000).

⁷ *Infra*, n 27; see, e.g., 148 Congressional Record 14,447 (statement of Sen. Leahy on whistleblower provisions within the Sarbanes-Oxley Act of 2002) ("[W]e include meaningful protections for corporate whistleblowers, as passed by the Senate. We learned from Sherron Watkins of Enron that these corporate insiders are the key witnesses that need to be encouraged to report fraud and help prove it in court.")

⁸ *Ibid.*

⁹ J.P. Near, T. Dworkin and M. Miceli, "Explaining the Whistle-Blowing Process: Suggestions from Power Theory and Justice Theory," 4 *Organization Science* 393, 400 (1993).

¹⁰ "Public regulators, law enforcement, and administrative agencies cannot effectively detect, prove, or deter complex economic wrongdoing without inside information. It is just too hard to piece together what is wrong." Interview with Pamela Bucy, Professor of Law, Univ. of Ala. Sch. of Law, Tuscaloosa, Alabama, in *Corp. Crime Rep.*, 20 May 2002; see also P. Bucy, "Private Justice," 76 *S. Cal. L. Rev.* 1, 55 (2002).

¹¹ 31 U.S.C. §§ 3729-3731 (2006).

¹² Pub. L. No. 101-12, 103 Stat. 16 (codified in scattered sections of 5 U.S.C.). WPA was the successor to the unsuccessful Civil Service Reform Act of 1978. See T.M. Devine, "The Whistleblower Protection Act of 1989: Foundation for the Modern Law of Employment Dissent," 51 *Admin. L. Rev.* 531, 532-35 (1999) (discussing the ineffectiveness of the CSRA).

information he or she “reasonably believes evidences - (i) a violation of any law, rule, or regulation, or (ii) gross mismanagement, a gross waste of funds, an abuse of authority, or a substantial and specific danger to public health or safety....”¹³ The WPA allows reporting to anyone, internal or external, and also provides a specific external entity to which whistleblowers may report - the Office of Special Counsel.¹⁴

The gains made in curbing misconduct against the government through whistleblowers, at little to no cost to the authorities, raised the stakes on whistleblowing. Eventually simply doing the right thing was not incentive enough and was cast aside as a secondary motivation for substantial financial incentives. The financial incentive laden whistleblower programs that headline today’s multi-million dollar awards originated in earnest with the False Claims Act (FCA).¹⁵

While the FCA dates back to the Civil War,¹⁶ financial incentives – such as *qui tam* rights¹⁷ – were not fully utilized until after the 1986 amendments to the FCA.¹⁸ The FCA creates civil liability, including treble damages, for any person that knowingly submits a false claim for payment to the US government.¹⁹ The FCA protects employees of companies that contract, subcontract, or receive funding from the federal government who provide information of a fraud against the federal government.²⁰

In 1986, Congress created greater incentives for whistleblowers to come forward through the right to initiate civil actions on behalf of the federal government – *qui tam* actions. As currently constructed, the FCA allows either the US Attorney General or a private party, in the name of the

¹³ 5 U.S.C. § 2302(b)(8) (2006).

¹⁴ Devine, *supra*, n 12.

¹⁵ 31 U.S.C. §§ 3729-3731 (2006); Beck, *supra*, n 6 (“Despite the availability of *qui tam* actions under [other] statutory provisions, only the False Claims Act has generated a large number of federal *qui tam* cases.”).

¹⁶ Beck, *supra*, n 6 at 555 (“Congress enacted the FCA in 1863, midway through the Civil War, in response to frauds perpetrated in connection with Union military procurement.”).

¹⁷ “Qui tam” means that the plaintiff is suing on behalf of herself as well as the government. 31 U.S.C. § 3730(b).

¹⁸ C.O. Broderick, “Qui Tam and the Public Interest: An Empirical Analysis,” 107 *Colum. L. Rev.* 949, 954 (May 2007).

¹⁹ 31 U.S.C. § 3729(a).

²⁰ 31 U.S.C. § 3729(a)(1)(A)-(G).

government (commonly referred to as a “relator”), to file a civil action against anyone that submits a false or fraudulent claim for payment to the federal government.²¹ The FCA prohibits employment discrimination and retaliation against not only *qui tam* plaintiffs, but also anyone who investigates, initiates, testifies, or provides assistance in any action filed or to be filed on behalf of the federal government for fraud in government programs.²² If the government intervenes, the relator is eligible to receive 15% to 25% of the damages received either through a judgment or settlement, plus reasonable attorney’s fees.²³ If the government declines to intervene, the relator can receive up to 30% of recovered damages, but not less than 25%.²⁴ However, if a relator does not prevail they are liable for their own costs and potentially for the defendant’s costs if there is a showing of frivolity.²⁵ The FCA has led to substantial gains for the Department of Justice (DOJ) in combating fraud against the government.²⁶

The FCA and WPA have generally been seen as successes by policy makers and lead to whistleblower programs being created in at least sixty other federal statutes.²⁷ A large number of the provisions protect employees in the private sector from violations related to workplace safety, public health and the environment. For instance, the Clean Air Act²⁸, the Energy Reorganization Act²⁹, the Safe Drinking Water Act³⁰, and the Occupational Safety and Health Act³¹ all provide protection to public and private employees who report employer actions that violate statutory provisions relating to health and safety. In addition, financial incentives have been expanded (but at

²¹ 31 U.S.C. § 3730.

²² 31 U.S.C. § 3730(h)(1).

²³ 31 U.S.C. § 3730(d)(1).

²⁴ 31 U.S.C. § 3730(d)(2).

²⁵ 31 U.S.C. § 3730(d)(4).

²⁶ US Department of Justice, Press Release, “Department of Justice Recovers \$3 Billion in False Claims Cases in Fiscal Year 2010,” 22 November 2010 (noting recovery of over \$27 billion since 1986), <http://www.justice.gov/opa/pr/2010/November/10-civ-1335.html>, last accessed on 7 April 2011.

²⁷ D.P. Westman & N.M. Modesitt, *Whistleblowing: The Law of Retaliatory Discharge*, (2d ed., 2002), 319-34, n 3 (listing federal statutes protecting employees against retaliation).

²⁸ 42 U.S.C. § 7622 (2008).

²⁹ 42 U.S.C. § 5851 (2008).

³⁰ 42 U.S.C. § 300j-9i (2008).

³¹ 29 U.S.C. § 660(c) (2006).

a much lower rate) - most recently in the IRS whistleblower program.³² The IRS program provides an individual who discloses tax fraud with an award ranging from 15% to 30% of the proceeds recovered by the IRS.³³

The laws protecting whistleblowers among the US states are similar in scope to those of the federal government (mostly in the public safety and health related matters). However, they vary widely in implementation particularly in the reporting obligations of whistleblowers. Today in the US, three forms of whistleblower programs are being used in state systems: (1) protecting only those employees who report externally to a government agency³⁴; (2) protecting employees who report either externally to a government agency or internally; or (3) protecting only those employees who initially report through internal corporate procedures.³⁵ Of the latter, several states have rigid rules that require internal reporting without exception. For example, New York law provides that a failure by an employee to give an employer reasonable opportunity to correct reported activity will render the employee ineligible for anti-retaliatory protection.³⁶

More commonly states that require internal reporting will provide whistleblowers with specific safe harbors.³⁷ For instance, New Jersey's Conscientious Employee Protection Act (CEPA)³⁸ provides some of the most far-reaching whistleblower protections in the nation while still requiring internal reporting. CEPA applies to private and public employees, making it unlawful for an

³² 26 U.S.C. § 7623.

³³ *Ibid.*

³⁴ These states include: Arizona, California, Connecticut, Hawaii, Iowa, Kentucky, Michigan, and Rhode Island. Ariz. Rev. Stat. Ann. § 38-531 (2001); Cal. Lab. Code § 1102.5 (West 2008); Conn. Gen. Stat. § 31-51m (1992); Haw. Rev. Stat. § 378-61 (2004); Iowa Code § 70A.28 (2006); Ky. Rev. Stat. Ann. § 61.102 (2008); Mich. Comp. Laws § 15.361 (2006); R.I. Gen. Laws § 28-50-2 (2008).

³⁵ These states include: Alaska, Colorado, Maine, Indiana, New Jersey, New York, New Hampshire, Massachusetts, Ohio, and Wisconsin. Alaska Stat. § 39.90.110 (2006); Colo. Rev. Stat. § 24-114-102 (2008); Me. Rev. Stat. Ann. tit. 26, § 833 (1987); Ind. Code § 22-5-3-3 (1990); N.H. Rev. Stat. Ann. § 275-E:2 (1988); N.J. Stat. Ann. § 34:19-1 to -8 (2008); N.Y. Lab. Law § 740 (McKinney 2008); Mass. Gen. Laws ch. 149 § 185 (2008); Ohio Rev. Code Ann. § 4113.52 (West 2008); Wis. Stat. Ann. § 230.81 (2003).

³⁶ N.Y. Lab. Law § 740(3) (McKinney 2008).

³⁷ Alaska, Maine, Massachusetts, New Hampshire, and New Jersey's statutes have a reasonable belief exception to the internal reporting requirement. Alaska Stat. § 39.90.110 (2006); Me. Rev. Stat. Ann. tit. 26, § 833 (1987); Mass. Gen. Laws ch. 149 § 185 (2008); N.H. Rev. Stat. Ann. § 275-E:2 (1988); N.J. Stat. Ann. § 34:19-1 to -8 (2008).

³⁸ N.J.S.A. §§ 34:19-1 to -8 (2008).

employer to take adverse employment action against an employee who discloses, objects to, or refuses to participate in actions that the employee reasonably believes are either illegal or in violation of public policy.³⁹ New Jersey has created a presumption of internal reporting by depriving whistleblower protection if a violation is not first reported internally. A person can be relieved of internal reporting only by demonstrating specific exceptions:

The protection against retaliatory action provided by this act...shall not apply to an employee who makes a disclosure to a public body unless the employee has brought the activity, policy or practice in violation of a law, or a rule or regulation promulgated pursuant to law to the attention of a supervisor of the employee by written notice and has afforded the employer a reasonable opportunity to correct the activity, policy or practice. *Disclosure shall not be required where the employee is reasonably certain that the activity, policy or practice is known to one or more supervisors of the employer or where the employee reasonably fears physical harm as a result of the disclosure provided, however, that the situation is emergent in nature.*⁴⁰

The wisdom of New Jersey's internal reporting requirement has not gone unchallenged,⁴¹ but ultimately has resulted in the nation's leader in state whistleblower protections.⁴² Therefore, while the federal system is best known, states like New Jersey have successfully implemented internal reporting requirements while still providing sufficient protection for whistleblowers.⁴³

The advantages of whistleblowing are evidenced by the rapid expansion of these programs throughout the US at both the state and federal levels. Whistleblower programs were extremely limited in scope in the 20th century. The broadest statute, the WPA, protected only certain federal employees.⁴⁴ More recently the scope of whistleblower programs has been expanded exponentially.

³⁹ *Mehlman v. Mobil Oil Corp.*, 707 A.2d 1000, 1008 (N.J. 1998) (citing J.H. Dorsey, "Protecting Whistleblowers," *N.Y. Times*, 2 November 1986) (At the time of its enactment in 1986, CEPA was considered "the most far reaching 'whistleblower statute' in the nation.")

⁴⁰ N.J.S.A. § 34:19-4 (emphasis added).

⁴¹ C. Dellatore, "Blowing the Whistle on CEPA: Why New Jersey's Conscientious Employee Protection Act Has Gone Too Far," 32 *Seton Hall Legis. J.* 375 (2008).

⁴² *Supra*, n 39.

⁴³ E.S. Callahan & T.M. Dworkin, "The State of the State of Whistleblower Protection," 38 *American Business Law Journal* 99, 128 (2000).

⁴⁴ G. Sinzdak, "An Analysis of Current Whistleblower Laws: Defending a More Flexible Approach to Reporting Requirements," 96 *Calif. L. Rev.* 1633, 1641 (December 2008).

In Sarbanes-Oxley, Congress extended material whistleblower protections into the realm of economic fraud. Sarbanes-Oxley ushered in greater reliance on internal compliance programs and mandatory disclosure.⁴⁵ The expansion of whistleblower provisions (and their accompanying incentives) into securities regulation continued with the recent adoption of Dodd-Frank.⁴⁶

III. THE DODD-FRANK ACT

From 2004, the US financial market was inundated with hundreds of billions of dollars of high-risk mortgages.⁴⁷ These mortgages were bundled into investment instruments referred to as residential mortgage-backed securities (RMBS).⁴⁸ In or about 2006, the market began to notice a substantial increase in the delinquency of residential mortgages that were the foundation of these investment schemes.⁴⁹ Owners of RMBS had difficulty selling their investments and began to purchase a form of “insurance” against their likely losses. This insurance is commonly referred to as credit default swaps (CDS). Eventually, CDS were not merely used to hedge investments, but became investment vehicles themselves as a way to profit from the failure of RMBS or CDO⁵⁰ securities. This added yet another layer of leverage on high-risk residential mortgages. Once housing prices fell, variable interest rates increased and homeowners became delinquent on their mortgages. The house of cards fell quickly, leading to a government funded bailout of some of the

⁴⁵ Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

⁴⁶ The SEC had a limited whistleblower program in place since the 1990s to reward whistleblowers in insider trading cases. By mid-2010 the program had paid only five rewards totaling \$159,537. S. Johnson, “Paid to Whistle,” *CFO.com*, 23 July 2010, <http://www.cfo.com/printable/article.cfm/14512666>, last accessed on 19 June 2011.

⁴⁷ Levin-Coburn Memorandum to the Members of the Permanent Subcommittee on Investigations, “Wall Street and the Financial Crisis: the Role of High Risk Loans” at 3, 13 April 2010, http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282, last accessed on 19 February 2011 (Subcommittee Memorandum).

⁴⁸ For a detailed examination of the causes of the economic crisis see H. Davies, *The Financial Crisis: Who is to Blame?* (Cambridge, 2010), 135 and the complaint captioned *SEC v. Goldman Sachs & Co.*, US District Court for the Southern District of New York, 10-cv-3229 (BSJ), 16 April 2010 (SEC Complaint) at ¶ 12.

⁴⁹ *Ibid.*

⁵⁰ Collateralized debt obligations (CDOs) are debt securities collateralized by debt obligations, including RMBS. These securities were typically packaged and “generally held by a special purpose vehicle (SPV) that issues notes entitling their holders to payments derived from the underlying assets.”

US's most revered financial institutions that recklessly leveraged their assets ten times over with little to no information on the underlying assets.⁵¹

On 21 July 2010, following the economic crisis, Congress hurriedly enacted the Dodd-Frank Act – the most sweeping reform in securities regulation in the US since the Great Depression.⁵² The complexity of Sarbanes-Oxley is surpassed only by the lengthy Dodd-Frank Act comprising over 2,000 pages, divided into sixteen titles, and by some accounts requiring regulators to create 243 rules, conduct 67 studies, and issue 22 periodic reports.⁵³ The Act represents a paradigm shift in financial regulation affecting all federal financial regulatory agencies and almost every aspect of the US (and to an extent the global) financial services industry.

The bulk of the Act addresses the purported causes of the crisis and seeks to remedy the systemic failures exposed in the market. For the most part, the Act seeks to regulate formerly under or unregulated transactions, such as derivatives and swaps, and market players, such as hedge funds and certain brokers like Bernie Madoff:

[B]y improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

While the aim of Dodd-Frank is clearly to further expand regulation of the financial markets, the sweeping reform also expanded whistleblower protection and incentives deeper into the private sector than ever before. Section 922 of Dodd-Frank amends the Securities and Exchange Act of 1934⁵⁴ inserting Section 21F to expand federal whistleblower protection and incentives in the securities industry. The whistleblower program is meant to reinforce the substantive reforms in the Act, but it fits awkwardly outside of the Act's more detailed provisions. Congress, in its haste, failed

⁵¹ Supra, n 48.

⁵² Supra, n 2.

⁵³ Davis Polk, “Summary of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010,” 9 July 2010.

⁵⁴ 15 U.S.C. § 78a, *et. seq.*

to adopt tailored whistleblower provisions necessary to address the unique regulatory framework already in place in the securities industry. In fact, it appears no consideration was formally given to the whistleblower program at all.⁵⁵ Likely as a result of this swiftness, the whistleblower provisions are extremely broad, and in some parts poorly drafted, leaving the SEC with little guidance for implementation.⁵⁶

Generally, persons providing “original information” to the SEC are eligible for a monetary award of 10% to 30% of the total sanctions obtained in a successful enforcement action exceeding \$1 million.⁵⁷ “Original information” is defined as information “derived from the independent knowledge or analysis of a whistleblower...not known to the SEC from any other source, unless the whistleblower is the original source of the information; and...not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.”⁵⁸ Eligible persons have little incentive to report directly to the SEC under the general terms of the Act. The only material risk is that a whistleblower that knowingly submits false information is ineligible for a bounty, but will likely still receive anti-retaliation protection.⁵⁹

Congress provided very vague and sweeping criteria that the SEC must consider when determining if and to what extent a bounty should be provided:⁶⁰

- (1) The significance of the information provided by the whistleblower to the success of the covered judicial or administrative action;

⁵⁵ The legislative history does not evidence any hearings before Congress on the Dodd-Frank whistleblower program.

⁵⁶ It appears the Dodd-Frank whistleblower provisions are patterned after the similar IRS whistleblower program, 26 U.S.C. § 7623.

⁵⁷ In addition to the bounty, the Act provides for typical anti-retaliation protections for eligible whistleblowers from discharge, demotion, suspension, threats, or harassment as a result of providing information to the authorities or internally about potential violations of securities laws. An aggrieved whistleblower has a private right of action against any employer that violates these provisions. A prevailing whistleblower has the right to reinstatement in their prior position, two times back-pay plus interest, and costs and fees. 21F(h).

⁵⁸ 21F(a)(3).

⁵⁹ 21F(i).

⁶⁰ 21F(c)(1)(a) (“The determination of the amount of an award made under subsection (b) shall be in the discretion of the Commission”).

- (2) The degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action; and
- (3) The programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers that provide information that leads to the successful enforcement of such laws.⁶¹

The statute further dictates that certain tipsters are not eligible for an award under the whistleblower program including: (i) employees of a regulatory authority, the DOJ, or other enforcement agency, (ii) any whistleblower convicted of a criminal violation related to the information provided, or (iii) any person that obtains the information from an audit required under the securities laws.

IV. SEC IMPLEMENTATION OF THE WHISTLEBLOWER PROGRAM

After some delay, the SEC adopted final rules on 25 May 2011. As previously discussed, the text of the whistleblower provisions in the Act lack specificity. Congress only set forth a broad principle based mandate to the SEC - create a procedure to receive whistleblower complaints, efficiently investigate and enforce them, and determine the factors necessary for a bounty to be paid. The task of detailed implementation was left to the SEC.⁶²

A. Key Elements of the Whistleblower Program

The SEC's Final Rules can be found in Sections 21F-1 through 21F-17 of the Exchange Act and include new Forms TCR and WB-APP.⁶³ A whistleblower is further defined by the SEC as an individual who "alone or jointly with others" provides information in accordance with specified procedures that "relates to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur."⁶⁴ A whistleblower is provided with anti-retaliation protection if they

⁶¹ 21F(c)(1).

⁶² The SEC is also required to conduct several studies and create a separate office within the SEC to administer and enforce the whistleblower program. Dodd-Frank Act, Section 924(d).

⁶³ 17 CFR Parts 240 and 249, SEC Final Rule, Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, 25 May 2011 (effective 12 August 2011) (Final Rules).

⁶⁴ 17 CFR § 240.21F-2(a).

possess a “reasonable belief” that the information provided “relates to a possible securities law violation” even if the whistleblower does not satisfy the conditions to qualify for an award.⁶⁵ Therefore, a whistleblower’s employment is protected simply if they have a reasonable basis to believe that the information provided relates to a federal securities violation.⁶⁶ Beyond anti-retaliation protection, the SEC’s main task was to clarify how and when a whistleblower becomes eligible for a bounty. Specifically, the SEC needed to define the following key terms: (1) voluntary submission; (2) original information; (3) successful enforcement; and (4) monetary sanctions.⁶⁷

1. *Voluntary Submission*

A submission is “voluntary” if it is made before a “request, inquiry, or demand” is made by the SEC or any other authority to the whistleblower related to the tip.⁶⁸ In addition, a submission of information will not be considered “voluntary” if the whistleblower was required to report the information to the SEC as a result of a pre-existing legal duty, a contractual duty that is owed to the SEC or another specific authority, or a duty that arises out of a judicial or administrative order.⁶⁹

2. *Original Information*

Information is considered “original” if it is: (i) derived from the whistleblower’s independent knowledge or independent analysis; (ii) not already known to the SEC from any other source; and (iii) not exclusively derived from an allegation already made in a prior hearing, report, investigation or news story.⁷⁰ However, if this type of information is obtained from certain persons likely to abuse their position as a fiduciary for personal benefit it is not considered “original”.⁷¹ Additionally, information obtained by an officer, director, trustee, or partner of an entity who was told of the

⁶⁵ 17 CFR § 240.21F-2(b).

⁶⁶ 15 U.S.C. § 78(u)-6(h)(1).

⁶⁷ 17 CFR § 240.21F-3.

⁶⁸ 17 CFR § 240.21F-4(a).

⁶⁹ *Ibid.*

⁷⁰ 17 CFR § 240.21F-4(b).

⁷¹ *Ibid.*

alleged misconduct in connection with the entity's processes for identifying, reporting, and addressing possible violations of law is excluded.⁷²

3. Successful Enforcement

“Successful enforcement” of a judicial or administrative action occurs in any of the following circumstances:

- (1) The original information causes the SEC to take action leading to the SEC bringing a successful judicial or administrative action based in whole or in part on conduct that was the subject of the original information; or
- (2) The original information was related to an on-going investigation by the SEC or other regulatory authorities, but the information significantly contributes to a successful action; or
- (3) The original information was reported through a company's internal compliance procedures before or at the same time the information was reported to the SEC; the company later provided the same information to the SEC or provided results of an audit or investigation initiated in whole or in part in response to information the whistleblower reported to the entity; and the information the entity provided to the SEC meets the above criteria.⁷³

If information is provided to another federal or state authority, a self-regulatory organization, or as part of a company's internal whistleblower procedures, the whistleblower must, within 120 days, submit the same information to the SEC in order to be eligible for an award. The date of submission will be considered the date of original disclosure provided that the whistleblower effectively proves such submission.⁷⁴ Therefore, if a whistleblower submits a complaint in accordance with internal reporting procedures, they must still report to the SEC within 120 days to be eligible for a bounty.

⁷² 17 CFR § 240.21F-4(b)(4)(iii). The rules also exclude information received from any employee whose principal duties involve compliance or internal audit responsibilities or who was retained to perform compliance or internal audit functions; or employees of public accounting firms that obtained such information through the performance of their duties as an independent public accountant.

⁷³ 17 CFR § 240.21F-4(c).

⁷⁴ 17 CFR § 240.21F-4(b)(7).

4. Monetary Sanctions

“Monetary sanctions” include “any money, including penalties, disgorgement, and interest, ordered to be paid and any money deposited into a disgorgement fund or other fund pursuant to Section 308(b) of [Sarbanes-Oxley] as a result of a Commission action or a related action.”⁷⁵ Once all criteria are met, the determination of the amount of an award is in the discretion of the SEC. However, the amount will be at least 10% and no more than 30% of the monetary sanctions that the SEC and/or other authorities are able to collect.⁷⁶

B. Rules Related To Internal Reporting

While Congress certainly left the SEC with a difficult task, the SEC added to Congress’ flawed drafting by creating a whistleblower program that exacerbated the SEC’s shortcomings and failed to take advantage of resources already in place, i.e. mandatory internal reporting programs. In the fall of 2010, the SEC released Proposed Rules for implementing the whistleblower provisions of Dodd-Frank.⁷⁷ In the Proposed Rules the SEC expressly rejected mandatory internal reporting:

Given the policy interest in fostering robust corporate compliance programs, we considered the possible approach of requiring potential whistleblowers to utilize in-house complaint and reporting procedures, thereby giving employers an opportunity to address misconduct, before they make a whistleblower submission to the Commission. Among our concerns was the fact that, while many employers have compliance processes that are well-documented, thorough, and robust, and offer whistleblowers appropriate assurances of confidentiality, others lack such established procedures and protections.⁷⁸

⁷⁵ 17 CFR § 240.21F-4(e).

⁷⁶ 17 CFR § 240.21F-5.

⁷⁷ Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 63237, 3 November 2010, available at <http://sec.gov/rules/proposed/2010/34-63237.pdf>, last accessed on 19 June 2011 (Proposed Rules).

⁷⁸ *Ibid*, 34-35.

During the public comment period the SEC received more than 240 comment letters and approximately 1,300 form letters on the proposal.⁷⁹ As expected, corporations and their related associations pushed for, *inter alia*, mandatory internal reporting by whistleblowers. For instance, Davis, Polk & Wardell, LLP, in line with many other business interests, argued that the Proposed Rules fail to promote the use of internal compliance systems as “the first and foremost method of addressing misconduct” and suggested the following amendments:

- Exclude from the definition of “whistleblower” a person who has access to an internal compliance system and who has failed to exhaust appropriate procedures under that system before reporting his or her complaint to the Commission;
- Require the Commission to contact a company upon receipt of a report of misconduct and provide the company with an opportunity to investigate the misconduct and report back, absent exceptional circumstances; and
- Allow corporations sufficient time to perform internal investigations without imposing a 90-day or other arbitrary deadline for the whistleblower to report an internally reported complaint to the Commission.⁸⁰

Meanwhile, the National Whistleblowers Center’s (NWC) submission was the key opposition supporting whistleblower interests. The NWC vehemently attacked any provision that would require internal reporting before a whistleblower could report violations to the SEC: “Any rule that would allow a corporation to make whistleblower protection contingent on compliance with an internal reporting scheme would illegally limit and chill the right of employees to anonymously disclose information to law enforcement agencies.”⁸¹

In the end, the NWC was able to preserve the core of the Proposed Rules, while corporations were only able to persuade the SEC to make nominal changes. The SEC stated in the

⁷⁹ Final Rules, *supra*, n 63 at 4; Public comments received by the SEC are available at <http://www.sec.gov/comments/s7-33-10/s73310.shtml>, last accessed on 13 June 2011 (Public Comments).

⁸⁰ *Ibid*; see also letters from the Association of Corporate Counsel and Edison Electric Institute. A number of other commenters also generally raised the concern that companies would be burdened if the Commission did not require employees to report possible violations of the securities laws internally either before or simultaneously with the submission of information to the Commission.

⁸¹ *Supra*, n 79, Letter from NWC to Elizabeth M. Murray, Secretary, SEC, 1 November 2010.

Final Rules that it would not mandate initial internal reporting of any kind, but instead sought to promote internal reporting through incentives:

We have determined not to include a requirement that whistleblowers report violations internally, but we have made additional changes to the rules to further incentivize whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate.”⁸²

The “additional changes” cited by the SEC are mere half measures that do very little to discourage whistleblowers to report externally. The key change made by the SEC was the addition of optional factors that may increase or decrease the bounty percentage for whistleblowers that report internally.⁸³ Factors that may increase an award include, but are not limited to: (1) significance of the information to the success of the enforcement action; (2) cooperation of the whistleblower; (3) the degree to which an award enhances the SEC’s ability to enforce the federal securities laws and protect investors; and (4) *participation in internal compliance systems*.⁸⁴ In addition, factors the SEC may use to decrease a reward include whistleblower interference with internal compliance systems.⁸⁵ The other “incentive” the SEC made in the Final Rules was a slight increase in the arbitrary deadline for a whistleblower to report to the SEC after first reporting internally - from 90 days to 120 days.⁸⁶ The rule is supposed to provide corporations with an additional 30 days to address internal complaints before the SEC may be informed by a whistleblower (not when a whistleblower can actually report to the SEC).

The Final Rules adopted by the SEC simply provide too many carrots and not enough sticks to make the whistleblower program efficient and useful. The vast divergence in risk/reward for whistleblowers under Dodd-Frank is unprecedented. Even the embattled FCA, which many today

⁸² SEC Summary of the Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545, at 5, 25 May 2011.

⁸³ 17 CFR § 240.21F-6.

⁸⁴ *Ibid.*

⁸⁵ *Ibid.*

⁸⁶ *Supra*, n 63.

claim allows too many frivolous claims⁸⁷, provides whistleblowers with a fair balance of impediments that must be overcome before a financial award can be obtained when compared to this new program. An FCA relator must first front the time and cost of initiating a lawsuit and gathering evidence, including attorney fees and costs. Also, a whistleblower risks being known publicly by their employer and co-workers if the *qui tam* complaint is unsealed.⁸⁸ Lastly, a whistleblower that does not prevail in a *qui tam* action could be liable for all of the defendant's costs and fees.⁸⁹ These disincentives were created (and enhanced in 1986) to ensure that only those whistleblowers that had a legitimate fraud claim filed *qui tam* actions.⁹⁰ In the end, the opportunities for life changing financial gains under the FCA are properly offset by potential risks. This balance is evidenced by the minimal shift from initial internal reporting to filing of *qui tam* actions after the 1986 amendments to the FCA.⁹¹

The SEC's amendments to the Proposed Rules fall well short of providing a similar assessment for potential whistleblowers. First, the Final Rules promote the submission of trivial or mistaken information to the SEC. Submitting a report to the SEC is very easy, requiring submission of only a Form TCR, which is short in length and requires negligible information. Also, a submission can be made anonymously through an attorney. These minimal hurdles require significant SEC follow-up. While misinformation can be easily identified and addressed by internal compliance departments, the SEC has far less ability to make a similarly quick determination. The

⁸⁷ W.E. Kovacic, "Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting," 29 *Loy. L.A. L. Rev.* 1799, 1855 (1996) ("[T]he *qui tam* mechanism provides inadequate disincentives for relators to file meritless suits."); J.H. Krause, "'Promises to Keep': Health Care Providers and the Civil False Claims Act," 23 *Cardozo L. Rev.* 1363, 1383 (2002) (suggesting that "meritless lawsuits" may be to blame for the increase in *qui tam* litigation).

⁸⁸ 31 U.S.C. § 3730(b)(2)-(3).

⁸⁹ 31 U.S.C. § 3730(d)(4) states that reasonable attorney's fees and expenses can be awarded where the defendant prevails and can demonstrate that the relator acted inappropriately. Senate Report on the 1986 Amendments to the FCA notes that this provision was added "in order to create a strong disincentive and send a clear message to those who might consider using the private enforcement provision of this Act for illegitimate purposes." S. Rep. No. 345, 99th Cong. 2d Sess. 29, 5266 (1986).

⁹⁰ *Ibid.*

⁹¹ *Supra*, n 18.

only real deterrent for whistleblowers is a requirement that Form TCR be submitted under penalty of perjury. This safeguard certainly limits the potential for blatantly fraudulent submissions, but does little to ward off information that relates to trivial activity or misinformation that a whistleblower mistakenly believes constitutes a federal securities violation. Whistleblowers submitting such information are still likely to receive anti-retaliatory protection and their identities will be protected if they submit anonymously. Therefore, the only downside to submitting misinformation is the loss of a bounty.

Second, even if a whistleblower had high-quality information of a securities violation, it benefits her to delay reporting and eventually report directly to the SEC. Delay and direct reporting to the SEC increases the opportunity for monetary sanctions to grow. If a whistleblower initially reports internally, a corporation would have the ability, and legal duty, to address an alleged violation expeditiously. Such action would limit the corporation's exposure to SEC enforcement, thus decreasing any potential monetary sanctions recovered. On the other hand, the time it takes the SEC to investigate and prosecute a securities violation - including the issuance of subpoenas and examination of witnesses - is far longer. This allows for violations to propagate - increasing monetary sanctions and the bounty collected thereunder. Thus, a whistleblower is incentivized to not reporting internally and delay reporting directly to the SEC.

There is negligible upside to initially reporting internally under the Final Rules - a chance of a slight increase in the percentage of the bounty received. Meanwhile, a whistleblower risks little submitting information, of any kind, to the SEC, standing to gain millions if a securities violation is ultimately discovered that is tangentially related to the information provided. Counsel for a recent whistleblower under the SEC's former bounty scheme explains that "[n]o matter what you do, you're still competing with a potential agency award of 10% to 30%, which even in a \$1 million case could be \$100,000," he says. "Companies are going to have to come up with some pretty tasty

carrots to compete with that!”⁹² The SEC has acknowledged this tension and the clear benefits of internal reporting when it made amendments to the Proposed Rules. It is curious why the SEC chose not to do more to promote corporate compliance systems.

V. THE CASE FOR REQUIRING INTERNAL REPORTING

Policy makers and commentators largely agree that the most efficient way to initially address corporate misconduct is not through federal regulators, but by empowering corporations to take action through effective internal compliance programs.⁹³ The efficiencies of these programs are bolstered by strong employee participation promoted by whistleblower protections and incentives.⁹⁴ Rather than promote this complementary form of regulation, the SEC has decided to weaken internal reporting at the hands of whistleblowing. This decision is astounding because the goal of the Act is to stop wrongdoing. Instead, the SEC has created a whistleblower program that is likely to jeopardize recent gains in internal compliance programs. The Final Rules improperly focus on the risks of ineffective compliance programs and disregard the benefits of strong and independent corporate programs.⁹⁵ A leading practitioner in employment matters aptly noted that the SEC program could “dramatically undermine” compliance policies and “discourage internal reporting in favor of an employee squirreling away information to protect his or her status as the ‘original source’ of the information.”⁹⁶

⁹² Steven Pearlman, a partner in the Chicago-based law firm of Seyfarth Shaw. D. Lindorff, “SEC Bounty Hunters: Dodd Frank and the SEC’s Zeal Make It Easier and More Lucrative for Whistleblowers to Tip the Feds Off to Securities Violations,” *Treasury & Risk & TR Breaking News*, 2 September 2010.

⁹³ *Supra*, n 9; see also L.A. Low, et al., “Enforcement of the FCPA in the United States: Trends and the Effects of International Standards,” *The Foreign Corrupt Practices Act*, at 123-24 (describing how the enactment of Sarbanes-Oxley has intensified ethics and compliance programs of U.S. listed companies); E. Schwartz, “Hiking the Cost of Bribery,” *US News & World Report*, 13 August 2007, at 31 (describing how Sarbanes-Oxley has “increased reporting requirements for public companies” leading “many firms to beef up internal investigation units” and provided incentives to disclose wrongdoing).

⁹⁴ *Ibid.*

⁹⁵ *Supra*, n 79, Joint Letter of General Electric Company, Google Inc., Honeywell Inc., JP Morgan Chase & Co., Microsoft Corporation, and Northrop Grumman Corporation to the SEC, 17 December 2010.

⁹⁶ Greg Keating, a shareholder at Littler Mendelson, the nation’s largest employment and labor law firm representing management, and author of “Retaliation and Whistleblowing: A Guide for Human Resources Professionals and Counsel” (Lexis Nexis 2005).

The SEC must acknowledge that Sarbanes-Oxley required the creation of costly internal reporting programs and should promote further development through the whistleblower program. The ideal whistleblower program would empower corporations to have robust, anonymous and good-faith internal reporting procedures. When these procedures fail, whistleblowers should then be allowed to report directly to the SEC, who can punish corporations for their inaction. Such a framework would optimize whistleblowing and internal reporting as complementary regulatory mechanisms. It is in rare circumstances when internal reporting will detract from the benefits of whistleblowing through cover-ups and retaliation. In these cases, the Dodd-Frank whistleblower program should exempt whistleblowers from internal reporting if they can prove: (i) it would be futile because the internal reporting program is compromised or management is already aware of the alleged violation and has failed to act within a reasonable time frame; and/or (ii) they have a reasonable fear of imminent physical harm.

Rather than protecting against the worst-case scenario, the SEC can promote the development of effective internal reporting programs through corporate incentives already in use. The SEC can make clear, very early on, that a finding of an inadequate internal reporting program will lead to greater fines and penalties similar to the DOJ's Principles for Prosecution of Business Organizations. Second, corporations must be required to log, investigate, report and resolve all complaints in a prompt and fair matter and if they do so, will be provided with decreased penalties. Through this framework internal reporting programs can be developed as a screening mechanism for the SEC, allowing the SEC to focus on large-scale fraud and securities violations – the reason for this reform.

A. Internal Reporting Is The Most Efficient Means of Securities Regulation

Effective monitoring of corporations benefits shareholders, employees, and the general public.⁹⁷ Monitoring comes in two forms – external and internal. External monitoring is the traditional form undertaken by government regulators and external gatekeepers. Internal monitoring is a more recent phenomenon that formally requires compliance officers, audit committees, internal auditors, and in-house gatekeepers to monitor corporate actions. While external monitoring allows for independent analysis, external monitors must rely on information provided by corporations.⁹⁸ Even well intentioned corporations are likely to provide incomplete or self-serving information, and worse, some may affirmatively hide or misrepresent information. The failings of external monitors in scandals such as Enron and WorldCom have been exhaustively discussed and demonstrate that external monitoring alone is insufficient.⁹⁹

The majority of commentators and policy makers now agree that effective internal reporting programs are the most efficient first line of defense against corporate fraud and regulatory violations. The evidence shows that effective internal mechanisms are more likely to lead to timely remedies of potential misconduct.¹⁰⁰ An “effective reporting system” encourages and facilitates complete, timely and accurate reporting by employees of misconduct in the workplace. The basic features of an effective internal compliance program should resemble those set forth in the US Federal Sentencing

⁹⁷ S.M. Bainbridge & C. J. Johnson, “Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307,” *Mich. St. L. Rev.* 299, 316 (2004); R.H. Kraakman, “Corporate Liability Strategies and the Costs of Legal Controls,” 93 *Yale L.J.* 857, 863 (1984).

⁹⁸ Information blocking and filtering occurs when information is withheld by subordinates and “communication upward [is] highly filtered and correspondingly inaccurate.” J.C. Coffee, Jr., “Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response,” 63 *Va. L. Rev.* 1099, 1144 (1977) (quoting R. Likert, “A Motivational Approach to a Modified Theory of Organization and Management,” *Modern Organization Theory* 184, 195-96 (M. Haire ed., 1959)); see also L.K. Trevino, “Out of Touch: The CEO’s Role in Corporate Misbehavior,” 70 *Brook. L. Rev.* 1195, 1209-10 (2005) (describing research regarding the distortion and filtering of information from subordinates to superiors in hierarchical organizations).

⁹⁹ J.C. Coffee, Jr., “Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms,” 84 *B.U. L. Rev.* 301, 308-10 (2004); J.N. Gordon, “Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley,” 35 *Conn. L. Rev.* 1125, 1125-43 (2003); J.R. Kroger, “Enron, Fraud, and Securities Reform: An Enron Prosecutor’s Perspective,” 76 *U. Colo. L. Rev.* 57, 59-60 (2005).

¹⁰⁰ *Supra*, n 9.

Guidelines (USSG). There should be a clearly structured program that is actively implemented and enforced, including a comprehensive system of internal controls and ongoing training of personnel. In particular, specific individuals within the organization should be delegated day-to-day operational responsibility for the program.¹⁰¹ Moreover, the program should include mechanisms that allow for anonymity or confidentiality, whereby the corporation's employees and agents may report or seek guidance regarding potential or actual misconduct without fear of retaliation.¹⁰²

The benefits of effective reporting programs are well-documented and can hardly be disputed.¹⁰³ These programs are cost efficient and useful in clarifying whistleblower mistakes.¹⁰⁴ Specifically, internal reporting limits the time necessary to investigate and remedy whistleblower claims.¹⁰⁵ Claims made internally to compliance officers and audit committees allow the parties with the best access to information and means of addressing issues to quickly take action. On the other hand external authorities must make inquiries, typically through subpoenas, for information. In addition, even if an external investigation is fruitful, enforcement can be timely, costly, and restrictive in available remedies. External reporting of mistaken misconduct or trivial information may lead to a costly investigation and unnecessary litigation. The cost of public dissemination of erroneous information can be significant for corporations, investors and employees.¹⁰⁶ Corporations

¹⁰¹ U.S.S.G. § 8B2.1b(5).

¹⁰² U.S.S.G. § 8B2.1b(2).

¹⁰³ C. Estlund, "Corporate Self-Regulation and The Future of Workplace Governance," 84 *Chi.-Kent L. Rev.* 617, 634 (2009) ("If these self-regulatory regimes do induce firms to internalize the public values underlying legal mandates, or to live up to their own stated objectives, they may grow into more robust forms of self-governance in which employees participate."); K. Rubinstein, "Internal Whistleblowing and Sarbanes-Oxley Section 806: Balancing The Interests of Employee and Employer," 52 *New York Law School Law Review* 637, 650 (2008) ("Internal reporting of alleged violations would provide a more effective method of vetting such concerns prior to permitting external disclosure.")

¹⁰⁴ K. Maxwell, "Blowing the Whistle Falls on Deaf Ears: Revamping Texas's Whistleblower Jurisprudence By Applying The Lessons of Garcetti and Sarbanes Oxley," 43 *Tex. Tech L. Rev.* 647, 681 (2011).

¹⁰⁵ *Supra*, n 9.

¹⁰⁶ T. Morehead Dworkin & J.P. Near, "Whistleblowing Statutes: Are They Working?," 25 *Am. Bus. L.J.* 241, 243 (1987).

should generally be given a reasonable opportunity to cure potential problems internally without fear of external retribution in the market.¹⁰⁷

Rather than create incentives for more effective reporting systems, the SEC has adopted a whistleblowing program that will render them redundant. The SEC's bounty program promotes external reporting and shifts the first line of defense for employee complaints of securities violations to an inefficient and under-staffed SEC.

B. Sarbanes-Oxley Demonstrated A Shift Toward Reliance on Internal Reporting Programs

Because of the clear benefits of internal reporting programs, Congress, the DOJ, and many government entities have sought to promote the creation and development of such programs. Most notably in 2002, following the scandals of Enron and WorldCom, Congress implemented a fundamental shift in the regulation of the securities industry. In Sarbanes-Oxley Congress mandated that the first line of defense against possible securities violations should be through internal channels by way of independent corporate audit committees and affirmative disclosure obligations on directors and gatekeepers.¹⁰⁸ After adoption of Sarbanes-Oxley, employee complaints and self-reporting of possible financial reporting violations abruptly became the norm within the executive suites of corporations.¹⁰⁹

Generally, Sarbanes-Oxley is a complex compilation of amendments to various federal statutes. The main focus of Sarbanes-Oxley is an increased role of management on corporate internal controls for financial reporting. Listed companies are required to: (i) have internal reporting

¹⁰⁷ Supra, n 79, NWC Letter. These statistic further supports a mandatory internal reporting regime if employees generally feel more comfortable and more likely, when everything being equal, to report internally.

¹⁰⁸ Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C. & 28 U.S.C.); L.C. Backer, "In the Wake of Corporate Reform: One Year In the Life of Sarbanes-Oxley – A Critical Review Symposium Issue: Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley," *Mich. St. L. Rev.* 327, 337 (2004) ("In its essence, the Sarbanes-Oxley Act of 2002 is about disclosure.")

¹⁰⁹ *Ibid.*

procedures in place for employees to report misconduct;¹¹⁰ (ii) have directors certify that such controls are in place and effective;¹¹¹ and (iii) publicly disclose within four days, through a Form 8-K, any material triggering events that could affect the market for a corporation's shares.¹¹² Internal compliance is specifically facilitated by the mandatory creation of audit committees, consisting of independent directors, to monitor corporate insiders, employees and compliance.¹¹³ Listed companies must implement a confidential and anonymous reporting procedure for questionable accounting or auditing matters.¹¹⁴ As a result many listed companies have implemented anonymous hotlines for employees to report alleged misconduct without fear of reprisal.¹¹⁵ Corporations are provided with an incentive to quickly implement these reporting procedures by requiring directors to certify that such controls are in place.¹¹⁶

Additionally, Section 406(a) of Sarbanes-Oxley requires all companies listed on US stock exchanges to adopt a code of ethics for senior financial officers or persons performing similar functions, which must include standards to promote: (i) honest and ethical conduct; (ii) full, accurate and timely disclosures; and (iii) compliance with applicable rules and regulations. Moreover, should any complaints received through internal procedures result in the uncovering of material securities violations, listed companies have a mandatory disclosure obligation under various rules to publicly

¹¹⁰ Sarbanes-Oxley § 301.

¹¹¹ Sarbanes-Oxley §§ 302 & 906.

¹¹² SEC Form 8-K is used for current reports under Section 13 or 15(d) of the Securities Exchange Act of 1934, filed pursuant to Rule 13a-11 or Rule 15d-11 and for reports of non-public information required to be disclosed by Regulation FD. 17 CFR 243.100 and 243.101.

¹¹³ 15 U.S.C. § 78j-1(m)(2) (audit committees are “directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer”). The audit committee may also act as a “qualified legal compliance committee” constituted for the purpose of receiving, retaining and considering any confidential report of evidence of material violations required to be reported to the company by law subject to the “detect and report” rules imposed by Sarbanes-Oxley § 307 (codified at 15 U.S.C. § 7245) and the regulations thereunder. See also Sarbanes-Oxley Act § 404 (codified at 15 U.S.C. § 7262) (requiring production by management of internal control reports).

¹¹⁴ Sarbanes-Oxley § 301(4).

¹¹⁵ S. Reisinger, “On Bended Knee: Companies Are Disclosing Overseas Bribes in Record Numbers. But Is Confession Always Necessary?,” *Am. Law*, July 2007, 73, 74. (“The Sarbanes-Oxley Act of 2002 mandated extra record keeping duties, compliance programs, and ‘whistle blower’ hotlines that have turned up numerous bribe allegations.”)

¹¹⁶ This is made most clear through the certification process imposed pursuant to Sarbanes-Oxley §§ 302 and 906 (codified at 15 U.S.C. §§ 7241, 1350).

disclose in an expedient manner.¹¹⁷ To further enhance reporting, anti-retaliation protections were put into place for employees that report accounting irregularities or assist government and regulatory agencies in inquiries on such irregularities.¹¹⁸ Section 1107 also provides for criminal sanctions for any retaliation against employees that disclose a federal offence.

As part of a review of Sarbanes-Oxley, one year after its enactment, it was noted that “[t]he public corporation has become an entity under surveillance by gatekeepers (outside directors, lawyers, and auditors) and government. It is also an entity that keeps watch on itself (through systems of reporting and control, and by threat of exposure through whistle blowers).”¹¹⁹ The evidence demonstrates that Sarbanes-Oxley, after significant investment by corporations, has created a corporate culture where anonymous whistleblower complaints and timely public disclosure have become the norm and resulted in the avoidance and/or unearthing of several significant violations.¹²⁰ It is only logical for the SEC to seek to further increase the gains made from Sarbanes-Oxley by expanding the use of internal reporting programs in securities regulation.

In addition to the expansive mandates of Sarbanes-Oxley, several other policies have been implemented to further promote effective corporate reporting programs. The Organizational Sentencing Guidelines (Guidelines or OSG), promulgated by the United States Sentencing Commission (USSC), provide for the reduction of sentences for corporations that have effective reporting programs in place.¹²¹ Under the Guidelines, a court must calculate the appropriate sentence range allowing for a subtraction of points from an organization’s Guidelines sentence

¹¹⁷ Form 8-K under Section 13 or 15(d) of the Securities Exchange Act of 1934, filed pursuant to Rule 13a-11 or Rule 15d-11 and for reports of non-public information required to be disclosed by Regulation FD. 17 CFR 243.100 & 243.101.

¹¹⁸ Sarbanes-Oxley § 806; H. Hassink, M. de Vries & L. Bollen, “A Content Analysis of Whistleblowing Policies of Leading European Companies,” 75 *Journal of Business Ethics* 25 (2007).

¹¹⁹ *Supra*, n 108.

¹²⁰ *Supra*, n 93; Cf. Miriam A. Cherry, “Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law,” 79 *Washington Law Review* 1029, 1069-84 (2004) (discussing the weaknesses of Sarbanes-Oxley, specifically the unclear procedures for employers to address employee complaints).

¹²¹ USSG § 8 (2009) (explaining that the Guidelines are designed to “provide just punishment, adequate deterrence, and incentives” for organizations to police themselves).

based on two factors: (i) the existence of an effective compliance program at the time of the misconduct and cooperation in the government investigation, and (ii) self-reporting of the misconduct.¹²² As such, organizations seeking to mitigate criminal punishment can do so by adopting a facially effective compliance and/or reporting illegal activity to prosecutors. Additionally, the DOJ's Principles of Federal Prosecution of Business Organizations suggests that prosecutors "make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation."¹²³

Some proponents of the SEC's whistleblower program contend that the financial crisis is an example of internal compliance gone wrong. This argument is nothing more than uninformed pandering. Before Dodd-Frank, internal reporting programs only dealt with financial reporting issues. Moreover, robust internal reporting and even a full-fledged whistleblower program, as adopted by the SEC, would not have stopped the financial crisis. The crisis resulted not from illegal actions, but reckless behavior.¹²⁴ The fact of the matter is that most, if not all, of the actions that led to the financial crisis – poor credit ratings, leveraging, swaps, and complex derivatives - were legal under pre-Dodd-Frank laws.¹²⁵ A whistleblower program is only as strong as the laws under which regulators can bring successful enforcement actions. The systemic risks that brought about the financial crisis are only now the subject of regulation found in the other 2,000 pages of Dodd-Frank.

¹²² USSG, § 8C2.5(f)-(g), comment note 12 (describing the effect of compliance programs and cooperation on the OSG score, and defining cooperation to include "the disclosure of all pertinent information known by the organization").

¹²³ USDOJ, Principles of Federal Prosecution of Business Organizations, 9-28.800 - Corporate Compliance Programs.

¹²⁴ J. Fisher QC, C. Cregan, J. Di Giulio & J. Schutze, "Economic Crime and The Global Financial Crisis," (2011) *Law and Financial Markets Review* 276, 282; *Supra*, n 48 at 135.

¹²⁵ *Ibid.* (i.e. the acquittal by jury of two Bear Sterns executives following the crisis, "Ex-Bear Fund Managers Not Guilty of Subprime Fraud," *Bloomberg*, 10 November 2009,

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=adMRekz7o4Yw&pos=1>, last accessed on 21 June 2011).

In addition, opponents of internal reporting programs as the first line of defense contend that these programs are mere “window-dressing” allowing for corporate cover-ups and decreased regulation.¹²⁶ However, unlike in most industries covered by whistleblower statutes where this behavior could be more prevalent, the incentives and opportunities for “cosmetic compliance” in securities regulation are severely circumscribed by a strong regulatory framework governing listed companies. Listed companies offering securities in the US are heavily regulated by mandatory disclosure requirements, strict accounting rules, the presence of independent gatekeepers, the threat of meaningful enforcement actions by the DOJ and SEC, and the potential for public backlash from cover-ups and illegal activity.¹²⁷ Any potential for retaliation against whistleblowers and corporate cover-ups has been severely lessened following the demise of Enron and its directors. Moreover, a fleet of gatekeepers aligned with regulators are now more independent and have far more access to corporate information. Therefore, the traditional fears of reprisal and other negative externalities that could arise from internal reporting by whistleblowers are nominal under this regulatory regime.

With these mitigating factors and laws promoting internal reporting already in place, it makes little sense to now abandon this framework without an express policy shift adopted by Congress. The SEC’s insistence on detracting from internal reporting is curious because promoting these

¹²⁶ Prof. Kimberly D. Krawiec argues that generally these programs fail to deter undesirable conduct within organizations and instead serve as “window-dressing” that legitimizes the organization’s behavior, enabling it to avoid legal liability. As a result, Krawiec argues, there may be both under-deterrence of prohibited conduct and an increase in costly, ineffective, internal compliance mechanisms. K.D. Krawiec, “Cosmetic Compliance and the Failure of Negotiated Governance,” 81 *Wash. U. L.Q.* 487, 489-90 (2003).

¹²⁷ J.C. Coffee, Jr., “Market Failure and the Economic Case for a Mandatory Disclosure System,” 70 *Virg.L.Rev.* 717 (1984); W.H. Beaver, “The Nature of Mandated Disclosure,” *Economics of Corporation Law and Securities Regulation* 317, 320-21 (R.A. Posner & K.E. Scott eds., 1980); M.B. Fox, “Civil Liability and Mandatory Disclosure,” 109 *Columbia Law Review* 237, 253-269 (2009); M. Guttentag, “An Argument For Imposing Disclosure Requirements on Public Companies,” 32 *Fla. St. U.L. Rev.* 123, 133-139 (2004); Cf. F.H. Easterbrook and D.R. Fischel, “Mandatory Disclosure and the Protection of Investors,” 70 *Virginia Law Review* 669, 715 (1984) (concluding about public company disclosure regulation “we cannot identify either benefit or detriment”); P.M. Healy and K.G. Palepu, “Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature,” 31 *Journal of Accounting and Economics* 405, 414 (2001) (concluding after a review of the research on disclosure requirements that “surprisingly little is known about why financial reporting and disclosure is regulated in the capital market”).

programs would have been easier and more efficient.¹²⁸ The policy shift away from compliance programs requires far greater discussion and legislative action – particularly with the potential negative effects that will result from the Final Rules.

C. The SEC Cannot Handle The New Whistleblower Program

The clear benefits of internal compliance programs and the government’s clear intention of promoting these programs are not the only reasons the SEC should require initial internal reporting of securities violations. As a practical matter the SEC, with its limited resources, cannot handle the new program as constituted. Dodd-Frank significantly increased the SEC’s workload not only with the whistleblower program, but also through its expanded role in monitoring hedge funds,¹²⁹ credit rating agencies, derivatives and other complex transactions.

Many proponents of the current rules admit to the SEC’s resource shortfall, but contend that receipt of more information, of any kind, will likely lead to “high value” information that otherwise would never have been relayed to the SEC. This argument poses several problems. First, the SEC has shown that under pre-Dodd-Frank levels it was unable to investigate and react to the limited whistleblower tips it received (i.e. Harry Markopolos in the Bernie Madoff case). The SEC’s former failures, which are well documented, show that more tips will only mean more significant frauds falling through the cracks. The SEC will be forced to make an inefficient allocation of resources away from other independent monitoring and investigatory actions to focus on fostering the whistleblower program. As a result, the SEC will suffer from a moral hazard problem - relying too heavily on the information provided by whistleblowers and not enough on self-initiated investigations. Also, corporations will need to shift a great deal of their resources dedicated to

¹²⁸ Supra, n 92 (“[C]ompanies are going to have to respond to the new statute by taking steps to try and keep employee whistleblowing within the company. [Attorney Pearlman] says this will take more than just setting up hotlines for reporting fraud anonymously-something many companies have already put in place in response to Sarbanes-Oxley”).

¹²⁹ Global hedge fund assets alone are approximately \$1.92 trillion. “Hedge Fund Industry Assets Swell to \$1.92 Trillion,” *Daily FT*, 24 January 2011, <http://www.ft.lk/2011/01/24/hedge-fund-industry-assets-swell-to-1-92-trillion/>, last accessed on 25 July 2011.

internal compliance to the substantial costs of responding to additional SEC investigations and inquiries. This will lead to corporate compliance programs being neglected by corporations – leading to even more tips being reported to the SEC.¹³⁰

The SEC can only act as a first line of defense if it actually believes it can be more efficient in receiving, investigating and remedying securities violations exposed by whistleblowers. By its own admission it surely cannot. Mary Shapiro, Head of the SEC is quoted as saying: “The real crunch comes after the [Dodd-Frank] rules are in place and we have to operationalize them...We lack the resources to do that.”¹³¹ Her prediction has so far been proven true. As recently as 20 July 2011, before the Final Rules even took effect, SEC officials warned that they “‘may be forced’ to not file charges in some cases and name fewer defendants in others, end some probes sooner and settle cases the agency would rather take to court if the current budget woes continue.”¹³²

With this knowledge, the SEC should be promoting internal reporting as a screening process, thereby simultaneously allowing corporations to reap further benefits from their previous investments in compliance programs. Specifically, the SEC should utilize internal reporting programs to limit the number of low priority or meritless complaints that it would otherwise receive allowing it to optimize its strained resources. Continued reliance on a make shift “‘triage process”¹³³ will undermine every effort of Congress to ensure the SEC receives and reacts to the highest quality information related to serious securities violations. Ideally, regulation unrestricted by resource

¹³⁰ “If more money meant a more effective SEC, then this would be a legitimate concern...Unfortunately, over the last decade the SEC’s budget has nearly tripled, yet it has repeatedly failed to stop the most egregious cases of fraud.” Quote from Rep. Ed R. Royce (Rep.), C. Riley, “SEC: We Need More Money to Stop Fraud,” *CNN Money*, 16 March 2011, http://money.cnn.com/2011/03/16/news/economy/sec_funding/, last accessed on 7 April 2011.

¹³¹ *Supra*, n 1, testimony of Mary L. Shapiro, Head of the US Securities and Exchange Commission, February 2011, before the US Senate Banking Committee.

¹³² J. Eaglesham, “Atlas Shrugged. Will Regulators,” *Wall Street Journal*, 20 July 2011, http://online.wsj.com/article/SB10001424052702304567604576456383493081922.html?mod=googlenews_wsj, last accessed on 22 July 2011.

¹³³ Even before Dodd-Frank, the SEC openly referred to its necessary prioritization of complaints due to a lack of resources as a “‘triage process.” “US Securities and Exchange Commission, Organizational Study and Reform,” *Boston Consulting Group*, 10 March 2011, <http://www.sec.gov/news/studies/2011/967study.pdf>, last accessed on 7 April 2011.

limitations may be as effective as internal reporting, but such a utopia does not exist in the reality of the SEC.

Even before Dodd-Frank, the SEC was unable to efficiently “triage” whistleblower tips, one of which handed them the billion-dollar Ponzi scheme of Bernie Madoff years before he was exposed. On 21 August 2009, the Office of Investigation of the SEC (OIG) concluded that despite receiving several substantive complaints *since 1992* about Bernie Madoff’s hedge fund operation it failed to uncover the massive fraud:

[T]he OIG found that although the SEC conducted five examinations and investigations of Madoff based upon these substantive complaints, they never took the necessary and basic steps to determine if Madoff was misrepresenting his trading. We also found that had these efforts been made with appropriate follow-up, the SEC could have uncovered the Ponzi scheme well before Madoff confessed...The OIG found that the conduct of the examinations and investigations was similar in that they were generally conducted by inexperienced personnel, not planned adequately, and were too limited in scope.¹³⁴

Importantly, the investigation into Madoff failed as a direct result of scarce resources. In 2004 the investigating team was told by superiors to stop working on the Madoff case and focus on a purportedly higher priority concern - mutual fund revenue sharing.¹³⁵

To make matters worse, the SEC is likely to have a flat budget for the fiscal year beginning in October 2011. At best the SEC will receive a slightly increased budget – still far less than necessary to handle its increased responsibilities. In the original version of Dodd-Frank it was envisioned that the SEC would be self-funded relying on money recovered from enforcement actions instead of being tied to a Congressional budget.¹³⁶ However, Congress’ fear of losing supervisory authority and accountability led to the SEC continuing to be part of the federal budget.

¹³⁴ SEC Office of Investigations Report, “Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme – Public Version,” 31 August 2009 (OIG Report).

¹³⁵ *Ibid*, 125-26.

¹³⁶ S. Rep. 111-176, 111th Cong., 2nd Sess. 2010 (30 April 2010) (Senator Dodd stated that “[t]he SEC has asked to be unfettered by the Congressional appropriation process and the new law would allow the agency to be self-funded.”)

As of 16 June 2011, the House of Representatives was proposing that the SEC's budget for the year beginning 1 October 2011 be kept flat at \$1.2 billion - \$200 million less than the nominal increase the Obama administration was seeking.¹³⁷ Even with the additional \$200 million proposed by President Obama the SEC will still have inadequate resources to staff the whistleblower program.

In March 2011, a Dodd-Frank-mandated review of the SEC by Boston Consulting Group Inc., explained that the SEC was understaffed to meet its obligations under Dodd-Frank.¹³⁸ The report found that the SEC was about 400 employees short of what was necessary to manage its new workload, which in addition to whistleblowing includes oversight of hedge funds, derivatives, credit-ratings firms and municipal bonds.¹³⁹ The report concludes that “[w]ithout sufficient human resources, the agency will be unable to complete the requirements of Dodd-Frank while maintaining its current activities... Thus, the SEC will be forced to shift resources away from existing activities toward items required by Dodd-Frank.”¹⁴⁰

The likely minimal increase in the SEC's budget coupled with greater responsibilities under Dodd-Frank makes efficient investigation and enforcement of the increased tips coming from the whistleblower program seemingly impossible. This will inevitably lead to avoidance of high-quality tips. In 2008, the SEC received more than 700,000 tips and outside complaints.¹⁴¹ Of the approximately 700,000 outside complaints, the SEC characterized only about two dozen as “high

¹³⁷ By way of comparison, JPMorgan's litigation reserves as of the third quarter of 2010 were \$4 billion. Thus, just one of the thousands of entities that the SEC is mandated to regulate has a war chest 4 times that of the regulatory authority. H. Touryalia, “10 Wall Street Expenses That Make The SEC's Budget Look Pathetic,” *Forbes*, 17 February 2011, <http://blogs.forbes.com/halahtouryalai/2011/02/17/10-wall-street-expenses-that-make-the-secs-budget-look-pathetic>, last accessed on 17 June 2011.

¹³⁸ *Supra*, n 133.

¹³⁹ *Ibid.*

¹⁴⁰ *Ibid.*, 197; see generally Black, “The Legal and Institutional Preconditions for Strong Securities Markets” 48 *UCLA Law Review* 781, 790 (2001).

¹⁴¹ S. Labaton, “SEC Chief Pursues Tougher Enforcement,” *New York Times*, 22 February 2009, <http://www.nytimes.com/2009/02/23/business/23schapiro.html>, last accessed on 16 June 2011.

value” tips.¹⁴² Since July 2010, when the Dodd-Frank Act took effect, but before the SEC promulgated any rules, the SEC already saw an increase of one or two tips per day.¹⁴³ This slight increase is already having an effect on the daily operations of the SEC.¹⁴⁴

The lack of resources will be magnified by the low rate of “high value” tips received, requiring significant review and investigation by the SEC simply to determine if a tip should be pursued at all. The percentage of “high quality” tips received from whistleblowers is likely to be very low if compared to the empirical data collected on *qui tam* enforcement actions filed under the FCA. In 2007, Christina Orsini Broderick conducted an empirical analysis on *qui tam* actions and found that 78% of filed *qui tam* actions were without merit.¹⁴⁵ The likely percentage of meritless claims under Dodd-Frank is likely to be even higher because whistleblowers have far less risk in submitting trivial or meritless complaints to the SEC and far greater chances of a bounty.¹⁴⁶ If a 78% frivolity rate is even close to an accurate forecast it is inevitable that the SEC will simply be unable to siphon off meritless complaints in time to adequately address more egregious securities violations.

Unlike the DOJ under the FCA, the SEC does not have the luxury of private *qui tam* actions to alleviate some of the upfront administrative burden of vetting complaints. A private relator under the FCA must hire an attorney, risk having to pay their fees if unsuccessful, and build a case on their own. Thereafter, the DOJ is provided with sufficient time to review the complaint and supporting evidence and decide if it wants to intervene in the action.¹⁴⁷ Moreover, if the case becomes stronger as it progresses the DOJ can intervene at a later stage.¹⁴⁸ Accordingly, private actors can continue to pursue cases and the DOJ can use its statutory screening process to limit the wasting of resources on

¹⁴² D. Clarke, “SEC Gets More Whistleblower Tips,” *Reuters*, 4 February 2011, <http://www.reuters.com/article/2011/02/04/sec-whistleblower-idUSN0423691220110204>, last accessed on 7 April 2011.

¹⁴³ *Ibid.*

¹⁴⁴ *Supra*, n 132.

¹⁴⁵ *Supra*, n 18.

¹⁴⁶ *Supra*, section IV, subsection B.

¹⁴⁷ 31 U.S.C. § 3730.

¹⁴⁸ *Ibid.*

low priority cases. On the other hand, the SEC has the sole onus to collect, review, investigate and prosecute any complaints – magnifying the consequences of almost 80% of tips being meritless.

With these break downs likely to surface from under funding and staffing, it is difficult to understand why the SEC would create a situation where its already overburdened workforce would be inundated with hundreds, if not thousands, of additional complaints with no prior screening. At some point, policy must not be motivated solely by aspiration, but with acknowledgment of reality. A mandatory initial reporting requirement, with limited exceptions, would remedy a majority of these problems with minimal risk of abuse from corporations.

D. The US Capital Markets Cannot Afford Increased Costs and Redundancy

The new whistleblower program will also lead to an increase in regulatory costs for public companies, as they will need to respond to increased SEC inquiries. In order to properly follow-up on whistleblower tips, to avoid another Madoff situation, SEC inquiries to corporations must increase across the board. Therefore, while corporations are forced to continue to comply with Sarbanes-Oxley (even though internal reporting has been severely undermined) they will also incur greater costs in replying to SEC inquiries when tips are frivolous or trivial in nature. Additionally, the potential costs to corporations if such SEC inquiries become public could be devastating. The likelihood of leaks is real because unlike the DOJ, with vast police powers,¹⁴⁹ the SEC has limited investigatory powers. Generally, SEC subpoena powers, while expanded in Sarbanes-Oxley, are more transparent and easily identify the conduct being targeted. This puts corporations and investors at risk even if the SEC only has a minimum threshold of evidence received from a whistleblower.¹⁵⁰ When these increased costs are aggregated with other recent regulations, there is sure to be a continued exodus of capital from the US to Europe and emerging markets. The

¹⁴⁹ 31 U.S.C. § 3730(b)(2)-(3).

¹⁵⁰ T.C. Pearson & G. Mark, “Investigations, Inspections, and Audits in the Post-SOX Environment,” 86 *Nebraska Law Review* 43, 115 (2007); W.R. Baker III & C.E. Campbell, “Sarbanes-Oxley Enhancements to the SEC’s Enforcement Authority,” 1386 *Practising L. Inst./Corp.* 499, 506-09 (2003).

securities industry needs better regulation that can extrapolate gains from existing structures, not more inefficient layers of piecemeal laws.

Rather than intensify regulatory costs on corporations, the SEC could have easily limited the impact of Dodd-Frank by forcing corporations to continue to develop effective reporting programs. To effectuate Sarbanes-Oxley, Congress required listed companies, big or small, to invest significant upfront and continuing funds into internal reporting programs. The cost of Sarbanes-Oxley mandated programs after just two years was valued at approximately \$1.4 trillion.¹⁵¹ Another study found that the cost of Section 404 compliance in its first year averaged about \$7.3 million for companies with market capitalizations in excess of \$700 million and about \$1.5 million for issuers with market capitalizations of \$75 million to \$700 million.¹⁵²

With no further expenditure, these programs could easily be used for receipt and investigation of Dodd-Frank complaints. Instead, under the current regime, regulatory costs will increase across the board, enhancing the likelihood of a continued outflow of capital from the US. Two recent studies have demonstrated that the cost of being a listed company in the US has increased appreciably since the adoption of Sarbanes-Oxley, leading to an outflow of capital from the US. In 2006, Henry Paulson conducted a detailed review of the current competitiveness of the publicly traded markets in the US.¹⁵³ The Paulson Report concluded that the US was losing ground in attracting capital, particularly in global IPOs.¹⁵⁴ One important factor in “[t]he loss of U.S. public market competitiveness compared to global public market...is the growth of U.S. regulatory

¹⁵¹ I.X. Zhang, “Economic Consequences of the Sarbanes-Oxley Act of 2002,” February 2005; J. Anderson, “Going Overboard -- Directors Getting More \$ as Workload Grows,” *New York Post*, 25 August 2003, 29; P. Zalewski, “Lawyers and Executives Have Spent Months and Money to Comply with Strict Corporate Governance Law, and More Limits Are Coming,” *Miami Daily Bus. Rev.*, 21 July 2003, 11; “Firms’ Audit Costs Rise on Sarbanes-Oxley, Business Report,” *Bloomberg*, 6 May 2003, www.busrep.co.za/index.php?fSectionId=565&fArticleId=140964, last accessed on 19 June 2011 (“Accounting costs for companies with less than \$3 billion in annual sales had more than doubled because of the Sarbanes-Oxley Act, according to a study released last week by law firm Foley & Lardner.”)

¹⁵² CRA Int'l, “Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update,” at 5-6 (2005).

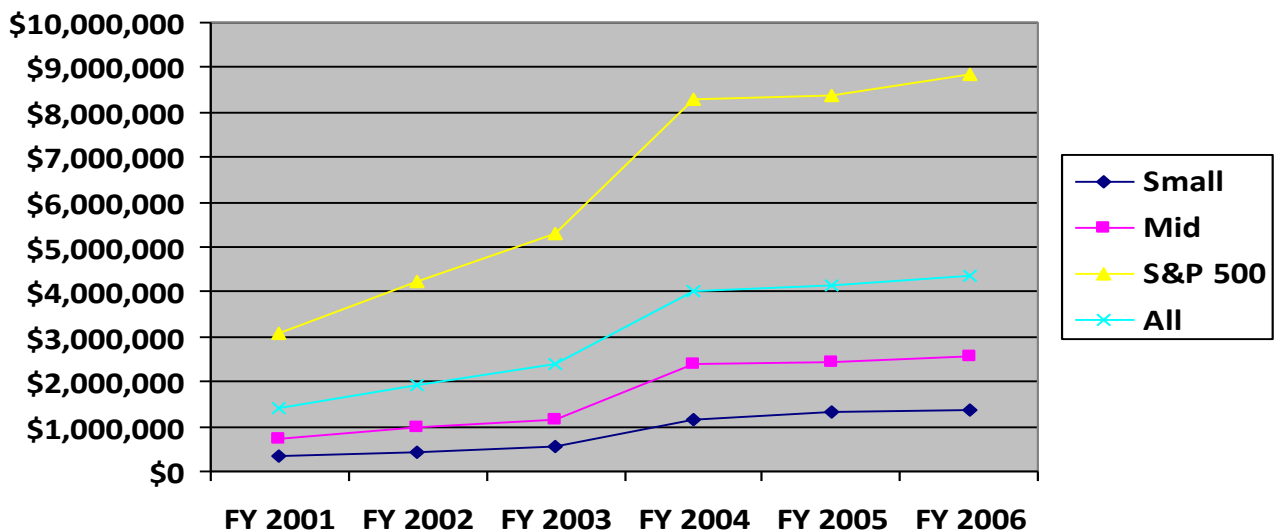
¹⁵³ Interim Report of the Committee on Capital Markets Regulation, 30 November 2006, <http://www.capmksreg.org/research.html>, last accessed on 19 June 2011 (Paulson Report).

¹⁵⁴ *Ibid.*

compliance costs and liability risks compared to other developed and respected market centers.”¹⁵⁵

The Paulson Report, in recommending a change to Sarbanes-Oxley implementation, described its costs to corporations as “overly expensive” and a leading factor in the lack of US market competitiveness.¹⁵⁶

Also, in 2007 a Foley & Lardner Annual Survey was released focusing on changes in the total costs of being a US public company. Following the enactment of Sarbanes-Oxley in 2002 each relevant cost category for corporations increased significantly between FY2001 and FY2006.¹⁵⁷ Specifically, the survey shows a significant increase in compliance costs for companies following enactment and implementation of Section 404¹⁵⁸:



While costly, this corporate investment into internal reporting programs has benefited corporations, regulators and investors. Sarbanes-Oxley has made corporations more transparent,

¹⁵⁵ *Ibid*, 10.

¹⁵⁶ Unlike the Paulson Report, this Article seeks to retain the gains of Sarbanes-Oxley and audit committees, and actually proposes to expand their use to more securities violations under Dodd-Frank. The Paulson Report merely demonstrates that the public capital markets in the US have reached a saturation point and more tailored and cost effective regulation is necessary to stay competitive in the global markets.

¹⁵⁷ T. Hartman, Foley & Lardner, LLP, “The Cost of Being Public In the Era Of Sarbanes-Oxley,” 2 August 2007, http://www.foley.com/publications/pub_detail.aspx?pubid=3736, last accessed on 19 June 2011.

¹⁵⁸ According to the survey data, the confidence intervals represent the range in which the average audit fees of companies in the indicated market cap category should fall at a 95% confidence level.

leading to less corruption and criminal behavior relating to financial reporting.¹⁵⁹ Further, Section 404 of Sarbanes-Oxley has led to conservative earnings reports.¹⁶⁰ Therefore, the regulations instituted by Sarbanes-Oxley can be seen as efficient and worthwhile.

It is unclear why the SEC, without Congress' express consent, would seek to detract from these gains and burden corporations with new regulatory costs rather than increase the efficiency of these programs. By merely making internal reporting a requirement, corporations would continue to invest and develop programs increasing the marginal benefit of every dollar already spent to comply with Sarbanes-Oxley. The advancement of internal reporting programs coupled with the resulting gains in efficiency of SEC enforcement would encourage investor confidence and liquidity in the markets.¹⁶¹

The current regime of optional internal reporting will have the opposite effect on corporate reporting programs. The returns to corporations from implementing internal reporting programs will become even lower as employees are lured to report directly to the SEC by multi-million dollar bounties. These redundant costs will amass onto already burdened corporate balance sheets and could lead to a further exodus of capital from US markets - a phenomenon that has been occurring over the last decade.¹⁶²

¹⁵⁹ S. Arping & Z. Sautner, "Did the Sarbanes-Oxley Act of 2002 Make Firms Less Opaque? Evidence from Analyst Earnings Forecasts," <http://ssrn.com/abstract=1561619>, February 2011 (concluding Sarbanes-Oxley made listed companies more transparent, particularly cross-listed companies).

¹⁶⁰ P. LLiev, "The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=983772, August 2009.

¹⁶¹ See generally, L. Zingales, "The Costs and Benefits of Financial Market Regulation," <http://ssrn.com/abstract=536682>, 2004 (the risks and benefits of regulatory intervention).

¹⁶² Certainly, these costs alone would not be material enough to cause an exodus. However, the continuation of piecemeal regulation hitting corporations every year and this abrupt change in course from an extensive and costly Sarbanes-Oxley regime will undoubtedly add to regulatory costs.

VI. CONCLUSION

Congress' attempt to increase regulation of the federal securities laws through creation of a whistleblower program is inherently an efficient and pro-active means of exposing complex securities violations. Unfortunately, drafting of the Whistleblower Incentives and Protection provisions was hasty and not properly debated within the Congressional framework. Instead, significant discretion was provided to the SEC to make determinations on fundamental issues.

In Rule 21F, the SEC missed a golden opportunity to: (i) promote whistleblowing, (ii) empower corporations to take immediate corrective action for securities violations, and (iii) allow the SEC's limited resources to be allocated to investigation and enforcement of the most egregious securities violations. Instead, the SEC has created a highly lucrative market for internal corporate information that will inundate an already saddled regulatory authority with complaints big and small, frivolous and meritorious, leaving the more serious to sit in a pile on a desk following the SEC's "triage process." The SEC, with the greatest of intentions, has been blind to the clear reality of its present circumstances.

The SEC should have road the coattails of Sarbanes-Oxley and promoted internal reporting programs as a means of screening whistleblower complaints. The whistleblower program would be highly effective in masking SEC shortcomings by requiring all whistleblowers to first make an allegation of securities violations through internal procedures. Any potential harm to whistleblowers could be mitigated in two ways. First, a whistleblower would be permitted to bypass internal procedures if: (i) an effective internal compliance program does not exist; (ii) management is already aware of the securities violation and has failed to remedy the problem in a reasonable timeframe; and/or (iii) the whistleblower has a reasonable fear of physical harm. Such a framework is not novel, and has already been adopted in several states. Second, the SEC could further dampen fears of corporate cover-ups and retaliation by creating greater incentives for corporations to have effective

compliance programs in place. The potential for smaller penalties from the SEC coupled with the already intact motivations in the Sentencing Guidelines and DOJ Principles will create considerable incentives for corporations. These steps would lead to a more efficient allocation of resources in the highly regulated securities industry, which requires the utmost standards in corporate governance and mandatory disclosure.

The current whistleblower program must be reevaluated with an eye towards greater tailoring and flexibility to allow the SEC to efficiently allocate resources and empower corporations to take swift action while not overburdening the public capital markets. If corporate reporting programs are allowed to be marginalized by the vast financial incentives in the new whistleblower program, then the most effective means of combating corporate fraud will wane unused while whistleblower complaints, with or without merit, queue at the SEC. It should not take another missed multi-billion dollar fraud to make the SEC realize the potential harm that lies in the current whistleblower program.