BETTER BOUNTY HUNTING: HOW THE SEC'S NEW WHISTLEBLOWER PROGRAM CHANGES THE SECURITIES FRAUD CLASS ACTION DEBATE

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As mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Securities & Exchange Commission recently created a whistleblower bounty program that promises financial rewards to individuals who provide original information to the agency about securities law violations. The final rules implementing this program—which passed 3-2, along party lines—have provoked significant controversy. The controversy has centered on the failure of the rules to make internal reporting by an employee-whistleblower a prerequisite to recovery, and the ramifications of that for corporate compliance systems. This Article approaches the new program with a broader lens, examining how it impacts the larger U.S. securities fraud deterrence regime. It demonstrates that the program undermines any remaining justifications for class action enforcement of Rule 10b-5. The new, pure bounty program should be viewed as a substitute for, not a complement to, the highly imperfect class action "bounty hunter" model of yesterday.

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INTRODUCTION

The Rule 10b-5 "fraud-on-the-market" (FOTM) class action has been dying a slow death. Congress dealt it a serious blow by enacting the Private Securities Litigation Reform Act in 1995,[1] and the Courts have been whittling away at it for decades.[2] Just this term, four Supreme Court Justices suggested it might be time to reconsider *Basic v. Levinson*,[3] the case which gave the FOTM class action life.[4] Scholars, for their part, have grown increasingly critical of the FOTM class action.[5] None seriously defend it as a compensatory tool, and many question its deterrence benefits.[6] But professors are cautious types, and academic proposals to eliminate the FOTM class action have tended to be conditional on concurrent changes to the U.S. securities fraud enforcement regime—changes that would compensate for any loss in deterrence the elimination of the FOTM class action *might* produce.[7]

This Article argues that the new "Whistleblower Bounty Program" (WBP) created by the Dodd-Frank Wall Street Reform and Consumer

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[1] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

[2] *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 175 (U.S. 2008); Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011).

[3] 485 U.S. 224 (1988); *see Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, No. 11-1085, Slip. Op. (Feb. 27, 2012) ("reconsideration of the *Basic* presumption may be appropriate" (Justice Alito, J., concurring); "the *Basic* decision itself is questionable" (Thomas, J., dissenting, joined by Kennedy, J. and Scalia, J.)).

[4] *Id.*, Slip. Op. at 5-6 ("Absent the fraud-on-the-market theory [adopted in *Basic*], the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class").

[5] *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 72 (2011) (asserting that the "consensus view among academics" is that the FOTM cause of action "just doesn't work").

[6] *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1314, 1321-23 (2008).

[7] *See infra*, Part III.A.

Protection Act[8] is the proverbial nail in the FOTM class action coffin. The WBP mandates that the Securities and Exchange Commission (SEC) pay significant financial rewards to eligible individuals who voluntarily provide the agency with original information about securities law violations, if that information leads to an enforcement action resulting in $1 million or more in sanctions.[9] The program has prompted a firestorm of controversy, but the debate thus far has been an insular one—focused on the efficacy of the WBP as a stand-alone program.[10] Little attention has been paid to the program's impact on the desirability of FOTM class actions. This Article demonstrates that the WBP promises to provide the same deterrence benefits that FOTM class actions are argued to provide, but more reliably and at less cost. Its adoption should therefore remove any hesitancy about abandoning the flawed FOTM class action.

FOTM class actions impose no direct sanction on the individual officers responsible for the alleged fraud. Instead, the settlement payments in these suits (and those that are not dismissed inevitably settle) are funded by the corporation, resulting in a transfer of wealth from one group of innocent shareholders to another.[11] If they aid in deterrence, then, they do so indirectly. Two arguments are typically made. First, FOTM class actions may enhance deterrence by helping to detect fraud. Second, FOTM class actions may motivate the SEC to do its job better.

The revelation of fraud negatively impacts a firm's stock price. If FOTM class actions threaten to reveal frauds, then, they may encourage directors and officers (whose reputations and compensation packages are tied to firm performance) to invest firm resources in fraud prevention measures and to refrain from committing fraud themselves. While many FOTM class actions merely "piggyback" on SEC investigations, empirical evidence suggests that some are responsible for uncovering fraud.[12] The impact of private litigation on fraud detection is relatively minor, however, as compared to other sources of fraud detection (such as employees and the media). This is hardly surprising, given the outsider status of the attorneys

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[8] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[9] *See infra*, Part I.

[10] For example, the Chamber of Commerce has criticized the program for not requiring whistleblowing employees to first report through internal compliance departments as a condition to receiving a bounty, and many contend that the final rules implementing the program will invite frivolous tips and disrupt trust within the workplace. *See generally infra*, Part II.

[11] Settlements are also funded by the corporation's insurer, but the insurance coverage is paid for by shareholders.

[12] *See infra*, Part III.B.

and lead plaintiffs who bring FOTM class actions and legal limitations on their ability to investigate. The WBP, by contrast, is a powerful tool for fraud detection, enticing precisely those insiders with the best access to evidence of fraud to come forward. To the extent class action lawyers have special expertise in identifying frauds, they may themselves participate in the WBP as whistleblowers. Thus, eliminating FOTM class actions in the wake of the WBP should lead to no loss in fraud detection, while saving the considerable costs associated with private enforcement.

Another oft-cited benefit of FOTM class actions concerns the disciplining influence they may exert on the SEC. FOTM class actions support a sophisticated plaintiffs' bar with strong incentives to identify and prosecute securities fraud. The existence of the plaintiffs' bar may help to keep the SEC honest and working hard. If FOTM class actions are eliminated, then, one might worry that the SEC will become captured by managerial interests, or simply become lazy and inept. What is to prevent it from simply ignoring all the high quality tips the WBP produces? The answer to this concern is that the WBP replaces one group of financially incentivized SEC monitors (FOTM class action attorneys) with another: whistleblowers and, importantly, their counsel. Under the WBP, whistleblowers may be represented by counsel (and must be, if the whistleblower wishes to remain anonymous). Many of the largest plaintiffs'-side securities firms have already opened whistleblower practice groups, and can be expected to strongly advocate for SEC follow-up on their clients' behalf. Should the SEC turn a deaf ear, these firms know how to turn to Congress or the media for help. One can also expect whistleblowers' counsel to assist the SEC in identifying and investigating high quality tips, alleviating any increased resource burden the elimination of FOTM class actions might impose on the SEC.

To say that the WBP obviates the case for FOTM class actions is not to say that it is perfect. Indeed, in conclusion this Article highlights some changes that policymakers might want to consider making to the program to increase its effectiveness. But even as presently constituted, the WBP eliminates any plausible justification for the continued existence of FOTM class actions. The remainder of this Article proceeds as follows. Part I offers a primer on the WBP and reports on its operations to date. Part II provides an overview of the insular debate that has raged over the WBP. Part III explores the broader question of the WBP's impact on the case for FOTM class actions. The Article then briefly concludes.

I. THE SEC'S NEW WHISTLEBLOWER BOUNTY PROGRAM

The Whistleblower Bounty Program (WBP) is a creation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[13] Section 922 of Dodd-Frank amended the Securities Exchange Act of 1934 to create a new Section 21F titled "Securities Whistleblower Incentives and Protection."[14] While the basic contours of the WBP are laid out in the statute, many details were left to the SEC to flesh out in rulemaking.[15] On August 12, 2011, final SEC rules regarding the WBP program became effective.[16] Part I.A provides a basic overview of the WBP, and also briefly discusses new protections it affords whistleblowers against retaliation. Part I.B reports on its track record to date.

A. *A Primer*

The WBP entitles "whistleblowers"—defined as individuals (not corporations or other entities) who provide the SEC with information about possible securities law violations pursuant to specified procedures[17]—to a bounty award if they meet the following criteria. First, a whistleblower must have provided information to the SEC "voluntarily."[18] Second, that information must have been "original."[19] Third, the information must have "led to" a successful SEC enforcement action resulting in more than $1,000,000 in monetary sanctions (a so-called "covered action").[20] Finally, the whistleblower must not otherwise be ineligible for an award.[21] If these criteria are met, the whistleblower is entitled to share in a bounty award of between 10% and 30% of the sanctions collected in the covered action and in certain "related actions," if procedural requirements for claiming an award are followed.[22]

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[13] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[14] 15 U.S.C. § 78u-6.

[15] 15 U.S.C. §§ 78u-6(j), 78u-7(a).

[16] *See* Securities Whistleblower Incentives and Protections, Exchange Act Release No. 64,545, 76 Fed. Reg. 34,300 (May 25, 2011).

[17] 17 C.F.R. § 240.21F-2(a)(1). These procedures include using specific forms and declaring under penalty of perjury that the information submitted is true and correct. *See id.* § 240.21F-9(a)-(b).

[18] *See infra* Part I.A.i.

[19] *See infra* Part I.A.ii.

[20] *See infra* Part I.A.iii.

[21] *See infra* Part I.A.iv.

[22] *See infra* Part I.A.v.

i. *Voluntariness*

The requirement of "voluntariness" encourages whistleblowers to come forward with information early. To be considered voluntary, a whistleblower's submission must be made before the SEC requests information related to the subject matter of the submission directly from the whistleblower or the whistleblower's representative.[23] It must also be made before any similar request by the Public Company Accounting Oversight Board (PCAOB), any self-regulatory organization (SRO), another authority of the federal government, or a state Attorney General or securities regulator.[24] The mere fact that a whistleblower's employer received a request from one of these authorities related to the whistleblower's subsequent submission does not, however, render the submission involuntary,[25] nor does a whistleblower's receipt of a request for information from his or her employer in connection with an internal investigation[26]—to be disqualifying, the request must come from one of these authorities, and must be made to the whistleblower or his or her representative (such as an attorney), *directly*.[27]

The requirement of "voluntariness" also serves to direct whistleblower awards to individuals who, in the absence of the WBP, might not come forward at all. Under the rules, submissions are deemed involuntary if the whistleblower was already required to report the information to the SEC as a result of (1) a pre-existing legal duty, (2) a duty arising out of a judicial or administrative order, or (3) a contractual duty owed to the SEC, PCAOB, any SRO, another authority of the federal government, or a state Attorney General or securities regulator.[28] If a

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[23] Such a request need not be accompanied by a subpoena to render a submission involuntary. 17 C.F.R. § 240.21F-4(a)(1)-(2).

[24] *Id*.

[25] "For example, an examination request directed to a broker-dealer or an investment adviser would not automatically foreclose whistleblower submissions related to the subject matter of the exam from all employees of the entity." *Supra* note 16, at 34,307.

[26] *See supra* note 16, at 34,308 ("we reject the suggestion of some commenters that a whistleblower should not be permitted to make a 'voluntary' submission after being contacted for information in the course of an internal investigation").

[27] In determining whether a whistleblower's submission "led to" a covered action, however, the SEC will "evaluate whether a previous request to the whistleblower's employer obtained substantially the same information, or would have obtained the information but for any action of the whistleblower in not providing the information to his or her employer. In such circumstances, [it] ordinarily would not expect to treat the whistleblower's submission as having ['led to' the covered action]." *Supra* note 16, at 34,309; *see infra* Part I.A.iii (discussing the "led to" requirement).

[28] 17 C.F.R. § 240.21F-4(a)(3).

contractual duty to report to the SEC is merely owed to the whistleblower's employer, it will not render the submission involuntary; the SEC is of the view that "employers should not be able to preclude their employees from whistleblower eligibility by generally requiring all employees to enter into agreements that they will report evidence of securities violations" to the SEC.[29]

ii. *Originality*

For whistleblowers to be entitled to a bounty, the information they voluntarily provide must be "original."[30] Section 21F defines "original information" as information that is derived from a whistleblower's "independent knowledge or analysis" and "is not known to the [SEC] from any other source, unless the whistleblower is the original source of the information."[31] Further, the information cannot be "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."[32]

"Independent knowledge" is defined by SEC rule as factual information in a whistleblower's possession that is not derived from "publicly available sources."[33] It is not limited to direct, first-hand knowledge of law violations, but includes knowledge gained through a whistleblower's "experiences, communications and observations in [] business or social interactions."[34] The term "independent analysis" is defined to mean a whistleblower's "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public," whether done alone or in combination with others.[35] "[T]here are circumstances," the SEC has explained, in which "individuals can review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to [SEC] staff in understanding complex schemes and identifying securities violations."[36]

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[29] *Supra* note 16, at 34,309.
[30] 17 C.F.R. § 240.21F-3(a).
[31] 15 U.S.C. § 78u-6(a)(3).
[32] *Id*.
[33] 17 C.F.R. § 240.21F-4(b)(2).
[34] *Id*.
[35] 17 C.F.R. § 240.21F-4(b)(3).
[36] *Supra* note 16, at 34,312.

In addition to being derived from independent knowledge or analysis, to be "original" the information must not already be known to the SEC from any other source, "unless the whistleblower is the original source of the information."[37] A whistleblower will be deemed the "original source" of information the SEC first obtained from another source if the other source obtained the information from the whistleblower or the whistleblower's representative.[38] To be considered the original source of information the SEC first obtains from another governmental authority or SRO, the whistleblower must have "voluntarily" provided the information to such authorities as that term is defined above.[39]

The following hypothetical may help to illustrate how the originality requirement operates. Assume that Sally tells her co-worker Frank about possible securities law violations she discovered taking place at their employer, Alpha Corporation. The suspected violations are not publicly known, and the SEC is unaware of them. Frank in turn reports the information he learned from Sally to the SEC. After receiving Frank's tip, the SEC commences an investigation. On these facts, Frank's submission counts as "original information" because it is based on his "independent knowledge" (a concept that, as noted above, includes second-hand information received from non-public sources) and was not previously known by the SEC. If Sally reports the same information to the SEC after Frank, her submission will also count as "original information" because it is likewise based on "independent knowledge" and, although the SEC was already made aware of the information by Frank, Sally is the "original source" of Frank's submission. Thus, both Frank and Sally will potentially be entitled to share in a bounty award if an enforcement action is brought against Alpha Corporation resulting in more than $1 million in monetary sanctions.

This is not to say, however, that Frank and Sally will be treated identically. Frank and Sally will be treated differently by virtue of the *timing* of their respective submissions. By reporting first, Frank will have an easier time than Sally in establishing that his tip "led to" a covered action, a concept discussed below. And if Frank's tip prompted the SEC to question Sally before she made her submission, Sally will be unable to meet the voluntariness requirement discussed above. Assuming both Frank and

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[37] 15 U.S.C. § 78u-6(a)(3).
[38] 17 C.F.R. § 240.21F-4(b)(5).
[39] *Id*.

Sally succeed in establishing their eligibility, the timing of their submissions may also impact the size of their respective awards.[40]

iii. *Leading to Success*

A whistleblower's submission must "lead to" a successful SEC judicial or administrative action that results in monetary sanctions (including penalties, disgorgement, and interest) of more than $1,000,000—a so-called "covered action."[41] In determining whether a covered action exists, the SEC may aggregate the monetary sanctions in two or more separately captioned SEC actions, if the proceedings arise out of the same nucleus of operative fact.[42]

The standard under which a whistleblower's submission of original information will be judged to have "led to" a successful covered action depends on whether the original information submitted concerned conduct already actively under investigation, by either the SEC or certain other authorities, at the time of submission or not. If so, the whistleblower's submission must have "significantly contributed to the success" of the covered action.[43] If not, the original information submitted need only have been "sufficiently specific, credible, and timely" to cause the SEC to commence an examination, open (or reopen) an investigation, or "to inquire concerning different conduct as part of a current examination or investigation," and the SEC must have brought a covered action "based in whole or in part on conduct that was the subject of the original information."[44] Thus, in the hypothetical posed above, the SEC would

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[40] *See infra* Part I.A.v.

[41] 17 C.F.R. § 240.21F-3(a)(3)-(4); 15 U.S.C. § 78u-6(a)(1).

[42] 17 C.F.R. § 240.21F-4(d)(1).

[43] 17 C.F.R. § 240.21F-4(c)(2). The SEC has indicated that in applying this standard, it will look at factors "such as whether the information allowed [it] to bring: (1) [a] successful action in significantly less time or with significantly fewer resources; (2) additional successful claims; or (3) successful claims against additional individuals or entities." *Supra* note 16, at 34,325. The SEC has also noted that, absent extraordinary circumstances, it will not consider information to have "significantly contributed" to the success of a covered action if "(i) [it] or some other law enforcement agency has issued a subpoena or other document request, inquiry or demand to an entity or an individual other than the whistleblower; (ii) there is evidence that the whistleblower was aware of the investigative request, inquiry or demand; and (iii) the whistleblower withheld or delayed providing responsive documents prior to making the related submission to the Commission." *Id*.

[44] 17 C.F.R. § 240.21F-4(c)(1). The SEC has indicated that its inquiry will "focus on whether the submission identifies persons, entities, places, times and/or conduct that corresponds to those alleged" by the SEC in the covered action, and that it may consider "whether, and the extent to which, the information included: (1) Allegations that formed the basis for any of the [SEC's claims in the covered action]; (2) provisions of the

judge Frank's submission under the easier "sufficiently specific, credible, and timely" test, because it was received before an investigation concerning the alleged misconduct was underway. Sally's tip, by contrast, would have to meet the tougher "significant contribution" test.

This would not be the case, however, if Frank were part of Alpha Corporation's internal compliance department, and Sally reported the same information to the SEC within a 120 days of reporting it to Frank. SEC rules provide that if a whistleblower provides information through "an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law," or to PCAOB, any SRO, another authority of the federal government, or a state Attorney General or securities regulator, and within 120 days the whistleblower submits the same information to the SEC, the SEC will treat the whistleblower as having submitted the information to the SEC "as of the date of [the] original disclosure, report or submission to one of these other authorities or persons."[45] Thus, in this revised hypothetical Sally would have an easier time establishing that her tip "led to" a covered action because it would be treated as having been made prior to the commencement of the SEC's investigation, thus subject to evaluation under the easier "sufficiently specific, credible and timely" test. Frank, as a compliance officer, would likely be rendered ineligible for an award, as discussed below in Part I.A.iv.

This special rule is meant to mitigate the possibility that the WBP will discourage employees from reporting internally before going to the SEC, for fear of losing their entitlement to a bounty, and thus undermine the effectiveness of internal compliance programs. The SEC also sought to encourage internal reporting by adopting a rule that credits a whistleblower in certain situations with information an internal probe uncovers. Specifically, a whistleblower who reports information through an entity's internal mechanisms at the same time or up to 120 days before the whistleblower reports the same information to the SEC will be credited with any information the entity later submits to the SEC that was discovered in the course of an internal audit or investigation initiated as a result of the

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securities laws that the [SEC] alleged as having been violated in the [covered] action; (3) culpable persons or entities (as well as offices, divisions, subsidiaries or other subparts of entities) that the [SEC] named as defendants, respondents or uncharged wrongdoers in the [covered] action; or (4) investors or a defined group of investors that the [SEC] named as victims or injured parties in the [covered] action." *Supra* note 16, at 34,324.

[45] 17 C.F.R. § 240.21F-4(b)(7).

whistleblower's report.[46] In our revised hypothetical, for example, it could be that the information that Sally provided to Frank, and later to the SEC, was not itself sufficiently "specific" and "credible" to cause the SEC to open an investigation. But if her disclosure to Frank prompted an internal investigation that uncovered additional information about securities law violations, and Alpha Corporation reported that information to the SEC, Sally might nevertheless be able to claim a bounty. She could take credit for all of the information submitted to the SEC by Alpha Corporation, and in this way potentially satisfy the "leading to success" requirement.

iv. *Ineligible Whistleblowers*

A variety of whistleblowers are ineligible for a bounty award even if they satisfy the criteria discussed above. Ineligible whistleblowers include employees of certain governmental agencies and self-regulatory organizations,[47] persons who fail to submit their information in the form and manner specified by the SEC, and those who fail to comply with SEC requests related to their submission.[48] Whistleblowers are also ineligible if they knowingly provide false or misleading information to the SEC with intent to hinder or mislead,[49] or obtain their information "by a means or in a manner that is determined by a United States court to violate applicable Federal or state criminal law."[50] A whistleblower's culpability for the misconduct at issue in the SEC action or related action for which an award is sought does not result in ineligibility unless the whistleblower is convicted of a related criminal violation.[51] But when considering a culpable whistleblower's application for a bounty any monetary sanctions he or she has been ordered to pay, or which an entity whose liability is based substantially on his or her conduct is ordered to pay, will be excluded in the SEC's determination of whether the $1 million threshold for a "covered action" has been met, and such sums "will not be included within the calculation of the amounts collected for purposes of making [bounty] payments."[52] Further, as discussed in Part I.A.v, culpability is a factor that

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[46] 17 C.F.R. § 240.21F-4(c)(3).

[47] 17 C.F.R. § 240.21F-8(c)(1)-(2). Spouses, parents, children, siblings, and household members of SEC employees are also excluded from eligibility. *Id*. § 240.21F-8(c)(5).

[48] 17 C.F.R. § 240.21F-8(a)-(b).

[49] 17 C.F.R. § 240.21F-8(c)(7).

[50] 17 C.F.R. § 240.21F-4(b)(4)(iv). Technically, information obtained in this manner is excluded from the definition of "original information."

[51] 17 C.F.R. § 240.21F-8(c)(3).

[52] 17 C.F.R. § 240.21F-16.

may cause the SEC to decrease the percentage of collected sanctions awarded to a whistleblower.

Whistleblowers are also excluded from eligibility if they obtained their information "through a communication that was subject to the attorney-client privilege" or "in connection with the legal representation of a client on whose behalf [the whistleblower or his or her] employer or firm are providing services."[53] There is an exception, however, if disclosure of the information would otherwise be permitted by 15 U.S.C. § 205.3(d)(2) or the applicable state attorney conduct rules.[54] Section 205.3(d)(2) allows an attorney appearing and practicing before the SEC in the representation of an issuer to reveal client confidences without the issuer's consent if necessary "to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors," to prevent the issuer from committing perjury in an SEC investigation or otherwise perpetrating a fraud on the SEC, and to "rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used."[55] This exclusion is designed to prevent the WBP from interfering with the attorney-client relationship by encouraging attorneys to breach confidences for personal financial reward, except in those situations where the law already countenances disclosure.[56]

The WPB also seeks to avoid "creating incentives for independent public accountants to personally benefit by 'front running' the firm's proper handling of information obtained through engagements required under the federal securities laws."[57] Thus, whistleblowers who obtained their information in connection with an audit of a company's financial statements are ineligible if disclosing the information to the SEC was contrary to requirements of Section 10A of the Securities Exchange Act of 1934.[58] Section 10A details the steps that a registered public accounting firm must

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[53] 17 C.F.R. § 240.21F-4(b)(4)(i)-(ii). Technically, information obtained in this manner is excluded from the definition of "original information."

[54] *Id*. *See generally* Barry R. Temkin & Ben Moskovits, *Lawyers as Whistleblowers Under the Dodd-Frank Wall Street Reform Act*, N.Y. ST. B.J. 10-23 (July/Aug. 2012).

[55] 15 U.S.C. § 205.3(d)(2).

[56] *See supra* note 16, at 34,314-315 (discussing the policy behind this exclusion).

[57] *Supra* note 16, at 34,318.

[58] 15 U.S.C. § 78u-6(c)(2)(C); 17 C.F.R. § 240.21F-8(c)(4). Whistleblowers who acquire information from a person who would be ineligible for this reason are likewise ineligible, unless they are providing the SEC "with information about violations involving that person." 17 C.F.R. § 240.21F-8(c)(6)(i).

take if, in the course of an audit of an issuer, it becomes aware of information indicating that an illegal act may have occurred at the issuer.[59] These steps begin with internal reporting through the client's corporate hierarchy, and end with disclosure to the SEC only if the issuer has not responded appropriately.[60] Whistleblowers are also ineligible if they are associated with a public accounting firm and obtained their information through the performance of an engagement (other than an audit) required of an independent public accountant under the federal securities laws, and the information relates to a violation by the engagement client or the client's directors, officers or other employees.[61] The SEC has made clear that "[p]ersons working on other engagements, to the extent they are not covered by Section 10A or are not required under the Federal securities laws, will not be deemed ineligible simply because the engagement is with an audit client of the firm."[62] Moreover, tips about violations of Section 10A are not contrary to the requirements of Section 10A; thus, an employee of a public accountancy firm who reports on his or her employer's failure to comply with Section 10A would be "eligible for an award based on a covered action against the public accountant or the issuer."[63]

The exclusion for whistleblowers who obtained their information in the course of an accounting engagement required under the federal securities laws is subject to an important exception. Such a whistleblower *may* claim a bounty if he or she has "a reasonable basis to believe that disclosure of the information to the [SEC] is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors," "has a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct," or "[a]t least 120 days [has] elapsed since [the whistleblower] provided the information to the

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[59] *See* 15 U.S.C. § 78j-1(b).

[60] Under Section 10A, a registered public accounting firm may become obligated to report information concerning suspected law violations directly to the issuer's board of directors; if such a report is made, the issuer then becomes obligated to notify the SEC within 1 business day and to furnish the public accounting firm with a copy of the notice furnished to the SEC. 15 U.S.C. § 78j-1(b)(3)-(4). If "the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period," it must furnish to the SEC "a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice." *Id*.

[61] 17 C.F.R. § 240.21F-4(b)(4)(iii)(D). Technically, information obtained in this manner is excluded from the definition of "original information."

[62] *Supra* note 3, at 34,336.

[63] *Supra* note 16, at 34,336 n.315.

relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or [the whistleblower's] supervisor."[64]

Subject to the same important exception, whistleblowers are ineligible if they obtain their information because: (1) they serve as an "officer, director, trustee, or partner of an entity and another person informed [them] of allegations of misconduct, or [they] learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law"[65]; (2) they are an "employee whose principal duties involve compliance or internal audit responsibilities, or are employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity"[66]; or (3) they are employed "by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law."[67] These exclusions are designed to ensure "that the persons most responsible for an entity's conduct and compliance with law are not incentivized to promote their own self-interest at the possible expense of the entity's ability to detect, address, and self-report violations."[68]

To return to our hypothetical, if Sally went to Frank with her information because he is a compliance officer at Alpha Corporation, and Frank in turn submitted the information she gave him to the SEC, he would be ineligible for a bounty *unless*: (1) he had a reasonable basis to believe that disclosure was necessary to prevent Alpha Corporation from engaging in conduct likely to cause substantial injury to Alpha Corporation or investors; (2) he had a reasonable basis to believe that Alpha Corporation was engaging in conduct that would impede an investigation; or (3) 120 days had elapsed since he reported it up the chain of command at Alpha Corporation. Of course, the third exception to Frank's ineligibility will not do him much good if in the course of those 120 days Sally reports the information to the SEC herself. In this scenario, Frank will fail the originality requirement because the SEC would already know the

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[64] 17 C.F.R. § 240.21F-4(b)(4)(v). If the whistleblower received the information under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's supervisor was already aware of the information, 120 days must have elapsed from the date the whistleblower received the information. *Id*.

[65] 17 C.F.R. § 240.21F-4(b)(4)(iii)(A).

[66] 17 C.F.R. § 240.21F-4(b)(4)(iii)(B).

[67] 17 C.F.R. § 240.21F-4(b)(4)(iii)(C). Technically, information obtained in any of these three manners is excluded from the definition of "original information."

[68] *Supra* note 16, at 34,314.

information at the time of his submission, and Frank would not be the "original source" of Sally's submission.

v. *Criteria for Determining the Bounty Award*

If one or more whistleblowers meet the above criteria and follow the required procedures for making a claim (discussed below), the SEC must award them, in the aggregate, at least 10 but not more than 30 percent of the monetary sanctions collected in the covered action.[69] Within this range, the amount awarded is in the sole discretion of the SEC.[70] The SEC must also pay eligible whistleblowers amounts equal to 10-30% of the monetary sanctions collected in certain "related actions,"[71] if specified claims procedures are followed.[72] A "related action" exists if it is based upon the same original information that led to the covered action, and is brought by the Attorney General of the United States, an "appropriate regulatory agency,"[73] an SRO, or a state Attorney General in a criminal case.[74] To receive an award based on a related action, the SEC must determine that the original information the whistleblower gave to the SEC also led to the successful enforcement of the related action under the same criteria used to evaluate awards for covered actions.[75]

In exercising its discretion to determine the appropriate award percentage, and, if there are multiple eligible claimants, their respective portions, the SEC will consider several factors.[76] In deciding whether to

[69] 15 U.S.C. § 78u-6(b)(1).

[70] 15 U.S.C. § 78u-6(c)(1)(A); 17 C.F.R. § 240.21F-5(a).

[71] *See* 15 U.S.C. § 78u-6(b)(1); 17 C.F.R. § 240.21F-b.

[72] *See* 17 C.F.R. § 240.21F-11 (detailing these procedures).

[73] "Appropriate regulatory agency means the [SEC], the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act (15 U.S.C. § 78c(a)(34))." 17 C.F.R. § 240.21F-4(f).

[74] 15 U.S.C. § 78u-6(a)(5); 17 C.F.R. § 240.21F-b(1).

[75] 17 C.F.R. § 240.21F-3(b)(2). In making this determination, the SEC may seek assistance from the authority that brought the related action. *Id*. If the SEC cannot obtain the information necessary to make this determination, an award based on the related action will be denied. 17 C.F.R. § 240.21F-3(b)(2)(ii). An award will also be denied if the Commodities Futures Trading Commission (CFTC) has already granted or denied the whistleblower a bounty in connection with the related action. 17 C.F.R. § 240.21F-3(b)(2)(ii). Section 748 of the Dodd-Frank Act amended the Commodity Exchange Act to require the creation of a CFTC whistleblower program similar to the WPB. *See* Whistleblower Incentives and Protections, RIN 3038-AD04, 76 Fed. Reg. 53,172 (August 25, 2011).

[76] If the SEC makes awards to multiple claimants, it "will determine an individual percentage award for each whistleblower, but in no event will the total amount awarded to

increase the amount of a whistleblower's award, the SEC will consider: (1) the significance of the information provided to the success of the covered action or related action[77]; (2) the degree of assistance provided by the whistleblower[78]; (3) the SEC's "programmatic interest in deterring violations of the securities laws"[79]; and (4) the extent to which the whistleblower participated in internal compliance systems.[80] In deciding whether to decrease the amount of a whistleblower's award, the SEC will consider: (1) the "culpability or involvement of the whistleblower in matters associated" with the covered action or related action[81]; (2) whether the whistleblower unreasonably delayed in reporting the suspected securities violations[82]; and (3) "in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system."[83] These factors are merely guidelines, and do not create a rigid formula—"the determination of the appropriate percentage of a whistleblower award will involve a highly individualized review of the facts and circumstances surrounding each award."[84]

vi. *Claims Process*

Dodd-Frank mandated the creation of a new "Office of the Whistleblower" (OWB) within the SEC's Division of Enforcement, and

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all whistleblowers in the aggregate be less than 10 percent or greater than 30 percent of the amount" collected. 17 C.F.R. § 240.21F-5(c).

[77] 15 U.S.C. § 78u-6(c)(1)(B)(i)(I). In considering this factor, the SEC may take into account a variety of things, including whether the reliability and completeness of the information provided allowed the SEC to conserve enforcement resources. *See* 17 C.F.R. § 240.21F-6(a)(1).

[78] 15 U.S.C. § 78u-6(c)(1)(B)(i)(II). Consideration of this factor may include an assessment of the whistleblower's level of ongoing cooperation, the timeliness of his or her submission, and any unique hardships experienced as a result of the assistance provided, among other things. *See* 17 C.F.R. § 240.21F-6(a)(2).

[79] 15 U.S.C. § 78u-6(c)(1)(B)(i)(III). For example, it may consider whether the covered action involves misconduct that is an SEC priority, or implicates industry-wide practices, or poses a particular danger to investors; the SEC may also consider the "degree to which an award encourages the submission of high quality information from whistleblowers." 17 C.F.R. § 240.21F-6(a)(3).

[80] 17 C.F.R. § 240.21F-6(a)(4).

[81] 17 C.F.R. § 240.21F-6(b)(1).

[82] 17 C.F.R. § 240.21F-6(b)(2).

[83] 17 C.F.R. § 240.21F-6(b)(3).

[84] *Supra*, note 16, at 34,331. The percentage awarded to a whistleblower in connection with a related action need not be the same as the percentage awarded to him or her in connection with the covered action. *See* 17 C.F.R. § 240.21F-5(b).

charged it with administering the WBP.[85] According to the SEC's Fiscal Year 2012 annual report on the WBP program, the OWB is currently staffed by a chief, deputy chief, eight attorneys (with an offer extended to a ninth), three paralegals, and one program support specialist.[86] Among other things, the OWB maintains a website (www.sec.gov/whistleblower) which provides information about the WBP as well as links to the forms required to submit a tip (Form TCR) and apply for a bounty payment (Form WB-APP). The OWB ensures that any Form TCR it receives by mail or fax is inputted into the SEC's "Tips, Complaints, and Referrals System" (the "TCR System"), a new centralized database for the "prioritization, assignment, and tracking of TCRs received from the public."[87] Whistleblowers also have the option to input their tip directly into the TCR System via an online version of Form TCR.

Once in the TCR system, a whistleblower's tip is "triaged" by the Enforcement Division's "Office of Market Intelligence" ("OMI"), a newly created office staffed with "a team of more than 40 former traders, exchange experts, accountants and securities lawyers," as well as an agent on loan from the F.B.I.[88] OMI evaluates each tip and assigns those identified as "sufficiently specific, timely, and credible to warrant the further allocation of [SEC] resources" to appropriate enforcement staff.[89] As the SEC's investigation proceeds, the OWB serves as a liaison between the whistleblower (or his or her lawyer) and enforcement staff; it also works with enforcement staff to track enforcement cases involving whistleblowers "to assist in the documentation of the whistleblower's information and cooperation in anticipation of an eventual claim for award."[90]

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[85] *See* 15 U.S.C. § 78u-7(d).

[86] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 2.

[87] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 4. For more information on the TCR System and OMI, see Ben Protess & Azem Ahmed, *With New Firepower, SEC Tracks Bigger Game*, N.Y. TIMES DEALBOOK (May 21, 2012); Sarah N. Lynch & Matthew Goldstein, *Exclusive: SEC Builds New Tips Machine to Catch the Next Madoff*, REUTERS.COM (July 27, 2011); Bruce Carton, *Details Emerge on SEC Office of Market Intelligence*, SECURITIESDOCKET.COM (Feb. 9, 2010).

[88] Ben Protess & Azem Ahmed, *With New Firepower, SEC Tracks Bigger Game*, N.Y. TIMES DEALBOOK (May 21, 2012).

[89] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 5. "When appropriate, tips that fall within the jurisdiction of another federal or state agency are forwarded to the [SEC] contact at that agency." *Id.*

[90] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 3.

After a final judgment is entered in a covered action, the OWB posts on its website a "Notice of Covered Action."[91] Whistleblowers then have 90 days to file a claim for an award based on that covered action, using Form WB-APP.[92] After the time for filing an appeal of the covered action has expired or, if an appeal has been filed, after the appeal has been concluded, the SEC will evaluate any whistleblower claims that have been timely filed in connection with the action.[93] It will determine whether any of the claimants meet the criteria for a bounty discussed above and, if so, the appropriate percentage of collected sanctions to award them as a bounty.

This involves multiple layers of review. First, the OWB comes up with a recommendation as to the appropriate disposition of an application for a bounty award.[94] Next, the OWB forwards this recommendation, along with a binder of supporting documentation, to the SEC's "Claims Review Staff," currently comprised of four senior officers in Enforcement and a senior attorney in the Office of the General Counsel.[95] The Claims Review Staff reviews these materials and issues a "Preliminary Determination." If the decision is to deny the application and the whistleblower does not object, the Preliminary Determination becomes a final SEC order. If the decision is to grant an award and the whistleblower does not object to the percentage, the Preliminary Determination becomes a "Proposed Final Determination." If the whistleblower objects to either the denial of his or her application or to the percentage awarded, the Claims Review Staff conducts an additional review (including of materials submitted by the objecting whistleblower) and then issues a Proposed Final Determination. All Proposed Final Determinations are forwarded to the SEC's five Commissioners. Within 30 days any Commissioner may request that the Proposed Final Determination be reviewed by the full Commission, in which case the Commission will issue a final order after such review is

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[91] 17 C.F.R. § 240.21F-10(a).

[92] *Id*.

[93] 17 C.F.R. § 240.21F-10(d).

[94] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 7. "OWB's process for its analyses includes reviewing and comparing the facts of a claim to the whistleblower statute and regulations, reviewing relevant databases for information regarding the case and subsequent enforcement action, interviewing Enforcement staff regarding the case and the whistleblower's actions, interviewing the whistleblower and/or their counsel, and conducting due diligence and legal research to ensure proper consideration is given to each award claim." SEC'S OFFICE OF THE INSPECTOR GENERAL, EVALUATION OF THE SEC'S WHISTLEBLOWER PROGRAM 5, Rep. No. 511 (2013).

[95] *Id*.

conducted. If no such request is made, the Proposed Final Determination becomes a final SEC order.[96]

A whistleblower can appeal the SEC's final decision denying his or her entitlement to an award, but an SEC decision regarding the amount of an award (including the allocation of an award as between multiple whistleblowers) is not appealable so as long the award falls within the required 10-30% range.[97]

vii. *Protection against Retaliation*

Even the lure of a substantial bounty payment may not be enough to compel individuals to become whistleblowers if they fear retaliation at their place of employment. Section 21F thus seeks to encourage participation in the WBP by prohibiting employers from discriminating against whistleblowers in the terms and conditions of employment because they have provided information to the SEC or have assisted the SEC in an investigation or prosecution related to that information.[98] This provision is enforceable in an action or proceeding brought by the SEC.[99] Moreover, a whistleblower who believes his or her employer has violated this provision may sue for reinstatement, two times any back pay owed, and for fees and costs.[100] Unlike Sarbanes-Oxley's anti-retaliation provision, which requires claims be brought through the Department of Labor,[101] the WBP's anti-retaliation provision allows whistleblowers to sue directly in federal court.[102] It also affords plaintiffs a more generous statute of limitations.[103]

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[96] *See generally* 17 C.F.R. § 240.21F-10(e)-(i) (detailing, with respect to awards for covered actions, the procedures for contesting the SEC's preliminary determination as well as the process by which it becomes a final order); *id*. § 240.21F-10(e)-(i) (same for related actions); *see also* SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 7 (discussing the role of the OWB and Claims Review Staff in this process).

[97] 17 C.F.R. § 240.21F-13(a).

[98] The retaliation provision also protects individuals who have made disclosures that are required or protected under Sarbanes-Oxley or a variety of other laws. *See* 15 U.S.C. § 78u-6(h)(1)(A).

[99] 17 C.F.R. § 240.21F-2(b)(2).

[100] 15 U.S.C. § 78u-6(h)(1)(C).

[101] *See* OSHA FACT SHEET: FILING WHISTLEBLOWER COMPLAINTS UNDER THE SARBANES-OXLEY ACT, *available at* http://www.osha.gov/Publications/osha-factsheet-sox-act.pdf.

[102] 15 U.S.C. § 78u-6(h)(1)(B)(i).

[103] 15 U.S.C. § 78u-6(h)(1)(B)(iii). For a discussion of the problems with Sarbanes-Oxley's anti-retaliation provision, see Terry Morehead Dworkin, *SOX and Whistleblowing*, 105 MICH. L. REV. 1757, 1764-67 (2007). For a discussion of how the WBP's anti-retaliation provision seeks to avoid these problems, see Rachel Beller, *Whistleblower Legislation of the East and West*, 7 N.Y.U. J. L. & BUS. 873, 914-15 (2011).

To be entitled to this protection, the whistleblower need not qualify for a bounty award; it is sufficient that they possessed a "reasonable belief" that the information they provided to the SEC related to a "possible" securities law violation.[104]

The WBP also seeks to protect whistleblowers by requiring the SEC to keep a whistleblower's identity confidential until it is required to be disclosed to a defendant in a public proceeding, or unless the SEC deems it necessary to share it with certain other authorities (in which case those authorities must keep it confidential).[105] A whistleblower also has the option of remaining anonymous up to the point of receiving payment of a bounty, at which time the whistleblower's identity must be disclosed to the SEC.[106] Anonymous Form TCRs must be submitted through an attorney, however, and the whistleblower must provide that attorney with a declaration under penalty of perjury that the information on the form is true and correct.[107] (Non-anonymous whistleblowers must make such a declaration directly on their Form TCRs.[108]) Finally, the WBP makes it unlawful to take actions to impede an individual from becoming a whistleblower, including by threatening to enforce a confidentiality agreement (except agreements related to legal representation).[109]

B. *Track Record to Date*

While the WBP remains in its infancy, some preliminary data sheds light on its operations thus far. The SEC is required to file an annual report with Congress reporting on the WBP and the current state of the "Investor Protection Fund" ("IPF"), the account from which bounties are paid.[110] In

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[104] 17 C.F.R. § 240.21F-2(b). It has been held that individuals will qualify as "whistleblowers" for purposes of the WBP's anti-retaliation provision even if they fail to submit their information to the SEC in compliance with the procedures that must be followed to claim a bounty. *See*, *e.g.*, *Kramer v. Trans-Lux Corp.*, 2012 U.S. Dist. LEXIS 136939 (D. Conn. Sept. 25, 2012).

[105] 15 U.S.C. § 78u-6(h)(2); 17 C.F.R. § 240.21F-7.

[106] *See* 17 C.F.R. §§ 240.21F-7(b); 240.21F-9(c) & 240.21F-10(c).

[107] *See* 17 C.F.R. §§ 240.21F-7(b)(1); 240.21F-9(c); 15 U.S.C. § 78u-6(d)(2).

[108] *Supra* note 17.

[109] 17 C.F.R. § 240.21F-17(a).

[110] *See* 15 U.S.C. § 78u-6(g)(5). Dodd-Frank mandates that bounty payments be made out of the newly created IPF, which is also to be used for funding the SEC Inspector General's suggestion program. 15 U.S.C. § 78u-6(g)(2); SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 9 n.17. The IPF has three funding sources. First, any monetary sanctions collected by the SEC that are not paid into a fund for victims under section 308 of the Sarbanes-Oxley Act or otherwise distributed to victims must be deposited into the IPF, unless the IPF's balance exceeds $300 million at the time the sanction is collected. 15 U.S.C. § 78u-6(g)(3)(A)(i). Second, any money in a

addition, the OWB is required to report annually to Congress "on its activities, whistleblower complaints, and the response of the [SEC] to such complaints."[111] In November 2012, the SEC filed one consolidated report covering the first full fiscal year of the WPB and OWB's operations.[112]

According to that report, the IPF is fully funded, with a balance of over $453 million as of the close of the 2012 fiscal year.[113] The report also indicates that over the course of the 2012 fiscal year the OWB returned over 3,050 phone calls to its whistleblower hotline,[114] received 3,001 whistleblower tips,[115] posted 143 Notices of Covered Action,[116] and oversaw the award of one whistleblower bounty.[117] "The most common complaint categories reported by whistleblowers were Corporate Disclosures and Financials (18.2%), Offering Fraud (15.5%), and Manipulation (15.2%)."[118] The tips came from individuals located in all 50 states and many foreign countries.[119] Officials have indicated that two to three of the daily tips coming to OMI through the WBP tend to be "high quality," often coming from "competitors or high-level industry executives

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section 308 fund that is not distributed to victims must be transferred to the IPF, unless the IPF's balance exceeds $200 million. *Id*. § 78u-6(g)(3)(A)(ii). Third, if there is not enough money in the IPF to pay a bounty award, the monetary sanction collected in the covered action on which the award is based shall be deposited into the IPF to cover the shortfall. *Id*. § 78u-6(g)(3)(B). The IPF may also keep any income from investments made with its funds. *Id*. § 78u-6(g)(3)(A)(iii); *see also id*. § 78u-6(g)(4) (detailing the investments that may be made with IPF funds).

[111] 15 U.S.C. § 78u-7(d).

[112] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012.

[113] *Id*. at 10.

[114] *Id*. at 4.

[115] *Id.*

[116] *Id.* at 8.

[117] *Id.* The paucity of awards does not indicate stinginess on the part of the SEC, but rather reflects the early stage of the WBP and the considerable time it takes to move from the initial receipt of a TCR to an actual award determination. "OWB is continuing to review and process applications for awards received during the 2012 fiscal year." *Id*. at 9. Few details were provided about the one case which has already resulted in the award of a bounty, in an effort to preserve the anonymity of the whistleblower involved. The report states that the award recipient helped to stop an ongoing multi-million dollar fraud and received the maximum bounty percentage of 30%. *Id*. at 8. The whistleblower "submitted a tip concerning the fraud and then provided documents and other significant information that allowed the [SEC] to move at an accelerated pace and ultimately led to the filing of an emergency action in federal court to prevent the defendants from ensnaring additional victims or further dissipating investor funds." *Id*. At the time of the report, $150,000 of the $1 million plus in sanctions ordered in the covered action had been collected, and the whistleblower had received nearly $50,000. *Id*.

[118] SEC ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM FISCAL YEAR 2012, 5.

[119] *Id.*

or managers that are knowledgeable about how securities markets work."[120] According to the OWB's chief, tips have also come in from employees, former employees, spouses, ex-spouses, in-house attorneys, one former CEO, and compliance officers, among others.[121]

The most recent data on the WBP comes from the SEC's Office of the Inspector General (OIG), in a report the OIG submitted to Congress in January.[122] That report discusses the results of the OIG's Congressionally-mandated performance audit of the WBP.[123] As part of that audit, the OIG conducted a statistical sampling of whistleblower TCRs submitted from April 12, 2011 to September 30, 2012.[124] Based on that sampling, it found: on average, OMI conducted initial TCR reviews within one day of receipt; 69% of TCRs received were deemed to require "no further action"[125]; and TCRs that were deemed to require further action were assigned to relevant enforcement personnel within 10 days of receipt, on average.[126] The OIG concluded that the "SEC generally is prompt in responding to information that is provided by whistleblowers, applications for whistleblower awards, and in communicating with interested parties," but recommended that its internal controls be strengthened through the adoption of performance metrics.[127] The OIG also found that the WBP is "clearly defined and user-friendly for users that have basic securities laws, rules, and regulations knowledge" and has been well publicized by the OWB.[128]

II. EVALUATING THE PROGRAM'S PROMISE: INSULAR VIEW

The WBP marks an important sea change in the SEC's relationship with private informants. Prior to its creation, the only experience the SEC had paying for tips was under a little used, and totally discretionary, insider

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[120] Tom Steinert-Threlkeld, *SEC Whistleblower Tip Rate: 7 A Day*, ONWALLSTREET.COM (May 23, 2012).

[121] *SEC Actively Tracking Corporate Conduct That Might Constitute Informant Retaliation*, BNA SECURITIES LAW DAILY (Oct. 11, 2012).

[122] SEC'S OFFICE OF THE INSPECTOR GENERAL, EVALUATION OF THE SEC'S WHISTLEBLOWER PROGRAM, Rep. No. 511 (2013).

[123] Pub. L. No. 111-203, 124 Stat. 1376, 1848-49 (2010).

[124] *Supra* note 122, at 14.

[125] A TCR may be designated as not requiring further action because it is of low quality, because it relates to a matter already under active investigation by the SEC, or because it is more suitably investigated by another law enforcement agency. *Id*. at 16 n.23.

[126] *Id*. at 15-16.

[127] *Id*. at v.

[128] *Id*.

trading bounty program.[129] With change comes controversy, and the WBP certainly has had its share of detractors. This Part attempts to structure the current debate over the WBP. In doing so, it takes the same insular view that has characterized prior discussions of the program—ignoring the WBP's impact on the desirability of other aspects of the United States' securities fraud deterrence regime, and instead examining its potential effectiveness as a stand-alone program. Part III will address the WBP's broader implications.

An evaluation of the potential effectiveness of the WBP must begin with a definition of its purpose. One possible definition is "to increase the number of high quality tips" related to securities law violations. But such a definition would be too narrow, for enhancing the number of high quality tips is not an end in itself. It is a means, rather, for better detecting and in turn deterring securities law violations. And deterring securities law violations is desirable only insofar as it operates to enhance overall social welfare—that is, only to the extent that the benefits of increased deterrence exceed the costs of the legal regime. Securities law violations, and in particular securities fraud (the primary concern of the WBP), can produce a variety of social harms. At the highest level of abstraction, securities fraud works to increase the cost of capital and decrease the allocative efficiency of the economy.[130] A legal regime can reduce the incidence of securities fraud by credibly threatening would-be fraudsters (and, perhaps, their employers) with sanction. But a legal regime produces costs of its own, some of which are indistinguishable from the social harms securities fraud itself creates. For example, if corporate agents perceive a risk of erroneous liability, or even mere false allegations, they may react by disclosing less information, which like fraud can reduce allocative efficiency; and if companies are held vicariously liable for their employees' frauds, excessive sanctions may cause boards to overinvest in fraud prevention measures, increasing the cost of capital.[131] A legal regime also consumes government

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[129] *See* Insider Trading and Securities Enforcement Act of 1988, 15 U.S.C. § 78u (1994).

[130] For a more detailed discussion of how securities fraud produces these costs, see Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2179-80 (2010).

[131] *Id*. at 2184 ("[O]verdeterrence produces some of the very same social costs as securities fraud itself: it can increase the cost of capital (e.g., if fear of liability causes companies to overinvest in precautionary measures or causes financial intermediaries to charge more for their services) and upset the allocative efficiency of the economy (e.g., if fear of liability causes companies to reduce disclosure of truthful information or,

resources that might be put to more profitable use elsewhere. The potential effectiveness of the WBP is discussed below with this broader social cost-benefit calculation in mind.

a. *Social Benefits*

The WBP will have the laudable effect of deterring securities fraud if it makes it more likely that fraudsters will be caught. A rational corporate manager contemplating fraud would weigh the benefits of committing fraud to him against the expected costs of being caught, discounted by the likelihood of being caught. Thus, if the likelihood of being caught goes up while the expected costs of being caught remain the same, rational corporate officers will find fewer frauds worthwhile.[132] Increasing the likelihood of detection may also galvanize directors and officers to take greater steps to prevent fraud by others within the firm, due to an increased likelihood of

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conversely, to disclose too much trivial information, thereby impeding share-price accuracy.").

[132] Jennifer Arlen and William Carney have hypothesized that most managers will find fraud-on-the-market worthwhile only in "last period" situations, when lying can buy them time to turn around an ailing firm, but being forthright will cost them their jobs and much of their wealth; achieving deterrence through the threat of monetary sanctions can be difficult in these situations, they explain, because managers may expect to be judgment-proof in the event the fraud proves unsuccessful. *See* Jennifer H. Alren & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691 (1992). The WBP, by increasing the likelihood a manager will be caught *by the SEC*, may help deter even this particularly intransigent type of fraud. The SEC has a variety of non-monetary sanctions in its arsenal, such as officer and director bars, and may refer matters to the Department of Justice for criminal prosecution.

Indeed, increasing detection levels may have a greater impact than would increasing the severity of even non-monetary sanctions. Expected utility theory predicts that risk-averse persons will be more deterred by a compensated increase in the severity of the sanction than an equivalent compensated increase in the probability of detection, because the former involves a higher variance. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 178 (1968). But even though people are generally assumed to be risk-averse, "one often encounters the notion that the probability of sanctions (or, as it is frequently expressed, the certainty of sanctions) matters more than their magnitude." Steven Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 481 (2004). This may reflect a weakness of expected utility theory as a predictor of human-decision making under uncertainty. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 265 (1979) ("In expected utility theory, the utilities of outcomes are weighted by their probabilities. . . . [But a series of choice problems demonstrates that] people overweight outcomes that are considered certain, relative to outcomes which are merely probable—a phenomenon we label the *certainty effect.*"); James D. Cox, *Private Litigation And The Deterrence Of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 3 (1997) (explaining that unlike expected utility theory, "prospect theory suggests that the probability of detection is far more likely to have an impact on agents than will increasing the sanction when there is a very low probability of detection").

corporate liability as well as reputational harm.[133] The WBP will increase the probability of detection if it prompts the submission of tips regarding frauds that would not otherwise have been exposed. Even with respect to frauds that would have come to light absent the WBP, the lure of a bounty might prompt earlier reporting; if so, the program may serve to limit the damage caused by fraud by facilitating quicker intervention to stop it.

It may seem obvious that the WBP would have the effects of encouraging more tips and prompting quicker intervention to stop ongoing frauds, but neither proposition has gone unchallenged. It has been argued, for example, that the WBP may actually discourage reporting—perversely leading to a *lower* probability of fraud detection—by "crowding out" internal motivations to blow the whistle.[134] The assumption underlying the WBP is that the lure of financial reward, as well as the promise of confidentiality and strong retaliation protection, will alter the internal cost-benefit calculation a potential whistleblower engages in when deciding whether to report wrongdoing or remain silent.[135] The costs of blowing the whistle can be significant, and include possible workplace retaliation and industry blacklisting; the benefits of reporting include any psychic gratification that may come from exposing the wrongdoing, as well as possible avoidance of complicity in that wrongdoing and resultant liability

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[133] If so, deterrence could be enhanced even if the individuals who commit securities fraud do not engage in the sort of rational decision-making process imagined above. *See, e.g.*, Donald Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) (questioning strong assumptions of rationality in this context). As I have argued elsewhere, faithful corporate agents of publicly held firms would take cost-justified measures to deter fraud even in the absence of corporate liability risk, because doing so would benefit the firm's largely diversified shareholders; in a world with agency costs, however, the specter of corporate liability may be necessary to prompt corporate agents to invest in fraud prevention. *See generally* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679 (2011).

[134] *See*, *e,g.*, Dave Ebersole, *Blowing the Whistle on the Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPREN. BUS. L. J. 123, 130-31 (2011) (making this argument); *cf.* Diego Pardow, What Should We Expect from the Dodd-Frank Bounty Program? (July 2012) (discussing this concern and ultimately finding it unpersuasive), *available at* ssrn.com/abstract=2115964. "Most generally, the crowding-out literature suggests that when people attribute their behavior to external rewards, they discount any moral incentives for their behavior, thereby lowering the perceived effect of intrinsic motivation." Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151,1178-78 (2010).

[135] *But see* Roberta Ann Johnson, WHISTLEBLOWING: WHEN IT WORKS--AND WHY 48 (2002) (observing that emotion may override consequentialist calculations in the whistleblowing setting).

exposure.[136] By entitling whistleblowers to a sizeable financial reward, protecting their confidentiality, and providing heightened protection against retaliation, the WBP seeks to increase the benefits of reporting and decrease the costs—tipping the scales in favor of reporting.[137] But if the promise of financial reward decreases the psychic benefits of reporting, it is possible that the WBP could have the opposite effect.

While theoretically possible, there is no evidence that the WBP has created such a crowding-out effect or will going forward. Financial bounties have been successfully used to increase detection in other regulatory areas,[138] and the uptick in the number of high quality tips the SEC has received in the wake of the WBP indicates they are working in the securities context as well.[139] Although a recent experimental survey by

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[136] In one whistleblowing study on corporate fraud, 84% of the non-anonymous whistleblowers included in the sample alleged "that they were fired, quit under duress, or had significantly altered responsibilities as a result of bringing the fraud to light." Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud*, 65 J. Fin. 6 (2010). For a comprehensive survey of studies done on whistleblower retaliation, see Marcia P. Miceli, et. al, WHISTLEBLOWING IN ORGANIZATIONS 101-130 (2008). *See also* Marsha J. Ferziger & Daniel G. Currell, *Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs*, 1999 U. ILL. L. REV. 1141, 1173 (observing that an informant may also incur more subjective costs, including "guilt over betrayal of a (former) friend, the frustration that inevitably arises from interacting with a federal agency, and fear arising from his concern that relation may be forthcoming—whether or not it is"); Geoffrey Christopher Rapp, *Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 B.Y.U. L. REV. 73, 109-18 (cataloguing a variety of "incentives that favor individuals blowing the whistle and those that caution against such activity").

[137] It has been asserted that "informants tip only when the discounted gains from doing so exceed the discounted losses," and a "discounted gain is not the amount an informant could receive in return for his information" but rather "the amount an informant legitimately expects to receive, discounted by the likelihood that amount will be reduced or not awarded at all." Ferziger & Currell, *supra* note 136, at 1171. Prior bounty programs that made the payment of bounties entirely discretionary on the part of the administering agency (such as the SEC's former insider trading bounty program and the pre-1996 version of the IRS's bounty program) have been widely judged as unsuccessful, perhaps because potential whistleblowers applied a deep discount to such uncertain rewards. Learning from these earlier failures, Congress deliberately chose to make WBP bounties non-discretionary, and required that they total no less than 10% of collected sanctions in a covered action. Of course, a potential whistleblower in the WBP continues to face uncertainty with respect to: (1) whether a covered action will result from her tip; (2) whether the SEC will deem her to have satisfied the eligibility criteria; (3) the amount of any award within the 10% to 30% range; and (4) whether she will have to share that award with other whistleblowers.

[138] *See* Dyck, et. al., *supra* note 136 (finding that employees revealed fraud in 41 percent of the cases in the sample from the healthcare industry—a setting where qui tam suits under the False Claims Act are available—but in only 14 percent of cases in the sample from industries where qui tam suits are not available).

[139] *See supra* note 120.

Professors Yuval Feldman and Orly Lobel supports a limited crowding-out effect attributable to financial rewards for whistleblowing, their results suggest the effect takes hold only in situations where the misconduct being reported does not evoke a high level of moral outrage and the promised bounties are small.[140] The bounties promised by the WBP are large, by contrast, and securities fraud—a scienter-based offense—should evoke significant moral outrage. In any event, experimental surveys may not reliably predict how individuals would respond to incentives in real world situations.[141] Intuition and experience tells us that large financial rewards work.

A more serious concern, voiced by many, is that the WBP will have the effect of allowing frauds to persist longer than they otherwise would, thus perversely increasing the social costs of fraud. This will occur, the argument goes, because the WBP creates an incentive for whistleblowers to bypass their companies' internal compliance departments in favor of direct reporting to the SEC.[142] Although the final rules sought to preserve the attractiveness of internal reporting in a variety of ways discussed in Part I,[143] they do not include a requirement that a whistleblower first report internally in order to be eligible for a bounty award. The Chamber of Commerce and Institute for Legal Reform criticized this choice as a decision to "put trial lawyer profits ahead of effective compliance and corporate governance."[144] These organizations issued a joint statement warning that the absence of an internal reporting requirement

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[140] *See* Feldman & Lobel, *supra* note 134, at 1202 ("our experiment shows that where misconduct is expected to evoke a lower level of moral outrage, the introduction of small bounties may actually decrease the rate at which it is reported").

[141] *See* Miceli, et al., *supra* note 136, at 26-32 (discussing the serious limitations for various approaches to studying the predictors of whistleblowing, including experimental surveys).

[142] *See, e.g.*, Vishal Baloria, et al., *A Lobbying Approach to Evaluating the Whistleblower Provisions of the Dodd-Frank Reform Act of 2010* 10 (August 2011), *available at* ssrn.com/abstract=1923310 (observing that the issue most frequently addressed in comment letters related to the WBP was the lack of a requirement of internal reporting); Lisa M. Noller, *A Modest Practitioner Proposal: Striking a Balance in Whistleblower Lawsuits*, 2012 U. CHI. LEGAL F. 129, 143-46 (raising this objection).

[143] As discussed in Part I.A.iii, whistleblowers who report through internal channels no more than 120 days before reporting to the SEC will be treated as having reported to the SEC on the date of the internal disclosure and will be credited with any information their company later reports to the SEC as a result of an internal investigation they prompted. A whistleblower's use of internal reporting mechanisms may also advantageously affect the size of any bounty they are awarded. *See supra* Part I.A.v.

[144] Press Release, U.S. Chamber Warns New SEC Whistleblower Rule will Undermine Corporate Compliance Programs (May 25, 2011), *available at* http://www.uschamber.com/press/releases.

> will make it harder and slower to detect and stop corporate fraud—by undermining the strong compliance systems set up under Sarbanes Oxley to ensure companies take whistleblowers seriously. Armed with trial lawyers and new large financial incentives to bypass these programs, whistleblowers will go straight to the SEC with allegations of wrongdoing and keep companies in the dark. This leaves expensive, robust compliance programs collecting dust, while violations continue to fester, eroding shareholder value.[145]

Concerns about undermining internal compliance programs led SEC Commissioners Troy Paredes and Kathleen Casey to vote against the adoption of the final rules.[146]

Early results indicate that, like the "crowding out" concern, this fear may be overblown. The OWB's chief has stated that a "significant majority" of the whistleblowers who have come forward since the program began reported that they used internal channels first.[147] And the Quarterly

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[145] *Id.* For a good discussion of the effect of Sarbanes-Oxley on internal compliance programs, see Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. Rev. 1107. For contrary views regarding the impact of the WBP on such programs, see Geoffrey Christopher Rapp, Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions: Written Testimony Submitted to the U.S. House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises (arguing against a bill that would have amended Dodd-Frank to require internal reporting as a condition to receiving a bounty); Justin Blount & Spencer Markel, *The End of the Internal Compliance World as We Know It, Or an Enhancement of the Effectiveness of Securities Law Enforcement? Bounty Hunting Under the Dodd-Frank Act's Whistleblower Provisions*, 17 FORDHAM J. CORP. & FIN. L. 1023, 1061 (2012) (arguing that "criticisms that the whistleblower provisions of Dodd-Frank will undermine internal compliance programs ring hollow" and "that the whistleblower provisions of Dodd-Frank have the potential to serve as an incentive for companies to more effectively implement and enforce their internal compliance programs and attempt to build more ethical cultures").

[146] *See* Troy A. Paredes, Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011) ("I believe that we could and should have calibrated the final rule differently, shifting the tradeoffs in favor of ensuring the integrity of internal compliance programs as a complement to government enforcement"); Kathleen Casey, Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011) ("While I appreciate that today's release seeks to provide additional incentives for whistleblowers to use internal reporting channels, I remain deeply concerned that they are not sufficient to preserve the value of internal compliance programs and their contribution to our enforcement efforts").

[147] Jaime Guerrero, *Most SEC Whistleblowers Tell Company First*, INSIDECOUNSEL.COM (March 28, 2012). This is consistent with documented whistleblower behavior in other regulatory contexts. *See* Miceli et al., *supra* note 136, at 9 ("Many studies have shown that nearly all whistleblowers who use external channels do so after first using internal channels").

Corporate Fraud Index[148] indicates that internal fraud reporting has actually increased in the wake of the WBP.[149] This may be because, in response to concerns about the WBP's potential impact on internal reporting, many firms proactively "shored up their anti-retaliation policies and tried to communicate more effectively to employees the organization's renewed commitment to internal reporting processes."[150] Moreover, even when a whistleblower does bypass internal channels, nothing prevents the SEC from informing the whistleblower's employer that a suspected law violation has been reported, so as to allow for swift internal investigation (so long as the SEC does not reveal the whistleblower's identity). Indeed, the SEC has indicated that "in most cases, upon receiving a whistleblower tip, its staff would contact a corporation and describe the allegations, giving the firm a chance to investigate the matter itself."[151]

Some also contend that the WBP creates incentives for whistleblowers to delay reporting of fraud until it grows severe enough to warrant at least $1 million in sanctions—the minimum amount needed for a "covered action."[152] Delay may indeed be a logical choice, if it is clear that no

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[148] The index is compiled from actual incidents reported by clients of The Network, a company that describes itself as "the leader in providing integrated governance, risk and compliance [] solutions that help organizations mitigate risk, achieve compliance and ultimately create better, more ethical workplaces"; among other products, The Network offers clients a confidential hotline for employees to report suspected law violations. *See* http://www.tnwinc.com/index.php/the-network/index.aspx.

[149] "Fraud-related incidents reflected in the Fraud Index include reports on corruption, theft, accounting and audit irregularities, misuse of assets, conflicts of interest, and violations of [the Foreign Corrupt Practices Act], UK anti-bribery and SEC legislation." Press Release, The Network & BDO Consulting Release 2nd Quarter 2012 Findings: Quarterly Corporate Fraud Index (Sept. 25, 2012), *available at* http://www.tnwinc.com/index.php/Releases

[150] Yin Wilczek, *Employees' Internal Fraud Reports Rise Even in Wake of SEC Whistleblower Program*, BNA WHITE COLLAR CRIME REPORT (2012) (quoting Luis Ramos, CEO of The Network); *see also* Shannon Kay Quigley, *Whistleblower Tug-Of-War: Corporate Attempts to Secure Internal Reporting Procedures in the Face of External Monetary Incentives Provided by the Dodd-Frank Act*, 52 SANTA CLARA L. REV. 255 (2012) (suggesting modifications to compliance programs to encourage internal reporting in response to the WBP).

[151] *See* Rapp, *supra* note 145. A recent empirical study shows that firms which lobbied against the adoption of the WBP had significantly weaker internal compliance programs relative to a sample of non-lobbying firms, a finding the study's authors view as inconsistent with the claim that the WBP will undermine internal compliance programs. *See* Baloria, et al., *supra* note 142.

[152] *See, e.g.*, John Ashcroft, et al., *Whistleblowers Cash In, Unwary Corporations Pay*, 40 HOFSTRA L. REV. 367, 371 (2011) ("whistleblowers have a perverse incentive to sit on knowledge of suspected wrongdoing instead of reporting at the first opportunity—after all, whistleblower information related to malfeasance that is allowed to fester and grow means a potentially higher bounty"); Rapp, *supra* note 136, at 93-94 ("the hard threshold below

covered action will result if the fraud is reported immediately. But the point at which a fraud will result in a covered action is likely hard for a potential whistleblower to predict, and delay carries with it considerable risks, making it a dangerous strategy. As explained in Part I, if the SEC learns of information from another person before the whistleblower reports it to the SEC or through his employer's internal compliance procedures, the whistleblower will fail the originality requirement (unless he is the "original source" of the other person's tip), and thus be rendered ineligible for a bounty.[153] A whistleblower will also fail the "voluntariness" requirement if, before he makes his report, the SEC or certain other authorities request related information from him.[154] And even if he can meet the originality and voluntariness requirements, if the SEC has already opened an investigation into the misconduct by the time a whistleblower submits his information, the whistleblower will face the more stringent "significant contribution" test for determining whether his tip "led to" a covered action.[155] Finally, unreasonable delay in reporting may adversely affect the size of the bounty awarded by the SEC, within the 10-30% range.[156] Thus, the WBP creates fairly strong incentives for whistleblowers to report promptly.

Apart from its impact on the probability and timing of detection, the WBP might also increase deterrence by raising the expected costs a fraudster faces if detected. As the Harry Markopolos-Bernie Madoff saga painfully illustrates, a meritorious tip to the SEC does not always result in investigation and punishment.[157] The WBP now gives tipsters (and their contingency-fee lawyers) a strong financial stake in monitoring and encouraging SEC follow-through. The WBP is also subject to ongoing Congressional oversight, with the OWB obligated to report to Congress annually on its response to whistleblower complaints.[158] Of course, poorer SEC follow-through is also a possible result of the WBP, if it prompts a

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which no awards are permitted creates a very real possibility that a potential whistleblower will be forced to delay reporting until the magnitude of fraud seems likely to trigger the bounty provision").

[153] *See supra* Part I.A.ii.

[154] *See supra* Part I.A.i.

[155] *See supra* Part I.A.iii.

[156] *See supra* Part I.A.v. Negative consequences also follow from any attempt on the part of a whistleblower to hinder an internal or external probe which may expose the wrongdoing. *See, e.g.*, *supra* notes 27 & 83.

[157] Luke Hornblower, *Outsourcing Fraud Detection: The Analyst as Dodd-Frank Whistleblower*, 6 J. BUS. & TECH. L. 287, 312-18 (2011) (telling the story of Harry Markopolos' unsuccessful efforts to get the SEC to pursue the Madoff Ponzi scheme).

[158] *See supra* note 111.

deluge of tips that overwhelm the SEC's processing capabilities. But with the creation of OMI and the revamped TCR System, the SEC appears well-equipped to handle the influx of information, and the recent OIG performance audit suggests it is doing a fairly good job processing tips so far.[159] Thus, the WBP may work to increase not just the likelihood fraudsters will be detected, but also the likelihood that they will be punished if detected.

b. *Social Costs*

All told, it seems likely that the WBP will help to reduce the social costs of fraud through enhanced deterrence. The question remains, however: At what cost? Administering the WBP will undoubtedly consume considerable government resources, as will the additional investigations it prompts. Potentially more onerous, however, are a variety of more indirect costs the program threatens to produce.

For example, some have warned that the program will elicit a high number of non-meritorious tips.[160] While it is unlikely that the WBP will produce many tips that are outright fabrications (the requirement that whistleblowers submit their tips under penalty of perjury, as well as the requirement that the SEC bring a covered action based on the tip before a bounty may be awarded, seems a sufficient guard against this), the lure of a large bounty could motivate individuals to view honest conduct as suspicious.[161] Since a whistleblower's identity will be kept confidential if the tip does not pan out, and retaliation protection kicks in so long as the whistleblower had a "reasonable belief" that their tip related to a "possible"

[159] *See supra* Part I.B.

[160] *See, e.g.*, Holger Fleischer & Klaus Ulrich Schmolke, *Financial Incentives for Whistleblowers in European Capital Markets Law?* 9, *available at* ssrn.com/abstract=2124678 (noting concerns that a "lottery mentality" may lead to unreliable tips); Blount & Markel, *supra* note 145, at 1041 (noting the argument that a "race to report may encourage employees to rush to the SEC with unreliable and frivolous claims"); Lucienne M. Hartmann, *Whistle While You Work: The Fairytale Like Whistleblower Provisions of the Dodd-Frank Act and the Emergency of "Greedy," the Eighth Dwarf*, 62 MERCER L. REV. 1279, 1307-08 (2011) (same).

[161] This is a particular risk when the boundaries of the legal prohibition are vague or uncertain, as is arguably the case under the Foreign Corrupt Practices Act. *See* Heidi L. Hansberry, *In Spite of Its Good Intentions, The Dodd-Frank Act Has Created a FCPA Monster*, 102 J. CRIM. L. & CRIMINOLOGY 195 (2012).

securities law violation,[162] reporting even when there is only a small chance observed conduct is unlawful is a sensible strategy.[163]

If mistaken tips become commonplace—something the recent OIG report suggests may be happening[164]—the ultimate damage they cause will depend on how efficient personnel at OMI (and, if the tips are made internally, in corporate compliance departments) become at screening for them. If such personnel become adept at doing so, disposing of mistaken tips early and privately, the costs of the problem may be fairly contained. This is not to say that such costs will necessarily be trivial—the specter of trigger-happy whistleblowers may foster a general atmosphere of distrust and suspicion amongst co-workers, which can negatively impact a firm's productivity.[165] But if mistaken tips frequently lead to serious investigations, the costs will be much more substantial. Such costs could include considerable legal fees, unwarranted reputational damage to firms and individuals, as well as undesirable *ex ante* effects on corporate behavior. For example, companies might choose to avoid profit-maximizing transactions that are legal but thought likely to arouse whistleblower suspicion. Firm managers might also become hesitant to share information outside a small cohort of trusted colleagues, to the detriment of the firm's operations, or may spend resources that could be put to more valuable use elsewhere assuring employees of the legality of the firm's behavior.

Even meritorious tips could lead to costly unintended consequences, if the WBP encourages the SEC to rely too heavily on corporate sanctions. The success of the WBP in eliciting tips will depend, in the long run, on how often the SEC is perceived to pay out bounties. Such bounties are available only in "covered actions"—*i.e.*, actions involving financial penalties in excess of $1 million dollars—and pay out only as a percentage of sanctions actually collected. A desire to make the program work might therefore lead the SEC to impose sanctions on deep-pocketed corporate defendants at a higher rate than it otherwise would. But, as I discuss in the next Part, the desirability of vicarious liability is a complex issue when a

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[162] *See supra* note 104.

[163] Delaying reporting until one's suspicions are substantiated is a dangerous strategy, for the reasons discussed above. *See supra* notes 151-156 and accompanying text.

[164] *See supra* note 125 and accompanying text.

[165] *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 99 (2002) (observing that "'high heat' monitoring poses some inchoate risk to morale and productivity that is extraordinarily difficult to measure but potentially quite large").

corporation is publicly held, and its use may have undesirable effects. It should also be noted that any increase in the number of SEC enforcement actions brought about by the WBP may also cause an increase in the number of securities fraud class actions filed, as class actions often piggyback on SEC enforcement efforts. Given that vicarious liability is a staple of the securities fraud class action, the WBP may result in greater corporate sanctions even if the SEC targets mostly individual defendants.

Some have also warned that the WBP will have a deleterious effect on the auditor-issuer and attorney-client relationships, eroding trust and in turn inhibiting the candor that is necessary to make those relationships work effectively.[166] As explained in Part I, auditors and attorneys are generally ineligible to claim bounty awards for providing tips that implicate clients.[167] But their ineligibility is subject to large exceptions.[168] Finally, some warn that the WBP's anti-retaliation provision will create a human relations nightmare, as firms find themselves hamstrung to fire underperforming, but whistleblowing, employees.[169]

c. *Striking the Right Balance*

Do the potential benefits of the WBP exceed its potential costs? At the risk of disappointing the audience, I do not claim to know. Whether, on net, the WBP will increase social welfare is a question no one can answer with certitude. The benefits and costs discussed above, while potentially very real, are also notoriously difficult to observe and measure. Individuals with different intuitions as to the level of undetected securities fraud plaguing the U.S. capital markets may view the balance differently. What I can say with some degree of confidence is that the program is likely to increase fraud deterrence, and that the SEC has done a reasonable job in trying to ensure that its costs do not dwarf its benefits.

Whether the SEC has *optimized* the program is far more debatable. A variety of different choices could have been made in calibrating the final rules. The SEC could have precluded attorneys and auditors from recovering bounties for providing tips relating to their clients without exception. It could have made the standard for invoking retaliation protection something more demanding than a "reasonable belief" the

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[166] *See, e.g.*, Temkin & Moskovits, *supra* note 54.
[167] *See supra* Part I.a.iv.
[168] *Id*.
[169] *See, e.g.,* Blount & Markel, *supra* note 145, at 1042 (observing that "a disgruntled employee who fears discipline or termination may report false or exaggerated tips to obtain whistleblower insulation in an effort to shield him or her from termination").

information submitted related to a "possible" securities law violation. It could have required internal reporting as a prerequisite to recovery, absent strong evidence of a corrupt corporate compliance department. Congress could have made different choices in the statute, as well, with respect to such things as whistleblower confidentiality, the threshold for what counts as a "covered action," and the range of permitted bounty payments. I could go on. Time and close monitoring will shed better light on the choices Congress and the SEC did make, and perhaps provide grounds for future revisions to the program. We must wait and see.

A far more tractable question concerns the impact of the WBP, now that we have it, on other aspects of the United States' securities fraud deterrence regime—and in particular on the controversial Rule 10b-5 "fraud on the market" class action. The next Part turns to this broader question, which has been neglected in the debate over the WBP, and suggests a stark answer.

III. EVALUATING THE PROGRAM'S PROMISE: BROAD VIEW

The SEC is not the only actor involved in policing the integrity of the U.S. capital markets. The Department of Justice can prosecute violations of the federal securities law criminally, and state regulators can bring civil and criminal proceedings against companies and individuals that violate state laws prohibiting securities fraud.[170] Then there is the distinctly American "bounty hunter" system of private enforcement, mascoted by the judicially implied Rule 10b-5 cause of action.[171] Private Rule 10b-5 enforcement lost its moorings in the common law long ago with judicial recognition of the "fraud-on-the-market" theory of reliance, which relieved plaintiffs alleging secondary market fraud of the need to prove that they individually relied on public misstatements that affected the price of securities traded in efficient markets.[172] As one commentator recently explained, this "had the effect of converting securities fraud from a transaction-based wrong—akin to common law deceit—into a market-based claim."[173] It also had the

[170] *See* Rose, *supra* note 130, at 2174-75.

[171] Explicit private enforcement provisions exist in securities laws, as well, such as Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. § 77k-l. But they are subject to careful limitations, and are far less controversial than private Rule 10b-5 enforcement as a result. *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976) (noting the "carefully drawn procedural restrictions on these express actions").

[172] *See Basic v. Levison*, 485 U.S. 224 (1988).

[173] Jill Fisch, The Trouble with Basic: Price Distortion after Halliburton 4 (unpublished manuscript), *available at* http://ssrn.com/abstract=2153133.

practical effect of removing the commonality obstacle to class certification that had beset common law deceit claims, paving the way for lawyer-driven Rule 10b-5 class actions.[174]

Few today defend Rule 10b-5 “fraud-on-the-market” (FOTM) class actions on the ground that they advance the goal of victim compensation.[175] This is because class members in such suits do not generally need compensation and, even if they did, the manner in which they are compensated does not advance justice in any meaningful sense. If shareholders are well diversified they will stand to lose from secondary market fraud roughly as often as they win.[176] This means they will be unlikely to suffer net out-of-pocket losses as a result of secondary market fraud over time.[177] Moreover, the corporation and its insurers, not the actual fraudsters, pay the settlements in these cases, meaning that at the end of the day innocent shareholders are left with the bill.[178]

In light of its failings as a compensatory tool, defenders of the FOTM class action herald it instead as an important supplement to the deterrence efforts of the SEC.[179] But the WBP now changes the SEC’s deterrence capabilities, warranting a reevaluation of the desirability of FOTM class actions.

a. *The Deterrence Case for Fraud on the Market Class Actions*

The deterrence justification for FOTM class actions is not straightforward. As noted above, corporate rather than individual liability is

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[174] *See supra* note 4.

[175] *See* Rose, *supra* note 6, at 1310-14.

[176] The fraud-on-the-market theory presumes that investors do not read corporate disclosures, but rather are passive price takers—a strategy that makes sense if investors are well diversified. *See* Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 624 (1992) (explaining that the fraud-on-the-market theory is “consistent with a ‘market model’ in which investors engage in little or no search (because they are unlikely to discover anything that would enable them to ‘beat the market’) and act as price takers”).

[177] This argument is traceable to the seminal article by Frank H. Easterbook and Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985). For a more recent discussion of the compensatory shortcomings of FOTM class actions, see Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 302-310).

[178] *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1550 (2006) (observing that the corporate defendant and its insurer typically advance the entire settlement amount).

[179] *See* Rose, *supra* note 175, at 1314 (explaining that, as “the original compensatory justification for private Rule 10b-5 enforcement grew less persuasive, a deterrence-based justification took on increased prominence”).

the norm in such actions. They therefore do not directly threaten would-be fraudsters with sanction. If such actions pack a deterrence punch, then, it is an indirect one.

The traditional deterrence rationale for vicarious corporate liability is that it forces a firm's owners to fully internalize the social costs of employee misconduct, creating an otherwise missing incentive for the firm to invest in measures to limit employee harm directed at third parties.[180] This is an important backstop, the argument goes, because personal liability will not suffice to deter employees in various situations, such as when they are judgment proof.[181] But this traditional justification for corporate liability fails in the FOTM context.[182] The owners of the companies sued in FOTM class actions are mostly diversified shareholders, and as such they naturally internalize the bulk of the social costs of securities fraud; moreover, the fact that they stand on both sides of the "v." in these suits means the settlement payments will not affect their incentives in any event (except to the extent of litigation costs and fees).[183] If FOTM class actions serve a deterrent function, then, a more nuanced explanation is required.

The "informational theory" of vicarious corporate liability potentially provides such an account.[184] According to that theory, corporate liability can help to mitigate the principal-agent conflict that exists between diversified shareholders and firm managers.[185] The idea is easy to understand: Although diversified shareholders have natural incentives to invest in fraud deterrence, the managers of their various portfolio firms may not.[186] If Rule 10b-5 class actions threaten to uncover frauds that would otherwise go undetected, it might help to correct this incentive misalignment. The revelation of fraud is likely to lead to a stock price

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[180] *See* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. L. REV. 1679, 1683-84 (2011) (discussing this traditional justification and citing the seminal articles expounding it).

[181] *See id.*

[182] *See* Arlen & Carney, supra note 132, at 693.

[183] *See id.* at 1688; *see also* Amanda M. Rose, *Fraud on the Market: An Action Without a Cause*, 160 U. PA. L. REV. PENNUMBRA 87, 90 (2011). For a careful analysis of corporate liability in fraud-on-the-market cases, see Arlen & Carney, *supra* note 132, at 706-16.

[184] *See* Rose & Squire, *supra* note 180.

[185] *Id*. at 1680.

[186] Committing securities fraud can help managers preserve their employment and increase the value of their stock-based compensation. Managers who would not themselves commit securities fraud might nevertheless underinvest in fraud deterrence efforts, because the benefits of those efforts might not be fully internalized in the firm's bottom line and thus might not inure to their personal benefit.

decline,[187] which may negatively impact the value of the managers' incentive compensation and diminish their reputational capital. It may also lead the board to fire any individuals implicated in the fraud, and cause the SEC or Department of Justice to pursue those individuals, as well.[188] The threat of these consequences may, in turn, improve managers' *ex ante* incentives to invest in measures to prevent fraud by others and to refrain from committing fraud themselves.

FOTM class actions might also aid in deterrence by exerting a disciplining force on the SEC. It is often asserted that if the SEC were granted an enforcement monopoly, it would become less aggressive in its deterrence efforts. The securities class action bar has strong financial incentives to expose fraud, and its presence may create a healthy competitive rivalry that keeps the SEC honest and working hard. A monopolistic SEC might also find itself resource constrained to pursue securities fraud at optimal levels.

Against these potential deterrence benefits must be weighed the costs of FOTM class actions. These include lawyers' fees and other litigation costs—including those incurred in FOTM class actions that merely piggyback on SEC enforcement cases, and thus do not aid in detection or check a slagging SEC. These sums are not insubstantial.[189] Potentially more troublesome are so-called "over-deterrence" costs that can be produced when legal error is a problem or excessive sanctions are imposed on vicariously culpable corporations. The forms these costs can take have already been mentioned,[190] and I have detailed them at greater length elsewhere.[191] Although the SEC can be expected to exercise discretionary non-enforcement when presented with a case of borderline merit, and to forego corporate sanctions if a firm had reasonable internal controls, the same cannot be expected of profit-driven plaintiffs' lawyers.[192] Over-deterrence costs are therefore likely to be higher in a private enforcement regime than an exclusively public one.[193] Private Rule 10b-5 enforcement can also have pernicious effects on public enforcement efforts. For example, the fear of follow-on private litigation can discourage firms from

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

[188] *See* Jonathon M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193 (2008).

[189] *See, e.g.*, Coffee, *supra* note 178, at 1539-40.

[190] *See supra*, text accompanying note 131.

[191] *See* Rose, *supra* note 130, at 2183-97

[192] *See id.* at 2200-03.

[193] *Id*.

self-reporting frauds to the SEC or otherwise cooperating with regulators.[194] Moreover, "the SEC's routine practice of allowing firms to settle fraud charges without admitting wrongdoing, something that arguably dilutes the reputational impact of the public sanction, is clearly aimed at protecting firms from parallel private liability."[195]

A growing cohort of scholars doubts that the deterrence benefits of FOTM class actions exceed their costs.[196] But even the most vocal critics of FOTM class actions have remained hesitant to recommend their abolition without compensating adjustments to the U.S. securities fraud deterrence regime. Professor William Bratton and Michael Wachter, for example, have proposed a tradeoff: "the SEC should ask for more money and refocus its enforcement operation on individual defendants and, in return, propose a rule that eliminates the [fraud-on-the-market presumption of reliance] in private litigation."[197] Professor Merritt Fox also recommends the elimination of fraud-on-the-market suits, but as part of a fundamental restructuring of the civil liability system governing mandatory disclosure.[198] I have likewise argued for the elimination of FOTM class actions, but only if simultaneous reforms are enacted to better align the SEC's interest with the national interest in achieving optimal securities fraud deterrence.[199] I have alternatively suggested that the SEC be given authority to prescreen, and potentially veto or usurp, FOTM class actions.[200]

The creation of the WBP now fundamentally changes the equation, removing any cause for these sorts of conditional prescriptions. As explained below, the WBP offers the same deterrence benefits that Rule 10b-5 class actions potentially provide, but it promises to deliver those benefits more reliably and at less cost than FOTM class actions. In light of the WBP, the case for FOTM class actions is no longer sustainable.

b. *The Whistleblower Bounty Program: Substitute not Complement*

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[194] *See* Rose, *supra* note 6, at 1336-37.

[195] Rose, *supra* note 130, at 2221; *see also* Samuel W. Buell, *Potentially Perverse Effects of Corporate Civil Liability*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT (Anthony S. Barkow & Rachel E. Barkow eds., 2010).

[196] *See* Bratton & Wachter, *supra* note 5.

[197] *Id*. at 82.

[198] *See* Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009).

[199] Rose, *supra* note 130, at 2228-29.

[200] Rose, *supra* note 6, at 1354-58. Professors Arlen and Carney, two early critics of the FOTM class action, were more resolute in their recommendation to eliminate respondeat superior liability in such suits. *See* Arlen & Carney, supra note 132.

[Dear Readers: In this part, which is still being written, I intend to address both the detection and motivational arguments in favor of FOTM class actions in light of the WBP. I sketch below some of the main points I intend to make.

Detection. I plan to start by putting the detection advantages of FOTM class actions in perspective, by reviewing the existing empirical research on topic. I will also explain why practically it may be difficult for FOTM plaintiffs' lawyers to do better—including both the legal limitations on their ability to investigate (e.g., the PSLRA's discovery stay) and the outsider status of plaintiffs' lawyers. Plaintiffs' lawyers do seek out confidential informants that can help them satisfy the PSLRA's pleading standards, but the WBP now gives those informants a more compelling reason to come forward on their own (and lawyers may continue to solicit such informants, now to serve as their counsel on contingency fee in connection with a WBP submission; although the promised payout may be smaller than in a FOTM suit, so too is the cost and risk of the representation to the attorney). If plaintiffs' lawyers have themselves developed some expertise in identifying frauds based on analysis of publicly available information, the WBP encourages them to serve as whistleblowers themselves (unlike in many other contexts, the WBP does not require a whistleblower to be an employee to be covered). Thus, it is unlikely that eliminating FOTM suits will dampen detection in any meaningful sense. I will then explain why the WBP is a much more sensible and effective way to elicit private information in furtherance of public policy goals than is class action litigation, which aids in detection in only a fraction of the cases brought (with many simply following-on the SEC's efforts). Moreover, unrestricted private enforcement carries significant costs, which I have detailed in my prior work (e.g., higher risk of legal error, difficulites related to sanction calibration, impact on public enforcer's use of discretionary non-enforcement, regulatory flexibility, etc.).

Motivation. Here I will recount concerns that have been voiced about the impact of eliminating FOTM class actions on the motivations of the SEC. I will start again by putting the argument in some perspective by highlighting the other (more powerful?) checks that exist on the SEC (e.g., state regulators, Congress, the media, institutional investors), and then explain how the WBP creates a new set of monitors in the form of whistleblowers and their counsel. These parties have every incentive to ensure that the SEC does not ignore the tips the WBP produces (or consistently target sanctions below the $1M mark, which would limit the program's effectiveness over time), and I will explain how these parties might exert influence. I will also address a related concern, namely that private enforcement must be retained because of current or future SEC resource constraints. The WBP essentially outsources the detection function to a more efficient group, and thus may actually save the SEC money (the bounties that the WBP pays out are funded by defendants and thus do not impact the SEC's operating budget). The SEC can also lean on whistleblowers' counsel to help them develop cases. To the extent the SEC finds it cannot adequately prosecute all cases, outsourcing enforcement is an option. In Dodd Frank, Congress required the OIG to analyze whether a qui tam provision should be added to the WBP. The OIG recently issue its report, finding no need for such a provision at this juncture, and suggesting it was an idea that could be reconsidered once additional data on the WBP's track record is available. Notably, the report stressed that if such a provision were adopted, it would be important to "include the condition that a public enforcer has the authority to oversee such litigation and to exercise veto power over opportunistic lawsuits"—precisely the power it lacks with respect to FOTM class actions.]

CONCLUSION

[Dear Readers: In addition to the ordinary summarizing, I intend to make a couple of additional points in the conclusion. The first is that the WBP is not perfect, even though I think it is good enough to warrant the elimination of FOTM class actions. I am particularly concerned with the $1M minimum for a "covered action" and the tying of bounty payments to sanctions actually collected, and how this might distort the SEC's penalty decisions. I need to give this further thought, but I think I agree with the suggestion that has been made by some, namely that the SEC be given discretion to award bounties when the sanctions awarded fall below the $1M threshold or even if they are entirely non-monetary in nature. The second point I want to make relates to the political feasibility of the suggested reform. Unlike past reform proposals related to the elimination of FOTM class actions, this one has some advantages. First, the WBP already exists and justifies the action without condition—no need to get Congress or the SEC adopt some other reforms simultaneously. Second, although securities class action lawyers will obviously be opposed to the proposal, at least they now can transfer their skills to whistleblower representation. It's also worth noting that four justices in *Amgen* suggested they are ready to make this move on their own by overruling *Basic*, and Judge Rakoff has brought the difficulties of overlapping public-private enforcement to the public's attention recently (no-admit settlements).]