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Should the SEC Limit the Size of Whistleblower Rewards?

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For nearly one-and-one-half years, the U.S. Securities and Exchange Commission ("SEC" or "Commission") has been considering implementing new rules that will govern its whistleblower reward program. This program, created as part of the Dodd-Frank Act's historic Wall Street reform legislation, created a *qui tam* program and established rules that provide for monetary rewards for whistleblowers who report securities fraud or violations of the Foreign Corrupt Practices Act.

The final rules are expected to be approved by the Commission in early 2020. The most highly contested issue in the rulemaking is a proposal to permit the Commission to reduce the amount of awards paid to whistleblowers in large cases. Presently, the Commission does not have regulatory authority to reduce the amount of payments given to whistleblowers solely based on the size of a potential reward. The proposed rule would change this status quo.

The proposal is fairly straightforward. Under the Dodd-Frank Act, the SEC *must* grant whistleblowers an award between 10% and 30% of any sanction over $1 million resulting from the whistleblower's original information. Thus, if a company is sanctioned $100 million based on a whistleblower's information, the Commission must award a qualified whistleblower no less than $10 million (10%) and no greater than $30 million (30%). Currently, the Commission applies a number of factors, both positive and negative, to determine whether a whistleblower should obtain a 10% reward, a 30% award, or some percentage in between. However, none of the factors permit the Commission to take into consideration the ultimate size of an award a whistleblower will receive. The proposed rule would permit the Commission to consider the ultimate size of an award, regardless of the other factors previously used to increase or decrease an award.

This issue has sparked widespread debate. Over 100,000 comments from members of the public have been filed on the SEC's website opposing the proposed rule. Numerous whistleblowers (including the ENRON whistleblower Sherron Watkins and the Bernie Madoff whistleblower Harry Markopolos) filed personal comments in opposition. Investor advocates, whistleblower experts, and public interest groups such as the National Whistleblower Center, Taxpayers Against Fraud, and Public Citizen, also opposed limiting rewards in larger cases, as did Senator Charles Grassley, the Chairman of the Senate Whistleblower Caucus. *No publicly traded company submitted comments in support of this limitation.* The main support for the rule change was filed by the Center for Market Competitiveness of the U.S. Chamber of Commerce. However, the Chamber's comments were highly criticized.

The Chairman of the SEC, Jay Clayton, publicly weighed in on this debate. Chairman Clayton expressed his overall support for the whistleblower program, remarking that it "has proven to be an invaluable component" of the SEC's "enforcement efforts," and confirmed that he does "not support a cap" on awards. However, the Chairman also recognized that "Congress vested in the Commission the authority and responsibility" to use "good judgment" to determine award amounts within the range of 10-30%." The current debate concerns whether or not the Commission should include a new rule permitting the reduction of awards in large cases, and if so, what that criteria should be.

Background to the Dodd-Frank Act's Whistleblower Program and the Proposed Rule Limiting Rewards

Under the Dodd-Frank Act, SEC whistleblowers who provide the Commission with "original information" that results in a successful enforcement action of at least $1 million are entitled to a reward of between 10-30% based on the fines and penalties recovered by the government. In other words, if a qualified whistleblower's disclosure results in a successful enforcement action, the Commission must pay the whistleblower an award, but the Commission can set that award anywhere between 10% and 30% of the proceeds collected from the wrongdoer. Entitlement to a reward is judicially enforceable.

Although Congress made the reward payments mandatory, they also vested the Commission with the discretion to set an award between 10-30% of the proceeds collected by the government. Under the SEC's proposal, in large cases (i.e. any case in which a whistleblower's reward would exceed $30 million), the whistleblower would be paid at the 10% rate, the lowest rate permitted under law, unless a whistleblower can meet a standard of proof that would be inapplicable in most cases.

The primary justification set forth in the rulemaking for reducing rewards in large cases was to "help ensure that the Investor Protection Fund (IPF) that Congress has established to pay meritorious whistleblowers is used in a manner that effectively and appropriately leverages the IPF to further the Commission's law-enforcement objectives." Precisely how reducing rewards would achieve this goal was not clearly explained. This is in part due to Congress' explicit directive that the amount of money in the IPF was not permitted to be criteria for determining the amount of an award. In the Dodd-Frank Act, Congress anticipated that the Commission may attempt to reduce awards based on the amount of funds in the IPF (i.e. the pool of money collected from sanctions that was earmarked to pay rewards from), and prohibited any such cost-benefit approach: "In determining the amount of an award . . . the Commission . . . *shall not take into consideration the balance of the Fund.*" 15 U.S.C. § 78u-6 (c)(1)(B)(ii) (emphasis added).

In its commentary to the proposed rules, the Commission also reasoned that reducing the amount of an award could promote the whistleblower program and incentivize reporting. The Commission staff attempted to explain this contradictory approach as "adjust[ing] an award downward so that the dollar amount of the payout is more in line with the program's goals of rewarding whistleblowers and incentivizing future whistleblowers from a cost-benefit perspective." How "adjusting an award downward" could ever be consistent with the "program's goals of rewarding whistleblowers and incentivizing future whistleblowers" was not explained.

The Statutory Mandates on Calculating a Whistleblower Award

The text of the Dodd-Frank Act provides the best guidance as to how Congress intended the

Commission to utilize its authority to set an award in the 10-30% range. Congress wanted the Commission to use its authority to set award amounts to promote positive behaviors by employees who witnessed wrongdoing.

The statute itself provides the clearest proof of this intent. Congress explained the criteria it expected the Commission to utilize when setting award amounts:

In determining the amount of an award . . . the Commission—

1. **shall take into consideration**—
    1. the **significance of the information** provided by the whistleblower to the success of the covered judicial or administrative action;
    2. the **degree of assistance** provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;
    3. the programmatic interest of the Commission in **deterring violations** of the securities laws by making awards to whistleblowers who provide information that lead to the successful enforcement of such laws; and
    4. such additional relevant factors as the Commission may establish by rule or regulation; and
    5. shall **not take into consideration the balance of the Fund**.

15 U.S.C. § 78u-6(c)(1)(B) (emphasis added).

When setting an award, Congress wanted the Commission to focus on the behaviors exhibited by the whistleblower, including factors such as the "significance of the information" and the "degree of assistance" provided by the whistleblower. But Congress was not only focused on using the new law to incentivize whistleblower behavior, they were equally focused on the deterrent effect paying whistleblowers would have on wrongdoing in the marketplace. This intent is reflected both in the statutory language itself, and in the Dodd-Frank-Act Senate Report. In that report, Congress explained that it was also focused on using the law as a deterrent and "intend[ed] for this program to be used actively with **ample rewards** to promote the integrity of the financial markets."

Nowhere in the proposed rule does the Commission attempt to explain how reducing awards simply based on the size of the violation and the resulting award amounts would in any manner promote these goals. Moreover, the Commission provided *no discussion whatsoever* concerning the *deterrent* effect on wrongdoing in the marketplace by offering very large awards to whistleblowers. This is highly significant as a cost-benefit analysis that incorporates consideration of the deterrent impact of paying large rewards heavily weighs in favor of paying rewards at the highest appropriate level.

The Deterrent Effect of Paying Significant Rewards

Congress required the Commission to consider the deterrent effect of paying awards as one of the critical criteria when weighing the amount of a whistleblower reward. In Section 922 of the Dodd-Frank Act, subsection 21F(c)(1)(B)(i)(III), Congress understood that the reward program could be effectively used as a tool for "deterring violations of the securities laws." Congress recognized that "making awards to whistleblowers" would send a very loud message to the market. The larger the reward, the greater the deterrent effect. This is why the Senate Report on the Dodd-Frank Act explicitly supported "ample rewards" when discussing the overall impact on market integrity triggered by the new whistleblower program.

A large award serves two purposes: to incentivize reporting and to deter publicly traded companies from engaging in wrongdoing and/or self-reporting misconduct through enhanced compliance. Large awards incentivize whistleblowers by sending a clear message that the United States is serious about paying awards. Many employees are skeptical about ever receiving a payment. Adding to this skepticism is the popular culture surrounding whistleblowing, that contradicts any expectation that the government will treat whistleblowers fairly. Most news articles about whistleblowing concern retaliation and the destruction of a whistleblower's career. These concerns weigh heavily against an employee deciding to take the enormous risk that nearly all whistleblowers confront.

The payment of large rewards enables whistleblower attorneys and government agencies to counter these negative messages. The payment of a large reward is the best tool that whistleblower advocates have to convince skeptical potential informants that if they take the risk in blowing the whistle, agencies such as the IRS and SEC will be their friend and supporter. It also sends a loud message in the marketplace.

The proposed rule, which focuses on reducing the amount of an award, sends the opposite message. Correctly or incorrectly, it creates the impression that agencies like the SEC are intending to use their administrative powers to find technical reasons for lowering payments. It creates an appearance of bias against whistleblowers, especially in light of the fact that there are no caps on executive compensation or other profit-based motives that proliferate the culture within the financial services industry. The message is that whistleblowers, who suffer so much, are unworthy of large awards, while others on Wall Street, who commit crimes or whose actions are purely selfish or greed-driven, have no caps on their salaries, and are often paid massive salaries and bonuses. Significantly, SEC Chairman Clayton recognized that the current proposal could send the wrong message to whistleblowers, and indicated that the final rule may positively address this perception issue.

Second is the deterrent effect triggered by paying large awards. Large rewards can have a remarkable impact on protecting the public interest and forcing corporations to implement reforms.

In a 2014 article in the *Villanova Law Review*, University of California-Davis professor of law and Chairman of the IRS Advisory Council Dr. Dennis J. Ventry explained that whistleblower disclosures have a major deterrent effect on corporate crime. Professor Ventry outlined the deterrent effect of whistleblowing:

Whistleblowers can do more than just uncover and report knowing violations of the law. They can also prevent noncompliance from happening in the first place. An effective whistleblower program (run either through a state's FCA or as a standalone statute) would add significant risk to noncompliance by increasing the probability of detection and the likelihood of potential penalties, the two most important variables in traditional tax deterrence models. In turn, ***increased aversion to noncompliance—due to increased fear of detection*** *and palpable penalties as well as additional variables such as moral, ethical and reputational inputs—would result in increased revenue collection…*

To further document the powerful deterrent effect of whistleblowing, Professor Ventry surveyed the literature on crime deterrence and noted that objective, scholarly, and empirical studies had long documented the fact that the "degree of deterrence" of crimes can be "calculated as product of probability of detection." Or, as explained by the Nobel Prize winning economist Gary S. Becker, "for the individual to elect to engage in crime, the gain relative to its loss must exceed the odds of capture."

Professor Ventry, citing to specific and well-documented examples, explained the importance of paying large rewards to increase to public perception that whistleblowers increase the "odds of capture." His conclusion on this matter was clear: "[K]eep whistleblower *awards* sufficiently high," as "sufficiently high awards" can be used to "induce external reporting of otherwise meritorious claims and provide incentives for whistleblowers to incur the risks and costs associated" with blowing the whistle.

Numerous studies fully support Professor Ventry's conclusions. These include: Aaron Chalfin and Justin McCrary, *Criminal Deterrence: A Review of the Literature* (2014); **Niels Johannesen and Tim Stolper,** *The Deterrence Effect of Whistleblowing: Evidence from Offshore Banking* (2017); Jaron H. Wilde, *The Deterrent Effect of Employee Whistleblowing on Firms' Financial Misreporting and Tax Aggressiveness* (2017); Jetson Leder-Luis, *Whistleblowers, The False Claims Act, and the Behavior of Healthcare Providers* (2019); Philip Berger and Heemin Lee, *Do Corporate Whistleblower Laws Deter Accounting Fraud?* (2019).

The study conducted by Berger and Lee, professors at the University of Chicago Booth School of Business and the Zicklin School of Business at the City University of New York exemplifies the conclusions of all of the major studies conducted on the deterrent value of whistleblowers. They concluded that there was "a high direct deterrence value of whistleblower cases." Like Ventry, they also recognized the benefits of paying large rewards, finding that the "opportunity for a large payout creates incentives for a whistleblower to come forward with their private information about fraud or misconduct, which can alleviate personal and professional costs arising from whistleblowing on one's employer" and "creates a profit motive for rooting out impropriety."

These objective studies all demonstrate that the benefits of deterring corporate misconduct through paying large rewards far exceeds the costs to the government of such payments. Furthermore, the funds for the rewards are generated from the very cases the whistleblowers report and are not paid from taxpayer monies. Thus, the actual monetary costs of paying large rewards is miniscule in comparison to the deterrence value of such payments. These benefits far exceed the direct monetary benefits derived from the specific whistleblower-generated sanction. This deterrence value generates long-range and high-value benefits to investors, taxpayers, and the markets.

Legal Requirements for Increasing or Decreasing Whistleblower Rewards

Congress intended the Commission to leverage the size of its award to achieve two goals: (1) encourage positive reporting behaviors by potential whistleblowers; and (2) create a deterrent effect on wrongdoing in the market. The factors that Congress (and the Commission) intended to trigger a large reward at or close to the 30% level were:

- "Significance of the information provided by the whistleblower";
- The "assistance" the whistleblower "provided" to the Commission;
- The impact an award may have on the Commission's "interest in deterring violations of the

securities laws by making awards to whistleblowers";

- "The degree to which an award enhances the Commission's ability to enforce the Federal securities laws and protect investors"; and
- "The degree to which an award encourages the submission of high-quality information from whistleblowers by appropriately rewarding whistleblowers' submission."

Paying rewards at the highest levels achieves these purposes. Reducing awards, based on their size alone, completely contradicts these goals. Reduction in a whistleblower reward based on the overall size of a reward would have a highly detrimental outcome on the deterrent effect of the law, undermine the language in the statute, and negate clear Congressional intent.

On the other hand, Congress also understood that the Commission could utilize its ability to reduce the amount of an award to discourage negative conduct within the market. In 2011, when the Commission issued its first set of rules governing the whistleblower program, it identified factors to decrease an award. Among these factors are:

- "Culpability," i.e. "the whistleblower's role in the securities violations";
- "Whether the whistleblower financially benefitted from the violations";
- "Whether the whistleblower knowingly interfered with the Commission's investigation of the violations";
- "Whether the whistleblower unreasonably delayed reporting the securities violations";
- Whether the whistleblower "interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation"; or
- Whether the whistleblower "made any materially false, fictitious, or fraudulent statements."

These criteria are all valid reasons for reducing a whistleblower reward.

The Proper Role of Authorizing the Commission to Reduce Rewards

The Commission already possesses the authority to reduce awards. But these reductions must be consistent with the primary goals Congress set forth in the Dodd-Frank Act itself.

Rewards should be paid at the maximum levels if the underlying facts are consistent with the criteria set forth by Congress for increasing the size of a reward. The ability of the Commission to reduce rewards in such cases, based solely on the size of a sanction or a potential reward, should be strictly prohibited. Paying a 30% reward is a small price to pay for obtaining the benefits Congress set forth in the Dodd-Frank Act statue.

On the other hand, paying large rewards to persons who engage in the negative behaviors outlined by the SEC in its current rules does not similarly serve the public interest. The Commission clearly has the authority to take the amount of an overall reward into consideration when lowering the percentage of an award where whistleblowers engaged in the bad behaviors identified by the Commission, such as interfering in Commission investigations or providing false or misleading information to the SEC. In this manner, the Commission can use its authority to approve the amount of a reward to serve the public interest and discourage bad behavior.

Thus, should a rule be approved that permits the Commission to take the overall amount of a potential payment into consideration when adjusting the percentages permitted under law, the following three criteria must be applied:

1. No reduction in cases that could negatively impact the deterrent effect of paying a large reward;

2. No reduction in cases in which whistleblowers engage in the positive behaviors outlined by Congress (and approved by the Commission in the 2011 rulemaking) in order to encourage those behaviors in future whistleblowers, and reward those behaviors in the cases under consideration; and

3. Reductions based on the overall amount of a potential reward could be permitted in cases in which the whistleblower engaged in the negative behaviors for which the Commission legitimately wants to discourage in the market, as identified in its current regulations.

If the Commission were to amend its current rules to authorize reducing rewards in large cases, no reductions should be permitted in cases that would undermine the deterrent effect triggered by large rewards. Furthermore, no reduction should be authorized in cases in which a whistleblower engaged in the positive behaviors identified by Congress and identified under current SEC rules. The Commission must give clear instructions to its staff that no reductions should be approved if those reductions undermine the overarching goal of incentivizing whistleblowers to report securities fraud or deterring frauds on Wall Street. When paying a large reward would further incentivize the positive behaviors identified by Congress or have a clear deterrent effect on future fraud, the Commission's rules should affirm that rewards in such cases are paid at the highest levels.

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