Will the SEC's Proposed Whistleblower Rules Undermine the Deterrent Effect of the Dodd-Frank Act?

Article By:

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The U.S. Securities and Exchange Commission's ("SEC" or "Commission") will shortly approve proposed amendments to its Dodd-Frank Act whistleblower program.[1] The most controversial proposal concerned a perceived "soft cap" that would limit the amount of awards in most large cases. The public debate over this "soft cap" focused primarily on how changes to the amount of compensation paid to whistleblowers would impact on the willingness of employees to step forward and risk their jobs, careers and reputations.

But the proposed rule would have an impact beyond its motivational effect on potential whistleblowers. The Commission's proposal also failed to consider how any perceived "cap" on damages would impact the deterrent effect of the DFA's whistleblower law. Congress explicitly required that the Commission evaluate the deterrent effect on corporate wrongdoing triggered by rewarding whistleblowers. However, when initially published by the Commission, the SEC did not consider the impact of its proposal on deterrence. Ultimately, the most beneficial role played by whistleblowers is not only providing the evidence to hold a specific fraudster accountable, but ultimately the long-term deterrent effects on crime can save investors and the public far more the is recovered from specific prosecutions. Congress understood this deterrent effect triggered by whistleblower laws, and mandated that the Commission consider these effects when deciding whether to pay a whistleblower a 10% award, a 30% award, or something in between.

Background to the Proposed Rule on Limiting Awards in Large Cases

Under the Dodd-Frank Act the SEC must compensate qualified whistleblowers whose original information results in a successful enforcement action an award of between 10-30% of the sanctions collected from the wrongdoer. By law the Commission must pay whistleblowers no less than 10% and no more than 30%. The monies are not paid by the taxpayers, but instead come directly from the corporations found guilty of securities frauds. Congress provided the SEC with specific factors it must consider when deciding the percentage of sanctions recovered that a whistleblower should be paid. None of these mandatory factors took into consideration the amount of compensation that a whistleblower could obtain.

But Congress also gave the Commission the authority to set the percentage of awards, and also provided the Commission with the discretion to create additional factors for evaluating the size of an award that were not explicitly set forth by Congress. The Dodd-Frank Act spelled out this authority: The "*Commission may establish by rule or regulation* " "*additional relevant factor."* Based on this authority, the Commission proposed that it could take into consideration the final size of an award when making its compensation decisions. The Chairman of the Commission, Mr. Jay Clayton, made clear that the SEC could not set a hard-cap on awards or set any monetary limitations. However, the proposed rules require the Commission to take into consideration to amount of an award a whistleblower could obtain, and lower the percentage paid to whistleblowers in large cases.

Although the proposed rule did not (and could not) authorize a hard monetary cap on the amount of an award, the proposal, however, instruct the Commission to create a rebuttal presumption that an award should be limited to 10% of sanctions obtained in cases where the wrongdoer was forced to pay over $300 million in fines and penalties. The proposed rules targeted the largest fraud cases, i.e. cases in which a whistleblower's information was so significant that the sanctions obtained from a wrongdoer would be over $300 million. In these cases a percentage "cap" would be presumed, i.e. a whistleblower would in all but a handful of exceptional cases, obtain the minimum percentage award of 10% provided that the whistleblower's award was $30 million or more, *before* taxes, case costs, or attorney fees were paid.

Opponents of this percentage cap pointed out that reducing awards in larger cases will discourage potential whistleblowers who are highly placed (in extremely high paying jobs) from ever taking the risk of being a whistleblower. The role played by reward laws in incentivizing high quality reporting is well established. The numbers bear this out. Since 2012 the SEC obtained over $2.5 billion in sanctions based on whistleblower disclosures, and returned over $750 million to harmed investors.

Based on the tremendous success of whistleblower reward laws Senator Charles Grassley (R-Iowa), the most respected expert on whistleblowing in the U.S. Congress, strongly opposed any rule-change that would justify reducing the amount of awards because they were too large. Quoting from the findings of the SEC's Inspector General, Senator Grassley explained: "*high rewards* can motivate potential whistleblowers to come forward because the monetary amount may mitigate the cost of professional and social sanctions that can result."

Senator Grassley's opinion was shared by the overwhelming majority of experts who comments on the proposal, including nationally recognized whistleblowers Sherron Watkins, Harry Markopolos and Frederic Whitehurst, investor advocates like Better Markets, and whistleblower organizations like the National Whistleblower Center and Taxpayers Against Fraud. The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness was almost alone supporting the Commission's proposed percentage cap on larger awards, arguing that large awards could disincentive whistleblowers from reporting concerns to corporate internal compliance programs.

The public debate over the percentage-based "cap" primarily centered on how a perceived "cap" could disincentive whistleblowers from reporting frauds. The Chairman of the SEC acknowledged that this debate had caused confusion over the commitment of the SEC toward the program, explaining that "uncertainty regarding the award process for very large awards, could deter potential whistleblowers from coming forward."

The concern over disincentivizing whistleblowers were well documented and extremely persuasive, the Chairman of the SEC admitted as much. But there is another reason why the Commission should not or cannot limit unilaterally limit awards. Large awards deter criminal activity.

Weighing the Deterrent Effect When Setting Awards

Congress *required* the SEC to consider the deterrent effect of paying awards whenever it agency exercises its discretion in setting the percentage for an award. Despite this requirement, when it proposed the “soft cap” on awards Commission did not consider on how this proposed rule could impact the deterrent effect of the whistleblower law.

Should the Commission decide to amend the rules to grant itself the discretion to reduce rewards in large cases, any such change must be carefully crafted in order to take into consideration the deterrent effect of paying large rewards. But as explained below, reducing awards would undermine the well-documented deterrent effect triggered by paying rewards. In fact, any policy permitting the reduction of an award, based solely on the size of an award, would have a devastating impact on the deterrent effect.

By explicitly incorporating an analysis of the deterrent effect of paying large awards, the Commission has an opportunity to improve its current program and explicitly address how it can use its authority to set award percentages that prevent corporate fraud and positively change market behavior.

Statutory Requirement to Consider the Deterrent Effect of Paying Rewards

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 that promote positive behavior by employees and to create a deterrent effect in the markets. Congress explained the criteria it required 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 . . .*
2. *the degree of assistance . . .*
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 . . .*

When setting the amount of a whistleblower award, Congress *required* the Commission to focus both on incentivizing certain whistleblower behaviors (including disclosure of “significan[t] . . . information” and provision of “assistance” to the Commission), and on the potential deterrent effect paying awards would have on wrongdoing in the marketplace. Congress understood that the reward program could be effectively used as a tool for “deterring violations of the securities laws,” recognizing that “making awards to whistleblowers” would send a very loud message to the market far beyond simply rewarding a valuable informant for providing excellent information in a timely manner. The larger the reward, the greater the deterrent effect.

This Congressional intent is reflected not only in the statutory language itself, but also explicitly in the Dodd-Frank-Act Senate Report. In discussing its focus on using the new whistleblower program as a deterrent, Congress explained that it “intend[ed] for this program to be used actively with **ample rewards** to promote the integrity of the financial markets.” (emphasis added).

The Deterrent Effect of Paying Significant Rewards

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.

Dennis J. Ventry, *Not Just Whistling Dixie: The Case for Tax Whistleblowers in the States*, 59 Vill. L. Rev. 425 (Aug. 2015).

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 first 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 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: **Niels Johannesen and Tim Stolper,** *The Deterrence Effect of Whistleblowing: Evidence from Offshore Banking* (2017); Christine I. Wiedman and Chunmei Zhu, *Do the SEC Whistleblower Provisions of Dodd-Frank Deter Aggressive Financial Reporting?* (2017); Jaron H. Wilde, *The Deterrent Effect of Employee Whistleblowing on Firms' Financial Misreporting and Tax Aggressiveness* (2017); Philip Berger and Heemin Lee, *Do Corporate Whistleblower Laws Deter Accounting Fraud?* (2019); Jetson Leder-Luis, *Whistleblowers, The False Claims Act, and the Behavior of Healthcare Providers* (2019).

The Wiedman and Zhu article looked directly at the SEC's whistleblower program, and concluded that empirical evidence supported a finding that paying awards enhanced detection:

These findings provide evidence of significant benefits of the SEC WB Program and underscore the role that whistleblowers can play in the detection and deterrence of fraud. While companies argue that regulations are costly and onerous, this research reinforces the argument that these regulations help the SEC leverage limited resources and encourage companies to improve their financial reporting and strengthen internal controls.

A paper published by the Stockholm School of Economics surveyed academic studies supported by empirical evidence to fully confirm the deterrent effect of paying whistleblower rewards. *See* Theo Nyrero?d and Giancarlo Spagnolo, *SITE Working Paper, No. 44: Myths and Numbers on Whistleblower Rewards,* Stockholm Inst. of Transition Econ., Stockholm Sch. of Econ. (2018). Their findings are clear:

As for empirical evidence on deterrence, Johannesen and Stolper (2017) found that whistleblowing had deterrence effects in the off-shore banking sector.

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Wilde (2017) also provide evidence that whistleblowing deters financial misreporting and tax aggressiveness.

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Bigoni *et al*. (2012) conducted laboratory experiments on leniency policies and rewards as tools to fight cartel formation. They found that rewards financed by the fines imposed on the other cartel participants had a strong effect on average price (returning it to a competitive level). In the model setting, this implies that rewards have a deterring and desisting effect on cartel formation. The authors also take it that the results are significant for real world scenarios. They also found that cartel formation was significantly lower in a reward environment than in a leniency environment alone.

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, specifically concluding that there is “a high direct deterrence value of whistleblower cases.” Like Ventry, Berger and Lee 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.

Case Studies: The Deterrent Effect of Paying Significant Rewards

Objective academic studies have verified that paying whistleblower rewards has a major impact on the deterring economic crimes. For example, Jetson Leder-Luis careful study, *Whistleblowers, The False Claims Act, and the Behavior of Healthcare Providers* (2019), documented that the deterrent value of whistleblower cases is over six-times as great as the immediate enforcement value. Leder-Luis looked at four major health care enforcement actions filed under the *qui tam* provisions of the False Claims Act. The cases directly resulted in a total of $1.9 billion in government recoveries. However, the deterrent value of these cases over the next five years was calculated to be $18.9 billion. As reported:

These 4 whistleblower case studies recovered around $1.9 billion for the federal government, but exhibit even greater benefit in deterrence effects, totaling around $18.9 billion. The average deterrence effect for these cases is around 6.7 times the settlement value over 5 years.

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Overall, these results indicate that the direct deterrence benefits of whistleblowing cases often exceed the settlement values many times over, and greatly exceed the retrospective damages used to compute those settlement values. This indicates large savings to the Medicare program as a result of these whistleblowing cases, exceeding both the direct recoveries to the government from the settlement as well as the whistleblower compensation.

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In addition to the fiscal effects described in the previous section, whistleblowing under the FCA creates incentives for providers to change the way they conduct healthcare.

In another objective economic study Philip Berger and Heemin Lee, in their article "*Do Corporate Whistleblower Laws Deter Accounting Fraud?,*" (2019), reviewed data related to accounting frauds. They concluded that the "exposure" to "False Claims Act" liability "reduces the likelihood of accounting fraud by 5% to 9%." Based on this they concluded: "Collectively, our results are consistent with the notion that the enhanced whistleblower regulation with a bounty model effectively motivates managers to prevent and avoid fraud, and we provide reasonable causal quantification of this effect on the population of affected firms."

Professor Ventry looked directly at the impact paying large rewards in the IRS whistleblower program. He looked at the fall-out from Mr. Bradley Birkenfeld's disclosures documenting illegal offshore banking in the Swiss bank UBS. This review is significant as Mr. Birkenfeld's award was the largest public award paid, to date, to an individual whistleblower. Professor Ventry described the long-term "collateral impact" and "effect" of Birkenfeld's whistleblowing:

The "treasure trove of inside information" that Birkenfeld provided U.S. officials formed "the foundation for the UBS debacle and everything that followed." Indeed, thanks to one of "the biggest whistleblowers of all time," the U.S. government (take a deep breath) received: $780 million and the names of 250 high-dollar Americans with secret accounts as part of a deferred prosecution agreement (DPA) with UBS; another 4,450 names and accounts of U.S. citizens provided as part of a joint settlement between the U.S. and Swiss governments; more than 120 criminal indictments of U.S. taxpayers and tax advisors; additional indictments against foreign bankers, advisors, and lawyers; still more foreign nationals pleading guilty to conspiring to assist U.S. taxpayers to file false returns and evade U.S. taxes; the closure of prominent Swiss banks—including the oldest private bank—based on their participation in helping U.S. clients evade tax liability; more than $5.5 billion collected from the IRS Offshore Voluntary Disclosure Program (OVDP), with untold tens of billions of dollars still payable due to only a quarter of the 39,000 OVDP cases being closed; program participants ratting out banks as a requirement of their participation; banks themselves disclosing the names and accounts of clients who refuse to participate in the program to avoid their own monetary penalties and to defer or avoid criminal prosecution; and the IRS aggressively going after taxpayers who tried to "stay under the radar" by failing to participate in the program and then "quietly" filing amended returns on foreign bank accounts for prior years. All because one person blew the tax whistle.

As explained by Mr. Ventry, the deterrent effect of Mr. Birkenfeld's massive award achieved unprecedented reforms concerning illegal offshore banking, money laundering, and tax evasion.

The Internal Revenue Service ("IRS") was able to leverage that payment to achieve remarkable enforcement successes resulting in billions of dollars recovered and tens of thousands of illegal accounts closed. In 2009, capitalizing on the fear of detection triggered by Mr. Birkenfeld's disclosures, the IRS launched an "Offshore Voluntary Disclosure Program," allowing taxpayers with undisclosed offshore accounts to self-report their crimes, reduce their penalties, and possibly avoid criminal prosecution. As of 2018, more than 56,000 delinquent taxpayers had come forward and the IRS had collected $11.1 billion in back taxes, while numerous individuals were successfully prosecuted.

After Birkenfeld's award was announced, other Swiss bankers were motivated by Birkenfeld's historic whistleblower payment and started to blow the whistle on their banks. As of 2014, nearly every Swiss bank had executed a settlement or plead guilty to tax crimes, often on the basis of whistleblower disclosures. In addition to the $11.1 billion collected from individual tax cheats, the United States collected an additional $5.09 billion from numerous Swiss banks. Thus, triggered by one whistleblower, the largest fraud prosecutions in U.S. history were successfully completed, and the U.S. taxpayers have, as of 2018, recovered $16.19 billion.

The Swiss banking industry quickly realized the impact paying a whistleblower a $104 million award would have on other employees working in that industry. Days after the Birkenfeld award was announced, bankers and their consultants held a major industry meeting in Geneva, Switzerland. At this meeting, the attendees "seethed" at Birkenfeld and attacked his "total lack of morality" for blowing the whistle on them. According to a reporter from *Agence France-Presse* who attended the meeting, Birkenfeld had "driven the nail into the heart of the once seemingly invincible Swiss bank secrecy" system. A respected banking consultant reportedly declared that their U.S. client offshore banking program was "over." The *Agence France-Presse* article is reprinted at: *https://dailystar.com.lb/ArticlePrint.aspx?id=188088&mode=print.*

The day after the Birkenfeld award was announced, the publication *SwissInfo,* online at https://www.swissinfo.ch/eng/whistleblower-payoff_birkenfeld-reward-may-tempt-other-bankers/33500198, reported on the reaction to the award in the Swiss newspapers, and published the following summaries of multiple Swiss press stories:

> *The Blick tabloid newspaper said . . . it proves how ruthlessly US officials are pursuing tax evaders and how determined they are to dry up tax havens.*
>
> *Zurich's Tages-Anzeiger went further describing it as a "seductive offer for bankers." "This enormous reward show how the US are raising the stakes in their tax fight with Switzerland . . . in promising such high compensation the IRS are hoping that more incriminating material is handed over."*
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> *The French-speaking daily Le Temps agreed that Birkenfeld's huge reward could encourage other bank employees to follow his example.*

Large rewards highlight the risk of detection. As explained by Ben Johnson, in this study published by the *Minnesota House Research Department*, "When people believe they will be caught and punished, they are less likely to commit crimes." Mr. Johnson discussed the Nobel Prize-winning economist Gary Becker's economic theory that "an increase in the likelihood of apprehension" has a “great() impact” on reducing crime. *See* Minnesota House Research Department, https://www.house.leg.state.mn.us/hrd/pubs/deterrence.pdf.

The Commission Did Not Evaluate the Impact on the Deterrent Effect of Paying Whistleblower Reward in its Rulemaking Proposal

The primary justification for approving this new authority 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.” This justification was troublesome, due 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. 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 made under subsection (b), the Commission . . . *shall not take into consideration the balance of the Fund.*” 15 U.S.C. § 78u–6(c) (emphasis added).

In the commentary to the proposed rules the Commission staff also reasoned that reducing the amount of an award could promote the whistleblower program and incentivize reporting. The Commission staff explained this apparently contradictory approach as follows: “[A]djust[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 be consistent with the “programs goals of rewarding whistleblowers and incentivizing future whistleblowers” was not adequately explained.

Neither justification discussed, directly or indirectly, the impact reducing awards in the largest cases could have on the deterrent effect of the DFA’s reward program. Given Congress’ explicit requirement that the deterrent effect of paying awards be weighed every time the Commission makes a decision setting the percentage range for an award, the SEC should reject any rule that would permit the Commission to reduce an award if such a reduction would undermine the deterrent effect. From a cost-benefit analysis, the benefits of paying large rewards overwhelmingly outweigh any alleged costs associated with these payments. Moreover, because there are no major costs to the American people associated with an effective whistleblower reward program. The opposite is true. Awards are paid by the wrongdoer, not the taxpayer. Awards are paid only if the whistleblower’s information helps to detect the criminal activity, activity that would remain unknown to law enforcement but for the whistleblower.

An effective whistleblower program creates a win-win-win-win scenario. The government wins by being able to police illegality. The whistleblower wins because he or she can obtain compensation. The public wins because a criminal is prosecuted. The markets win because potential bad-actors are deterred from committing crimes, permitting fair competition and long-term savings to investors.

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[1] *See* Whistleblower Program Rules, 83 Fed. Reg. 34,702 (2018), Rel. No. 34-83557; File No. S7-16-18.

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