THE UNIVERSITY OF TOLEDO COLLEGE OF LAW

Written Statement of

Geoffrey Christopher Rapp
Professor of Law
University of Toledo College of Law

Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Regarding "Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions"

May 11, 2011

Good afternoon Mr. Chairman and distinguished members of the Subcommittee. Thank you for the opportunity to present to you my reactions to the proposed legislation modifying the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Whistleblowing is the single most effective method of detecting corporate and financial fraud. Employee disclosures are by far the most common source of fraud detection. One of the major impediments to the detection of fraud involves the cost of acquiring and gathering information indicating that a fraud has occurred. Insiders have the best access to such information and can discover fraud at a much lower cost when compared to outsiders including market actors and regulators. In addition to having access to the information relating to a fraudulent scheme, whistleblowers are often highly trained and sophisticated professionals with the technical expertise to understand the complex financial transactions at the core of many instances of securities and financial fraud.

In recognition of the important role that whistleblowers can play in the financial fraud setting, the Sarbanes-Oxley Act of 2002 for the first time created a uniform federal protection for financial fraud whistleblowers. Prior to the enactment of the Sarbanes-Oxley whistleblower protections, employees who blew the whistle were covered by a patchwork of state statutes and common law remedies, and true protection was sporadic if present at all. The central idea of the anti-retaliation provision in Sarbanes-Oxley was to motivate employees to blow the whistle by protecting them from retaliation in the workplace.

Unfortunately, the Sarbanes-Oxley provisions had a number of holes. The statute was procedurally complex, provided only limited damages in civil actions by whistleblowers, provided no right to a jury trial, and limited opportunities for terminated employees to participate in the early stages of an investigation. Enforcement of the Sarbanes-Oxley provisions fell to the Occupational Safety and Health Administration, which had some experience in administering other federal whistleblower provisions. Unfortunately, as the General Accounting Office concluded in a 2010 report, OSHA investigators often lacked the training to "understand complex securities and navigate complex legal issues in order to conduct an investigation"[1] of a Sarbanes-Oxley claim.

As a result, Sarbanes-Oxley provided the illusion of protection for financial fraud whistleblowers without providing a truly meaningful and robust method for ensuring such protection. Empirical research on whistleblowing since the passage of Sarbanes-Oxley has lent some confirmation to view that the statute was ineffective in motivating whistleblowers to bring fraud to light. Since the passage of Sarbanes-Oxley, the percentage of whistleblowers who were employees *fell* from 18% to 13%[2]; had the

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[1] GENERAL ACCOUNTING OFFICE, WHISTLEBLOWER PROTECTION: SUSTAINED MANAGEMENT ATTENTION NEEDED TO ADDRESS LONG-STANDING PROGRAM WEAKNESSES, GAO 10-722 (August 2010), at 24.

[2] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2250 (2010).

statute provided truly robust protection, one would have expected an increase in the level of employee whistleblowing.

Most fundamentally, Sarbanes-Oxley failed to offer any sort of financial incentive for whistleblowers who bring fraud to light. Sarbanes-Oxley "screamed out"[3] for a whistleblower bounty scheme. If the aim of a policy is to encourage whistleblowing, bounty programs work. In industries subject to the federal False Claims Act, for instance, employee tips are responsible for 41% of fraud detection, as opposed to just 14% in other industries.[4]

The reason bounties work is that a whistleblower faces tremendous disincentives, which bounties can help offset. Most whistleblowers will be subject to some form of retaliation on the job. Various studies indicate that between 82%[5] and 90% [6]of whistleblowers are fired, quit under duress, or are demoted.. More than 60% of whistleblowers report having been blacklisted by other firms in their industry.[7] In addition to these economic costs, a whistleblower is likely to face severe social ostracism and experience personal hardship as she struggles to bring fraud to light. By adding the possibility of a bounty reform, policymakers can offset these potential costs and encourage individuals with information about fraud to blow the whistle rather than remain silent. Bounties are particularly effective because "successful" whistleblowing involves not just an initial decision to expose fraud, but persistence as that fraud is investigated.

Section 922 of the Dodd-Frank Act answered the glaring need for a bounty provision for financial fraud whistleblowers. In short, under Dodd-Frank, whistleblowers who voluntarily provide original information on securities fraud violations would be entitled to 10-30% of the sanctions obtained by the Securities and Exchange Commission in a successful enforcement action. Since the passage of the Act, the SEC has been hard at work in developing rules to govern its administration of the new bounty program. A proposed draft of those rules was released in November 2010. Since then, the SEC has received hundreds of comments – more than a thousand, in fact, if petitions are included – on its proposed rules. The final draft of those rules is expected to be released some time this summer.

The legislation under discussion in today's hearing would modify the Dodd-Frank approach, making what I view as three significant changes. First, the proposed

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[3] Jarod Spencer Gonzalez, *A Pot of Gold at the End of the Rainbow: An Economic Incentives-Based Approach to OSHA Whistleblowing*, 14 EMP. RIGHTS & EMP. POL'Y J. 325, 346 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1538336.
[4] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2215 (2010).
[5] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2216 (2010).
[6] Kim R. Sawyer et al., *The Necessary Illegitimacy of the Whistleblower*, 29 BUS. & PROF. ETHICS J. 85 (2010), at *4, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=917316.
[7] Kim R. Sawyer et al., *The Necessary Illegitimacy of the Whistleblower*, 29 BUS. & PROF. ETHICS J. 85 (2010), at *2, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=917316.

legislation would require that employee whistleblowers raise their concerns internally before going to the SEC. Whistleblowers failing to do so would be denied a bounty, unless they demonstrate that their employer lacks an internal reporting process or a policy prohibiting retaliation, or demonstrates that the fraud involved high-level managers or bad faith. On a related note, the proposed legislation would task the SEC to notify corporations of any investigation launched as a result of a whistleblower tip and give those firms an opportunity to take remedial action. Second, the proposed legislation would eliminate the mandatory nature of bounties present in the Dodd-Frank provision. Third, the proposed legislation would prohibit contingency fees for attorneys representing whistleblowers in connection with Dodd-Frank bounty claims.

The question of whether whistleblowers should be required to report internally is one that the SEC considered in detail in connection with its proposed rules. SEC staff members are the federal government's resident experts in financial regulation and corporate governance, and those experts came to the conclusion, in the Commission's proposed rules, that an internal reporting requirement was unnecessary. The main argument that has been advanced in favor of such a requirement is that Dodd-Frank would damage existing internal reporting structures adopted by corporations after the passage of Sarbanes-Oxley.

In response to this argument, the SEC made several observations. First, it noted that not all employers have robust and well documented internal reporting procedures. Moreover, the SEC expressed its view that even without imposing a requirement of internal reporting, internal reporting structures are unlikely to be bypassed. The SEC noted that in most cases, upon receiving a whistleblower tip, its staff would contact a corporation and describe the allegations, giving the firm the chance to investigate the matter itself. The SEC did not expect the Dodd-Frank structure, without an internal reporting requirement, to "minimize the importance of effective company processes for addressing allegations of wrongful conduct."[8]

In addition, even without a hard requirement of internal reporting, many whistleblowers will likely do so anyway. Most whistleblowers see themselves as loyal employees, and they often blow the whistle out of a desire to help their firms. Even without a formal requirement of internal reporting, most employees will likely use internal processes anyhow.

The proposed requirement for internal reporting would complicated both the process and the expected benefit of whistleblowing for a potential tipster. A potential whistleblower would have to make a judgment call about whether the high-level management and bad-faith exceptions applied before contacting the SEC, or else risk losing her eligibility for a bounty. This added uncertainty would dull the incentives Dodd-Frank seeks to use to "put more cops on the beat."

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[8] SECURITIES EXCHANGE COMMISSION, PROPOSED RULES FOR IMPLEMENTING THE WHISTLEBLOWER PROVISIONS OF SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934, Nov. 3, 2010, at 35.

In addition, the requirement of internal reporting might delay effective intervention in cases of serious fraud. Since a potential whistleblower won't know for sure whether the exceptions would apply, she is likely to choose to report internally. A group of motivated fraudsters, however, might choose to retaliate and cover up fraud rather than take genuine remedial efforts. By comparison, a whistleblower who complains directly to the SEC will likely trigger the kind of contact the SEC described in its proposals rules, where a member of the Commission's enforcement staff contacts the firm. Such a call is far more likely to deter a cover-up. By imposing a hard requirement of internal reporting, the proposed legislation may delay a regulatory response to serious fraud. Since the financial markets today operate at an incredible velocity, any delay in bringing fraud to light can magnify the seriousness of fraud and the potential loss to the investing public.

In addition, the proposed internal reporting requirement would address only a portion of potential whistleblowers. In many instances, a whistleblower may contact the SEC not about fraud at her employer, but instead about fraud at a subsidiary corporation, a related entity, a client or a even a competitor. The proposed legislation complicates matters by forcing a whistleblower to decide who exactly is responsible for the fraud – their own employer, or someone else – before deciding whether internal reporting is required.

A second aspect of the proposed legislation would eliminate the "mandatory" nature of Dodd-Frank bounties, giving the SEC the authority to award either *no* bounty even in cases where a tip led to a successful enforcement action meeting the $1 million threshold, or a bounty below 10% of the sanction collected. Again, this proposal would likely dull the incentives Dodd-Frank was meant to foster. The original draft of the Administration's Investor Protection Act of 2009, which included whistleblower bounties, as well as the early Congressional drafts of bills that became Dodd-Frank, would have made the payment of bounties purely discretionary as suggested in the proposed legislation today. By my reading of the legislative history of Dodd-Frank, the decision to make such bounties mandatory was made in connection with a committee print submitted by Senator Dodd on March 15, 2010. That suggests the mandatory nature of bounties in Dodd-Frank reflected a deliberate decision.

The primary concern that would arise if bounties were purely discretionary is whether the SEC would in fact award bounties on a regular basis. The SEC was given a purely discretionary authority to pay bounties by the Insider Trading and Securities Fraud Act of 1988. Between 1988 and 2010, when the Dodd-Frank Act subsumed the insider trading whistleblower bounty program, the Commission reportedly paid just $160,000 to only five whistleblowers.[9] The SEC appeared at the time to have little interest in whistleblowers and there was no evidence that the anemic program had any effect in deterring insider trading. Similarly, when the payment of bounties in the tax fraud setting by the Internal Revenue Service was purely discretionary, prior to the Tax Relief and Health Care Act of 2006, the IRS had a rather dismal record of rewarding whistleblowers.

[9] Michael Mann et al. *Enforcement Initiatives*, 1867 PLI/CORP 479, at 487 (Feb. 16, 2011).

The reformed IRS program served as a model for the Dodd-Frank provision and made bounties mandatory at a certain level of disputed tax liability.

There is also some empirical evidence gathered in experimental settings suggesting that *small* bounty awards can be ineffective or even counterproductive. Where only small rewards are available, potential whistleblowers may be *less* likely to reveal fraud than where no bounties are available at all.[10] It may be that where a small bounty is available, that amount of money isn't enough to compensate a potential whistleblower for the perceived downsides of bringing fraud to light; at the same time, it may also lead a potential whistleblower to assume that someone else will blow the whistle in search of such an award. Eliminating the Dodd-Frank minimum 10% bounty floor for covered actions might actually lead to less whistleblowing, as tipsters become complacent and assume someone else will step forward.

In addition, the Dodd-Frank Act already involves a fair amount of discretion. The SEC can deny bounties to whistleblowers whose information is not "original", who do not provide such information "voluntarily," or who fall into one of the categories excluded from claiming a bounty. Moreover, all the SEC has to do to avoid paying a bounty under Dodd-Frank is settle an enforcement action for $999,999, below the $1 million in sanctions threshold imposed by the Act. Making bounties discretionary in all cases, as the proposed legislation would do, simply increases the likelihood that the Commission will direct its energies to other priorities rather than respond to and reward whistleblower tips.

A third aspect of the proposed legislation would prohibit contingency fee arrangements for attorneys representing whistleblowers seeking SEC bounties. This proposal would virtually guarantee that no whistleblowers were represented by talented attorneys in connection with the application for a bounty. No such prohibition on contingency fee arrangements exists in other federal bounty programs, such as the False Claims Act. Contingency fees are a regular part of False Claims Act practice and there are no indications of widespread abuse. The process for claiming a bounty will involve detailed submissions to the SEC, and having a talented lawyer is essential for a whistleblower in making such submissions. The SEC is also likely to prefer working with counsel to individual whistleblowers, since attorneys can help process the information in a whistleblower's possession in a readable and usable manner. This increases the likelihood that fraud will be quickly stopped and deterred. Moreover, under Dodd-Frank the decision not to pay an award may be appealed to the appropriate U.S. Court of Appeals. Very few attorneys would take on such time-consuming representation absent the possibility of a contingency fee. The whistleblowers in these cases simply can't afford to pay attorneys by the hour. They have usually been terminated or suspended. One story has circulated of a Sarbanes-Oxley whistleblower who, even though eventually successful in a retaliation claim, accumulated $100,000 in attorneys

[10] *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties and Protections for Reporting Illegality*, 87 TEX. L. REV. 1151, 1201 (2010).

fees and was forced to sell his family farm.[11] That kind of story could become the norm if contingency fees were prohibited.

In conclusion, let me add that I think the proposed changes in Dodd-Frank's whistleblower provisions would have a negative symbolic effect. In the 2005 Deficit Reduction Act, Congress created a strong financial incentive for states to adopt their own False Claims Acts with whistleblower bounty provisions. Where such laws were enacted, states would be entitled to a larger share of recovery in successful Medicaid fraud cases. As a result, a number of states have either adopted such laws or are currently considering doing so. In my own state, Ohio, Republican Attorney General Mike DeWine proposed in March an Ohio whistleblower bounty rewards statute, which is now under consideration in Columbus. Congress should continue to support strong whistleblower protection and reward programs, and the proposed legislation may result in mixed signals.

[11] Beverly H. Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change*, 44 AM. BUS. L. J. 1, 25 (2007).

United States House of Representatives
Committee on Financial Services

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