


2012

## 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 Provision

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### Recommended Citation

Justin Blount and 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 Provision*, 17 Fordham J. Corp. & Fin. L. 1023 (2012).  
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# 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 Provision

## Cover Page Footnote

Justin Blount is an Adjunct Lecturer at Baylor Law School and an in-house corporate attorney practicing in Waco, Texas. B.B.A. in Finance, Southwestern Oklahoma State University; J.D., Baylor Law School; M.B.A., University of Texas at Austin. The opinions stated herein are his own. Spencer Markel is a corporate and securities associate in DLA Piper's Silicon Valley Office. B.A. in Political Science, Brigham Young University; J.D., Baylor Law School; LL.M., Securities and Financial Regulation, Georgetown University Law Center. Special thanks to my wife Janette for her support and perseverance. The opinions stated herein are his own.



# FORDHAM

JOURNAL OF  
CORPORATE & FINANCIAL LAW

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AS WE KNOW IT, OR AN ENHANCEMENT OF THE  
EFFECTIVENESS OF SECURITIES LAW ENFORCEMENT?  
BOUNTY HUNTING UNDER THE DODD-FRANK ACT'S  
WHISTLEBLOWER PROVISION

*Justin Blount*  
*Spencer Markel*

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WORLD AS WE KNOW IT, OR AN  
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WHISTLEBLOWER PROVISIONS**

*Justin Blount\* & Spencer Markel\*\**

**ABSTRACT**

In the wake of Bernard Madoff's \$65 billion Ponzi scheme and the recent economic crisis stemming largely from loosely regulated subprime lending and mortgage-backed securities, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, signaling loudly and clearly that change is coming to Wall Street. But Wall Street is not the only one receiving a message. Buried deep within the 2,319 pages of the Dodd-Frank Act, companies can find Section 922, the whistleblower provision, which provides a bounty for whistleblowers who report securities violations to the Securities and Exchange Commission.

These bounty provisions and the subsequent rules implementing them have been criticized by many as ineffective and unnecessarily intrusive on established internal compliance programs. In light of these criticisms, this Article analyzes the Dodd-Frank bounty program and its likely effect on corporate internal compliance programs, relying largely upon literature and studies in the areas of behavioral economics, organizational behavior and business ethics relating to whistleblowing. The authors argue that rather than undermining internal compliance programs, the Dodd-Frank bounty program will serve as a much-needed check on poorly administered

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internal compliance programs that are not adequately policing fraud  
and unethical behavior.

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## INTRODUCTION

In the wake of Bernard Madoff's \$65 billion Ponzi scheme and the recent economic crisis stemming largely from loosely regulated subprime lending and mortgage-backed securities, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") on July 21, 2010, signaling loudly and clearly that change is coming to Wall Street.<sup>1</sup> But Wall Street is not the only one receiving a message. Buried deep within the 2,319 pages of the Dodd-Frank Act, companies can find Section 922, the whistleblower provision.<sup>2</sup> This provision rewards individuals who assist the Securities and Exchange Commission ("SEC") in uncovering *any* securities violations.<sup>3</sup> Section 922 requires the SEC to pay whistleblowers a cash bounty ranging from ten to thirty percent of any "monetary sanctions,"<sup>4</sup> including settlements, in excess of \$1 million that the government recovers through civil or criminal proceedings as a result of the whistleblower's assistance.<sup>5</sup>

Given the enormous size of recent settlements and fines for violations of securities laws, the potential payouts under these whistleblower provisions can be quite lucrative. One such area of securities law that has recently seen some staggering settlements and fines is the Foreign Corrupt Practices Act ("FCPA"), an act that prohibits bribes to foreign government officials.<sup>6</sup> In 2010, for example,

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1. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (to be codified at 15 U.S.C. § 78o-11); Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 21, 2010, at B3, available at <http://www.nytimes.com/2010/07/22/business/22regulate.html>.

2. Dodd-Frank Act § 922(b).

3. *Id.*

4. *Id.* § 922(a)(4). The term "monetary sanctions" is defined as any of the following that are derived from any judicial or administrative action: (1) any monies, (penalties, disgorgement, and interest) ordered to be paid; and (2) any monies deposited into a disgorgement fund or another fund pursuant to Section 308(b) of the Sarbanes-Oxley Act of 2002 as a result of such action or any settlement of such action.

5. *Id.* § 922(b)(1).

6. Titan Corp., Quarterly Report (Form 10-Q), 16 n.8, (Nov. 1, 2004), available at <http://www.secinfo.com/dVut2.11Z1e.htm> (In 2004 Titan Corporation was penalized \$28.5 million); SEC v. Goldman, Sachs & Co., SEC Litigation Release No. 21592, 2010 SEC LEXIS 2288 (July 15, 2010), available at <http://www.sec.gov/litigation/litr21592.htm>; SEC Charges KBR and Halliburton for FCPA Violations, SEC Press Release No. 2009-23 (Feb. 11, 2009), available at <http://www.sec.gov/news/>

FCPA enforcement activity rose to such a high level that fear of FCPA liability became ubiquitous in the business community due to record levels of enforcement actions, industry-wide investigations, prosecutions of individuals and international anti-corruption cooperation.<sup>7</sup> The dynamic duo, the SEC and Department of Justice (“DOJ”), dwarfed the level of enforcement activity from any prior year in the FCPA’s thirty-three year history.<sup>8</sup> Additionally, because of criticism from a perceived lack of enforcement in the period preceding the recent financial crisis, the SEC has become more aggressive in pursuing enforcement actions for traditional securities law violations as well.<sup>9</sup> Against this background, Dodd-Frank’s guaranteed financial incentives coupled with its fortified anti-retaliation provisions will likely turn the heat up for both multinational and domestic companies. This potential for a large

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press/2009/2009-23.htm (stating that a record settlement was reached in 2008 involving Kellogg, Brown & Root, Inc. and its parent company Halliburton Co. in which both companies agreed to pay a \$402 million fine to the DOJ as well as \$177 million in disgorgement of profits to the SEC based on allegations of bribery of Nigerian officials over a ten-year period); *SEC Charges Baker Hughes with Foreign Bribery and with Violating 2001 Commission Cease-and-Desist Order*, SEC Press Release No. 2007-77 (Apr. 26, 2007), available at <http://www.sec.gov/news/press/2007/2007-77.htm> (\$44 million settlement with Baker Hughes, Inc. in 2007); *Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay \$450 Million in Combined Criminal Fines*, DEP’T OF JUSTICE (Dec. 15, 2008), <http://www.usdoj.gov/opa/pr/2008/December/08-crm-1105.html> (In 2008, the DOJ, the SEC, and German authorities settled an enforcement action against the German electronics and engineering tycoon Siemens AG, along with its subsidiaries located in Argentina, Bangladesh, and Venezuela. The criminal fines, penalties, and disgorged profits totaled more than \$1.6 billion and now constitute the largest settlement in the history of the FCPA. The DOJ also assessed a criminal penalty of \$448.5 million on Siemens AG and \$500,000 on the implicated subsidiaries. Additionally, the SEC required Siemens AG to disgorge more than \$350 million in profits to settle a related civil complaint.).

7. GIBSON, DUNN & CRUTCHER LLP, 2010 YEAR-END FCPA UPDATE 1–3 (2011), available at <http://www.gibsondunn.com/publications/Documents/2010YearEndFCPAUpdate.pdf>; see also Bethany Hengsbach, *Proposed Whistleblower Provision Could Dramatically Increase FCPA Risk*, GOVCON (May 12, 2010), <http://www.governmentcontractsblog.com/2010/05/articles/fcpa/proposed-whistleblower-provision-could-dramatically-increase-fcpa-risk/> (stating that in just the first few months of 2010 alone, the government collected \$1.2 billion in FCPA sanctions).

8. GIBSON, DUNN, & CRUTCHER LLP, *supra* note 7, at 1.

9. See Edward Wyatt, *S.E.C. Pursuing More Cases Tied to Financial Crisis*, N.Y. TIMES, July 20, 2010, at B2, available at <http://www.nytimes.com/2010/07/21/business/21sec.html>.

financial reward has created in the minds of many compliance professionals a fear of widespread and opportunistic whistleblowing.

These whistleblower provisions and the subsequent rules implementing them<sup>10</sup> have been criticized by many as ineffective and unnecessarily intrusive on established internal compliance programs. Some believe that these existing internal compliance programs can be quite successful in deterring fraud and should not be undermined.<sup>11</sup> In light of these criticisms, this Article analyzes the Dodd-Frank bounty program and its likely effect on corporate internal compliance programs and internal employee reporting. This Article will particularly rely upon literature and studies in the areas of behavioral economics, organizational behavior and business ethics. Part I briefly outlines relevant bounty programs and whistleblower laws to illustrate how the Dodd-Frank whistleblower provisions are properly engineered to churn out tips. Part II reviews the specific structure of these whistleblower provisions and eligibility requirements for obtaining a reward. Part III discusses the criticisms of these provisions, and specifically how the provisions conflict with internal compliance programs. Part III will also answer these criticisms and make specific recommendations on how to structure and implement internal compliance programs in order to maximize internal reporting in light of these whistleblower provisions. Finally, Part IV offers concluding remarks.

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10. Implementation of the Whistleblower Provisions of Section 21F, Exchange Act Release No. 34-64545, 2011 SEC LEXIS 1816 (May 25, 2011) [hereinafter Implementation of the Whistleblower Provisions].

11. See, e.g., Dave Ebersole, *Blowing the Whistle on the Dodd-Frank Whistleblower Provisions*, 6 ENTREPRENEURIAL BUS. L.J. 123, 132 (2011); see also *U.S. Chamber Warns New SEC Whistleblower Rule Will Undermine Corporate Compliance Programs*, PRESS RELEASES, U.S. CHAMBER OF COMM. (May 25, 2011), <http://www.uschamber.com/press/releases/2011/may/us-chamber-warns-new-sec-whistleblower-rule-will-undermine-corporate-compliance> (“In approving this new whistleblower rule, the SEC has chosen to put trial lawyer profits ahead of effective compliance and corporate governance. This rule 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.”) [hereinafter U.S. CHAMBER OF COMM.].



## I. THE BOUNTY MODEL

Understanding how the structure of the Dodd-Frank bounty program can significantly increase tips and enforcement actions begins with understanding the program's design and its roots. For more than 140 years, federal agencies have benefited from bounty programs in some form or fashion.<sup>12</sup> Under a bounty scheme, a private informant may receive a percentage of any penalties the government recovers from legal action taken based on the proffered information. Under such schemes, the government is essentially partnering up with private citizens in enforcing a particular law.

In spite of the alleged economic efficiencies of bounty programs, some believe they create perverse incentives and should be repealed on ethical and policy grounds.<sup>13</sup> The reasoning is simple—the financial incentives of reporting are oftentimes fueled by greed or revenge. This situation may result in snitching against fellow associates, employers, relatives and even family members.<sup>14</sup> Senator Reid of Nevada best captured this philosophy during a 1998 congressional debate when he labeled the Internal Revenue Service (“IRS”) whistleblower program a “[r]eward for rats.”<sup>15</sup>

As noted by Professors Ferziger and Currell, despite the potential moral hazards of bounty schemes, they survive for one reason—they work.<sup>16</sup> The bounty model is a win-win system. These programs allow the government to recover billions of dollars annually that it could not have recovered otherwise without the information provided by informants, and in return, the government agencies pay out millions in bounties.<sup>17</sup> But not all federal bounty programs are the same, and not all programs have achieved the same results. A comparative analysis of several bounty and plain-vanilla whistleblower programs demonstrates

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12. See, e.g., Act of Mar. 2, 1867, ch. 169, § 7, 14 Stat. 471, 473 (codified as amended at I.R.C. § 7623 (2006)).

13. See, e.g., 144 CONG. REC. S4397 (1998) (statement of Sen. Reid).

14. See, e.g., Kara Scannell, *Ex-Wife Gets \$1 Million in Payment over Pequot Case*, WALL ST. J. (July 24, 2010), <http://online.wsj.com/article/SB1000142405274870.3294904575385551259982316.html>.

15. 144 CONG. REC. S4397 (1998) (statement of Sen. Reid).

16. See 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, 1143.

17. See *id.*

why the Dodd-Frank whistleblower provision will most likely do what it was created to do—generate tips.

A. SHOW ME THE MONEY:  
THE FALSE CLAIMS ACT

The False Claims Act (“FCA”) authorizes private citizens to bring *qui tam* actions<sup>18</sup> on behalf of the federal government against any person who defrauds the federal government.<sup>19</sup> Under the FCA, the government has the right to intervene in a *qui tam* suit.<sup>20</sup> If the government intervenes, it is primarily responsible for conducting the litigation, but the *qui tam* plaintiff remains a party to the suit.<sup>21</sup> The most important feature of the FCA is that it entitles the *qui tam* plaintiff to at least fifteen percent and up to thirty percent of any amounts recovered, depending on how much the plaintiff contributed to the litigation and whether the government intervened.<sup>22</sup>

The FCA’s *mandatory* reward of at least fifteen percent and a maximum recovery of up to double that amount plays an integral part in the stockpiles of cash handed out to informants each year.<sup>23</sup> In 2009 alone, the United States government obtained \$2.4 billion from FCA cases, the second-highest recovery amount in history.<sup>24</sup> Of that \$2.4 billion, about \$2 billion was recovered in lawsuits filed under the FCA’s bounty program.<sup>25</sup> The whistleblowers received a hefty \$255 million in

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18. *Qui tam* is the Latin abbreviation for the Latin phrase “*qui tam pro domino rege quam pro se ipso*,” which means “he who pursues this action on our Lord the King’s behalf as well as his own.” 1 JOHN T. BOESE, CIVIL FALSE CLAIMS AND QUI TAM ACTIONS 1–7 (3d ed. 2007). *Qui tam* actions have their origins in the courts of Ancient Rome. *Qui tam* actions flourished under the common law and statutes of England during the Middle Ages and were transported to the American colonies and later into American law. See Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 96 n.19 (2007).

19. See 31 U.S.C. §§ 3729-33 (2006); see also *id.* § 3730(b)(1) (authorizing *qui tam* actions).

20. *Id.* § 3730(b)(4).

21. *Id.* § 3730(c).

22. *Id.* § 3730(d).

23. Dep’t of Justice, Office of Public Affairs, *Justice Department Recovers \$2.4 Billion in False Claims Cases in 2009; More than \$24 Billion Since 1986*, U.S. DEP’T OF JUSTICE (Nov. 19, 2009), <http://www.justice.gov/opa/pr/2009/November/09-civ-1253.html>.

24. See *id.*

25. See *id.*

awards.<sup>26</sup> These unparalleled numbers demonstrate that whistleblowers will not shy away from huge financial incentives to tattle.

B. A FLURRY OF TIPS: THE IRS'S 2006  
AMENDMENT TO THE WHISTLEBLOWER PROGRAM

In 2006, Congress amended the IRS whistleblower program to strengthen the IRS's ability to pay rewards to tax whistleblowers.<sup>27</sup> Now, like the FCA-model, the IRS whistleblower provisions require the IRS to pay between fifteen and thirty percent<sup>28</sup> of collected proceeds in disputes where the information substantially contributes to a decision to take administrative or judicial action. In order to qualify for a bounty, if the action is brought against an individual taxpayer, their gross income for any taxable year subject to the action must exceed \$200 thousand annually.<sup>29</sup> Additionally, the total amount collected in the action must exceed \$2 million.<sup>30</sup>

Comparing the tips accrued in 2007 with those accrued in 2008 shows that the new amendment is fulfilling its intended purpose. In 2007, the IRS received eighty-three claims alleging a total underreported income of \$8 billion.<sup>31</sup> In 2008, the IRS received 1,890 claims alleging a total underreported income of \$65 billion.<sup>32</sup> Because it takes years under the IRS bounty program to issue the bounty, it is difficult to assess how the massive influx of tips will affect actual enforcement.<sup>33</sup> Despite this uncertainty, supporters of the IRS bounty program point to the billions of dollars in tax revenue the IRS stands to gain under the program.<sup>34</sup>

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26. *See id.*

27. *See generally* Tax Relief & Health Care Act of 2006, Pub. L. No. 109-432, § 406(d), 120 Stat. 2922, 2958 (codified at I.R.C. § 7623 (2006)).

28. I.R.C. § 7623 (b)(1).

29. *Id.* § 7623(b)(5)(A).

30. *Id.* § 7623(b)(5)(B).

31. TREASURY INSPECTOR GEN. FOR TAX ADMIN., DEP'T OF THE TREASURY, DEFICIENCIES EXIST IN THE CONTROL AND TIMELY RESOLUTION OF WHISTLEBLOWER CLAIMS 6 (2009), available at <http://www.treasury.gov/tigta/auditreports/2009reports/200930114fr.pdf>.

32. *See id.*

33. David Kocieniewski, *Whistle-Blowers Become Investment Option for Hedge Funds*, N.Y. TIMES, May 19, 2010, at B1, available at [http://www.nytimes.com/2010/05/20/business/20whistleblower.html?pagewanted=1&\\_r=1](http://www.nytimes.com/2010/05/20/business/20whistleblower.html?pagewanted=1&_r=1).

34. *See* Erika A. Kelton, *To Catch a Tax Cheat*, N.Y. TIMES (Aug. 7, 2008), <http://www.nytimes.com/2008/08/07/opinion/07iht-edkelton.4.15087010.html>.

C. MISSING THE MARK:  
THE INSIDER TRADING ACT

Exploring a bounty program that lacks a mandatory payout provision sheds light on how much a guarantee of financial reward can influence a whistleblower's decision. The Insider Trading and Securities Fraud Enforcement Act of 1988 ("Insider Trading Act") authorizes the SEC to pay a bounty of *up to* ten percent of penalties imposed in insider trading cases.<sup>35</sup> Despite the program's lifespan of over twenty years, the SEC has only paid a meager \$159,537 to a total of five claimants.<sup>36</sup> In explaining these poor statistics, the Inspector General noted that the bounty program "is not fundamentally well-designed to be successful."<sup>37</sup>

There are several arguable explanations for the failure of the Insider Trading Act's bounty program. First, with regard to the potential bounty payout, the Insider Trading Act's ten percent *cap* falls considerably below the fifteen to thirty percent reward available under the FCA and the IRS plans.<sup>38</sup> This decreased financial incentive eliminates or at the very least discourages a large class of motivated whistleblowers.<sup>39</sup> Second, the SEC's ability to limit its rewards to penalties imposed under the Insider Trading Act further underscores this reward gap. In comparison, the FCA permits a *qui tam* litigant to recover a share of any settlements rather than just penalties imposed.<sup>40</sup> Finally, the rewards

35. See generally Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4677 (1988) (codified as amended at 15 U.S.C. § 78u-1).

36. See H. DAVID KOTZ, INSPECTOR GENERAL, U.S. SEC. & EXCH. COMM'N, ASSESSMENT OF THE SEC'S BOUNTY PROGRAM 5 (2010), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf>.

37. *Id.*

38. See discussion *supra* Part I.A-B.

39. Compare 15 U.S.C. § 78u-1(e) (2002), amended by Pub. L. No. 111-203, § 923(b)(2)(b) (2010) ("[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts . . . to the person or persons who provide information leading to the imposition of such penalty."), with I.R.C. § 7623(b)(1) (2006) ("If the Secretary proceeds with any administrative or judicial action . . . based on information brought to the Secretary's attention by an individual, such individual shall . . . receive as an award at least 15 percent but not more than 30 percent of the collected proceeds . . .").

40. Compare 15 U.S.C. § 78u-1(e) (amended 2010) ("[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the

under the Insider Trading Act are entirely discretionary with the SEC and not subject to judicial review.<sup>41</sup> In other words, even in the event of a successful prosecution, SEC informants may not receive any portion of the recovery.<sup>42</sup> The correlation between the absence of a mandatory payout provision and a very low number of reported tips is not likely a coincidence.

#### D. SOX'S OLD PROCEDURAL BACKLOG AND WEAK PROTECTIONS

The devastating shake in investor confidence from the Enron, Tyco and WorldCom scandals inspired the passage of the original Sarbanes-Oxley Act ("SOX").<sup>43</sup> There are two specific provisions from SOX that received the most publicity, Section 302 and Section 404. Section 302 requires senior management to certify the accuracy of reported financial statements, and Section 404 mandates that management and auditors maintain and assess adequate internal controls for financial reporting.<sup>44</sup> However, SOX also contained whistleblower provisions which did not encompass a bounty reward, but rather sought to encourage whistleblowing based solely on an employee's anti-retaliation cause of action.<sup>45</sup>

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Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty."), with 31 U.S.C. § 3730(d) ("If the Government proceeds with an action brought by a person under subsection (b), such person shall . . . receive at least 15 percent but not more than 25 percent of the proceeds of the action or settlement of the claim . . .").

41. See 15 U.S.C. § 78u-1(e) (amended 2010) (noting that the Commission's determination as to an appropriate reward "shall be final and not subject to judicial review").

42. See *id.*

43. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of titles 11, 15, 18, 28 and 29 of the U.S.C) [hereinafter SOX]. Dodd-Frank contains provisions that amend the old SOX whistleblower provisions. See generally Dodd-Frank Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1840 (2010); see also JAY P. LECHNER, GREENBERG TAURIG LLP, DODD-FRANK AMENDS SARBANES-OXLEY AND CREATES NEW WHISTLEBLOWER PROTECTIONS 1-2 (2010), available at [http://www.gtlaw.com/portalresource/lookup/wosid/contentpilot-core-40116922/pdfCopy.name=/GTAlert\\_DoddFrank%20Whistleblower%20Provisions\\_July2010.pdf?view=attachment](http://www.gtlaw.com/portalresource/lookup/wosid/contentpilot-core-40116922/pdfCopy.name=/GTAlert_DoddFrank%20Whistleblower%20Provisions_July2010.pdf?view=attachment).

44. SOX §§ 302, 404.

45. *Id.* § 806.

Under SOX, a covered company cannot “discharge, demote, suspend, threaten, harass, or in any other manner discriminate” against a whistleblower who reports covered information to a federal regulatory or law enforcement agency, a member or committee of Congress, or the employee’s supervisor or such other person within the organization who “has the authority to investigate, discover, or terminate misconduct.”<sup>46</sup> If a whistleblower suffers retaliation for making a report, Section 806(a) gives that employee a retaliation cause of action.<sup>47</sup> However, before the employee can litigate this claim in court, the employee must first file a complaint with the Department of Labor (“DOL”), who then refers it to the Occupational Safety and Health Administration (“OSHA”) for investigation<sup>48</sup>. Following the investigation, an administrative law judge from the DOL hears the evidence from the investigation and renders a decision.<sup>49</sup> The employer may immediately stop any action upon a showing by clear and convincing evidence that the employer would have taken the action in the absence of the whistleblowing.<sup>50</sup>

SOX is telling of a potential whistleblower’s reliance on, and the importance of, job security.<sup>51</sup> SOX did little to encourage risk-averse information holders to blow the whistle on corporate fraud because of the lack of effective whistleblower protection and sufficient incentive to report. First, SOX’s whistleblower provisions contained no financial incentive for a potential informant. Second, the bureaucratic process of bringing a retaliation claim often drew cases out over years, severely setting back claimants in the meantime.<sup>52</sup> Third, the particularly short ninety-day statute of limitations on retaliation claims undercut the effectiveness of these provisions, as most potential claimants did not realize the scope of their rights and how to pursue them in such a short period.<sup>53</sup> Finally, SOX’s remedies only allowed for “equitable

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46. *See id.*

47. *See id.* § 806(a).

48. *See* Terry Morehead Dworkin, *SOX and Whistleblowing*, 105 MICH. L. REV. 1757, 1761 (2007).

49. *See id.*

50. *See id.*

51. *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1196–97 (2010) (noting that in their study on whistleblower incentives, protection from retaliation can be a significant incentive, particularly for female whistleblowers).

52. *See e.g.*, *Welch v. Cardinal Bankshares Corp.*, 454 F. Supp. 2d 552, 553 (W.D. Va. 2006).

53. *See* Dworkin, *supra* note 48, at 1763.

compensatory damages”<sup>54</sup> but neither punitive nor mental anguish damages. Overall, these statutory drafting flaws played a substantial role in the shamefully low number of cases found in favor of SOX claimants.<sup>55</sup>

## II. THE DODD-FRANK BOUNTY PROGRAM

### A. A NEW AND IMPROVED STATUTORY FRAMEWORK

The Dodd-Frank bounty program incorporates many of the same elements of prior successful bounty programs while resolving most of the shortcomings found in other less successful bounty and whistleblower programs. Congress modeled the Dodd-Frank Act closely after the largely successful IRS whistleblower bounty program.<sup>56</sup> Similar to the mandatory payout provisions under the FCA and IRS bounty programs,<sup>57</sup> Section 922 provides a mandatory award for whistleblowers. The SEC *must* pay whistleblowers a minimum of ten percent and up to thirty percent of an award from a successful prosecution of more than \$1 million assessed by the SEC and recovered in other “related actions.”<sup>58</sup>

In addition to borrowing mandatory payout provisions, Section 922 also resolves the stifling issues that once plagued the 2002 SOX whistleblower provisions in the form of fortified job security for

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54. Listed damages include reinstatement with the same seniority, back pay with interest, and compensation for any special damages resulting from the discrimination including litigation costs, expert witness fees and reasonable attorney fees. See 18 U.S.C. § 1514A(c)(2) (2010).

55. See Beverley Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection under Sarbanes Oxley: A Proposal for Change*, 44 AM. BUS. L.J. 1, 20–38 (2007). Professors Earle and Madek report that through May 2006, of the 677 completed Sarbanes Oxley complaints, 499 were dismissed and ninety-five were withdrawn. Of the cases that went to an administrative law judge, only six (two percent) of the 286 resulted in a decision for the employee.

56. See COMM. BANKING, HOUS., & URBAN AFFAIRS, THE RESTORING AMERICAN FINANCIAL SECURITY ACT OF 2010, S. REP. NO. 111-176, at 12 (2010).

57. See discussion *supra* Part I.A-B.

58. Dodd-Frank Act, Pub. L. No. 111-203, § 922(b)(1), 124 Stat. 1376, 1841 (2010). “Related Actions” are judicial or administrative actions brought by the DOJ, a self-regulatory organization (“SRO”), a state attorney general or another “appropriate regulatory authority” that are based on original information provided by a whistleblower that leads to the successful enforcement of an SEC action.

whistleblowers.<sup>59</sup> Section 922 creates a new private right of action for employees who have suffered retaliation because of *any* lawful act done by the whistleblower in providing information to the SEC.<sup>60</sup> Whistleblowers may now bring an action in federal court<sup>61</sup> as opposed to an administrative court.<sup>62</sup> This change overcomes the procedural headaches and lengthy waiting periods that once discouraged employees from reporting under the old SOX whistleblower provisions.<sup>63</sup> Furthermore, Section 922 affords employees with the right to a jury trial<sup>64</sup> rather than just a bench trial or a trial in front of an administrative law judge—limits found under the old SOX provisions.<sup>65</sup> Section 922 also further incentivizes employees to take a chance and blow the whistle by giving sharper teeth to the remedies section of the program. Now, courts can require corporations who retaliate against whistleblowers to reinstate the employee and pay double-back pay with interest, litigation costs, expert witness fees and reasonable attorney’s fees.<sup>66</sup>

A qualifying whistleblower receives a minimum bounty of ten percent of any monetary sanction of \$1 million or higher, ensuring that a whistleblower entitled to recovery will receive a substantial award.<sup>67</sup> However, Section 922 places wide discretion in the hands of the SEC to award up to three times that amount, considering, among other factors: (1) the significance of the information provided by the whistleblower; (2) the degree of assistance provided by the whistleblower; and (3) the programmatic interest of the Commission in deterring violations of the relevant securities laws.<sup>68</sup> Additionally, whistleblowers have the right to

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59. See discussion *supra* Part I.D.

60. Dodd-Frank Act § 922(h)(1)(A) (“(i) in providing information to the Commission in accordance with the whistleblower incentive section; (ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or (iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 . . .” the Securities Exchange Act of 1934 . . . and “any other law, rule, or regulation subject to the jurisdiction of the [SEC].”)

61. See *id.* § 922(h).

62. See discussion *supra* Part I.D.

63. See *e.g.*, *Welch v. Cardinal Bankshares Corp.*, 454 F. Supp. 2d 552, 553 (W.D. Va. 2006).

64. Dodd-Frank Act § 922(j).

65. See discussion *supra* Part I.D.

66. Dodd-Frank Act § 922(h)(1)(C).

67. *Id.* § 922(b)(1)(A).

68. *Id.* § 922(c)(1)(B).



be represented by counsel.<sup>69</sup> Unlike the Insider Trading Act's whistleblower provisions,<sup>70</sup> bounty determinations are subject to review in an appropriate federal court of appeals—although the amount of an award, as long as it falls between ten and thirty percent, is not appealable.<sup>71</sup>

The design of the Dodd-Frank bounty program borrows the successful aspects of its predecessors while rectifying the significant flaws that rendered other programs ineffective. The combination of fortified job security and potentially huge cash bounties, reminiscent of other similar programs, will undoubtedly catch the eye of thousands of potential bounty hunters. All in all, based upon these incentives, the program seems destined to pump out a sizable increase in tips.<sup>72</sup> Indeed, the few months following Dodd-Frank's passage indicate that the program has already begun having its tip-generating effect.<sup>73</sup>

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69. *See id.* § 922(d)(1).

70. *See* discussion *supra* Part I.C.

71. *See* Dodd-Frank Act § 922(f).

72. *But see* Feldman & Lobel, *supra* note 51, at 1194-95, 1207. In the study conducted by these authors on whistleblowing incentives, their survey results indicated a high reward may actually produce a “crowding out effect” that reduces whistleblowing when the conduct being reported is particularly morally outrageous. *See id.* at 1194. However, their study does show that both protection and a high reward can serve as an incentive to blow the whistle, and point out that a “holier-than-thou effect” is displayed in the survey results. *See id.* at 1207 (“The study, moreover, demonstrates that informed policy makers must factor in the possibility that informants may underestimate the role of financial incentives in their own decision to report. Whereas people perceive others as reporting mainly for money, they tend to perceive their own social enforcement actions as more ethically driven.”).

73. *See* Joe Palazzolo, *After Dodd-Frank SEC Getting At Least One FCPA Tip A Day*, WALL ST. J. CORRUPTION CURRENTS BLOG (Sept. 30, 2010, 11:21 AM), <http://blogs.wsj.com/corruption-currents/2010/09/30/after-dodd-frank-sec-getting-at-least-one-fcpa-tip-a-day/> (“The Securities and Exchange Commission has been receiving at least one tip a day about potential foreign bribery violations since a whistleblower bounty program became law in July. . . . The figure is likely to be sobering for international companies that have witnessed an eightfold increase in enforcement of the Foreign Corrupt Practices Act since 2004, and as multi-million dollar settlements in such cases have become the norm. . . . Experts also predict the law will nudge more companies to self-disclose potential FCPA violations out of fear that a whistleblower will do it first, putting the company on bad terms with Justice and the SEC.”).

## B. THE DODD-FRANK BOUNTY PROCESS

Bounty hunters seeking their pot of gold need not worry too much about tricky qualifications under Dodd-Frank, as the SEC has promulgated detailed rules setting forth the process for submitting information.<sup>74</sup> An in-depth discussion of the details of all of the qualification procedures of the Dodd-Frank bounty program is beyond the scope of this Article, particularly with respect to issues relating to attorney/client privileged communications and attorneys acting as whistleblowers. However, a general overview of the requirements follows.

Generally, to qualify for a Dodd-Frank bounty, the whistleblower must provide the SEC with “original information.”<sup>75</sup> This means that the information must be: (1) derived from the independent knowledge or independent analysis of a whistleblower; (2) unknown to the Commission from any other source; and (3) not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media.<sup>76</sup> “Independent knowledge” must be derived from a non-publicly available source.<sup>77</sup> However, a claimant may still perform an “independent analysis” on publicly available information and still provide “original information,” assuming the analysis “reveals information that is not generally known to the public.”<sup>78</sup> The definition of “original information” contains exceptions for information derived from attorney/client privileged communications: (1) officers, directors, trustees, or partners of an entity who learn of the violation through another person or through internal compliance processes; (2) employees or other persons associated with a public accounting firm where the information is obtained through an engagement as an independent public accountant under the securities laws; and (3) information obtained through a violation of criminal law.<sup>79</sup>

The SEC has promulgated specific forms and procedures for whistleblowers to use in submitting information.<sup>80</sup> The first is Form TCR (for “tip, complaint, or referral”), which sets forth the original

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74. Implementation of the Whistleblower Provisions, *supra* note 10, at 158-63.

75. Dodd-Frank Act § 922(a)(3).

76. *Id.*; 17 C.F.R. § 240.21F-4(b) (2012).

77. 17 C.F.R. § 240.21F-4(b)(2).

78. *Id.* § 240.21F-4(b)(3).

79. *Id.* § 240.21F-4(b)(4).

80. *Id.* §§ 240.21F-9 to .21F-10, 249.1800–.1801.

information that the whistleblower is submitting.<sup>81</sup> The form must be signed, and the whistleblower must declare, under penalty of perjury, that the information is true and correct to the best of the whistleblower's knowledge and belief.<sup>82</sup> The form may be completed anonymously, but if so submitted, it must be through counsel, and prior to submission the whistleblower must sign the form under penalty of perjury and provide it to counsel.<sup>83</sup>

If an SEC action results in a monetary sanction that may potentially provide an award for a whistleblower, the SEC will publish a "Notice of Covered Action" to allow whistleblowers with a prospective claim to seek recovery of their award.<sup>84</sup> To submit a claim, the whistleblower must use Form WB-APP.<sup>85</sup> While Form TCR may be submitted anonymously, in order to claim an award on Form WB-APP, the whistleblower must disclose their identity and verify it in a form acceptable to the SEC prior to payment.<sup>86</sup>

Section 922 does not contain any difficult obstacles that bounty hunters must overcome to qualify for a reward. In fact, the broad and encompassing qualifications allow for just about anyone with original knowledge, except a limited number of excluded parties,<sup>87</sup> to come forward and hit the jackpot. This apparent breadth has given rise to concerns and criticisms that these whistleblower provisions may result in harmful and opportunistic whistleblowing behavior that ultimately causes more harm than good.

### III. BYPASSING INTERNAL COMPLIANCE: CRITICISMS AND RESPONSE

The whistleblower provisions of the Dodd-Frank Act have been criticized for numerous reasons.<sup>88</sup> However, this Article focuses on one critique that is commonly asserted—that Dodd-Frank incentivizes bypassing costly internal compliance programs and reporting securities

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81. *Id.* § 240.21F-9(a)–(b).

82. *Id.*

83. *Id.* § 240.21F-9(c).

84. *Id.* § 240.21F-10(a).

85. *Id.* § 240.21F-10(b).

86. *Id.* § 240.21F-10(c).

87. *Id.* § 240.12F-8(c).

88. *See, e.g.*, Ebersole, *supra* note 11, at 135-45.

law violations behind the company's back, and instead directly to the SEC to seek an award.<sup>89</sup>

A. A RACE AGAINST TIME: EXTERNAL WHISTLEBLOWING  
COMPETING AGAINST CORPORATE COMPLIANCE CONTROLS

Many have argued that the Dodd-Frank whistleblower provisions may incentivize employees who uncover securities law violations to report them directly to the SEC, thereby bypassing and undermining internal compliance reporting mechanisms. This situation would in turn threaten compliance efforts by dangling the prospect of a multimillion-dollar bounty in front of potential whistleblowers.<sup>90</sup> This incentive structure could culminate in a “race” to the doorstep of the SEC before the information is no longer “original.”<sup>91</sup> This race includes several fierce competitors—other potential whistleblowers who may be privy to the same information and of course, the company suspected of the wrongdoing. Attorneys and compliance professionals have concerns that this race may result in several undesired consequences.

*1. Forcing Companies to Self-Report*

First, the race may alter the dynamics of determining when and if a company should self-disclose potential FCPA violations to the government.<sup>92</sup> Rather than investigating and remediating issues in-house before deciding whether they warrant a voluntary disclosure, companies may feel forced to self-report when doing so would not normally be necessary. They might feel the need to disclose even the smallest infractions or rush to self-report issues that they do not yet understand, in the hopes of stemming a larger, more invasive government investigation or receiving cooperation credit.<sup>93</sup> Rather than “driving home the message of compliance,” the race will encourage some

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89. See, e.g., U.S. CHAMBER OF COMM., *supra* note 11.

90. Obiamaka P. Madubuko & Rick Firestone, *New SEC Whistleblower Program and Added Disclosure Rules in Dodd-Frank Act: Will These New Regulations Help or Hinder FCPA Compliance Efforts?* BLOOMBERG L.R. (2010), [http://www.mwe.com/in-fo/pubs/firestone\\_madubuko\\_dodd-frank.pdf](http://www.mwe.com/in-fo/pubs/firestone_madubuko_dodd-frank.pdf).

91. See *id.* at 4.

92. See Madubuko & Firestone, *supra* note 90, at 4.

93. See *id.*

employees “to work secretly against their companies to first report corruption without giving the company a chance to address the issue.”<sup>94</sup>

This race to report also runs contrary to the goal outlined in the federal sentencing guidelines. Dating back several decades, the federal government has encouraged corporations to implement and maintain their own internal compliance programs and to voluntarily disclose suspected misconduct in exchange for mitigating potentially harsher penalties for white-collar crime.<sup>95</sup> The current federal sentencing guidelines provide robust incentives for corporations to implement internal compliance programs and report suspected violations to appropriate government regulators.<sup>96</sup> In fact, corporate defendants can receive credit for having an “effective compliance and ethics program,” as well as for self-reporting suspected misconduct while fully cooperating with regulatory authorities.<sup>97</sup>

The race incentivizes corporations to rush hastily to involve federal authorities before other potential whistleblowers beat them to the punch. Pressing on corporations is the potential loss of credits that may result from a whistleblower getting to the doorstep first. Accordingly, the race undermines the goal of the federal sentencing guidelines by encouraging self-reporting prior to a thorough internal investigation. Internal compliance programs thrive best when they are actually used and not overlooked.

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94. *Id.*

95. See MICHAEL DIAZ JR. ET AL., DIAZ RUES, ATTORNEYS & COUNSELORS, *Whistle-Blowers, Dodd-Frank and the FCPA: The Perfect ‘Anti-Competitive’ Storm for U.S. Businesses*, 6 (Jan. 25, 2011), <http://documents.jdsupra.com/7062c02d-ac97-49a4-a7b7-b8ed185e82d2.pdf>; see also Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 3–4 (1997) (“In recent years, federal and state laws have sought to promote good corporate citizenship by encouraging business entities to establish internal compliance programs designed to avoid—or at least detect—illicit conduct. The most significant impetus toward effective internal corporate policing occurred in 1991, when the United States Sentencing Guidelines . . . made the existence of an ‘effective’ internal compliance program the *sine qua non* for receiving leniency upon conviction. As a result, corporations nationwide have sought to establish compliance programs that qualify for preferred treatment under federal law.”).

96. See DIAZ ET AL., *supra* note 95, at 6; see also U.S. Sentencing Guidelines, 18 U.S.C. App’x § 8C2.5(f) (2010).

97. See DIAZ ET AL., *supra* note 95, at 6.

### 2. Discouraging Cooperation with Regulatory Authorities

Second, some argue that this race to report may *disincentivize* whistleblowers from helping their companies cooperate with the regulatory authorities. Under Dodd-Frank, the bounty is structured as a percentage of a corporation's total monetary sanction.<sup>98</sup> Accordingly, facilitating the company's cooperation with government investigators can actually lead to a decrease in the sanctions imposed, thereby diminishing the whistleblower's award in the process.<sup>99</sup> A whistleblower, therefore, would benefit from a corporation who does not receive credits for cooperation with regulatory agencies.

### 3. Increased Costs from Flimsy and Frivolous Tips

Third, the race to report may encourage employees to rush to the SEC with unreliable and frivolous claims. Frivolous claims drain government and corporate investigative resources and the desire to receive an award could also give rise to a "lottery mentality" that transforms a company's own employees into bounty hunters.<sup>100</sup> Given the potential to collect record-setting rewards from a settlement or action, bounty hunters may play the odds by eagerly seeking out any opportunity to report potential misconduct in hopes of striking gold.

This "just in case" mindset may lead employees who may not understand the elements of a particular securities law violation to report information to the SEC on a matter that is not actually a violation of the law. For example, many argue that the FCPA, which falls within the SEC's enforcement authority, lacks sufficient clarity and contains many ambiguities.<sup>100</sup> Additionally, there is little case law interpreting the FCPA given that most cases end in settlement.<sup>101</sup> Thus, incentivizing

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98. Dodd-Frank Act § 922(a)(4), (b), 124 Stat. 1376, 1841 (2010).

99. See DIAZ ET AL., *supra* note 95, at 7.

100. Mike Koehler, *The Financial Reform Bill's Whistleblower Provisions and the FCPA*, FCPAPROFESSOR.BLOGSPOT.COM (July 20, 2010, 12:02 AM), <http://fcpaprofessor.blogspot.com/2010/07/financial-reform-bills-whistleblower.html>.

101. See *id.* ("Against the backdrop of little substantive FCPA case law, the FCPA is enforced based largely on government enforcement agency interpretations that have never been accepted by a court. For every FCPA enforcement action alleging conduct that all reasonable minds would agree violates the FCPA, there is seemingly three FCPA enforcement actions alleging conduct that many reasonable minds question whether the conduct even violates the FCPA. Yet, these latter FCPA enforcement actions, notwithstanding the dubious and untested legal theories they are based on, are routinely settled by companies via a resolution vehicle that does not require the

employees to blow the whistle in a complex area of law could result in a rash of flimsy and frivolous tips.

Further, the Dodd-Frank anti-retaliation protection may only solidify the probability that meritless tips will reach new heights.<sup>102</sup> Whistleblower protection applies to whistleblowers regardless of whether they provide a tip that does not end in an enforcement action.<sup>103</sup> Therefore, 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.<sup>104</sup> Companies will likely feel discouraged about pursuing questionable claims due to what is at stake with a jury trial in federal court—especially considering the formidable remedies<sup>105</sup> available to employees.

Based upon these fears, some believe a new era has begun:

[Where] internal corporate investigations of FCPA violations will never be the same, with a bevy of eager, lurking whistle-blowers attempting to sponge information from the investigation and then recasting, packaging and selling it as “original information” to hungry government prosecutors and investigators in order to cash in their chips at the Justice Department’s dealer table.<sup>106</sup>

B. ANSWERING THE CRITICISMS: THE THREAT OF EXTERNAL  
WHISTLEBLOWING IS A NECESSARY COMPANION TO EFFECTIVE  
INTERNAL COMPLIANCE PROGRAMS

The whistleblower provisions of Dodd-Frank are not perfect, and will almost certainly give rise to some problematic and opportunistic behavior from potential whistleblowers. No incentive system is free

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company to admit or deny the SEC’s allegations. Quite simply, a settled SEC FCPA enforcement action does not necessarily represent the triumph of the SEC’s legal position over the company’s, but rather reflects a risk-based decision primarily grounded in issues other than facts and the law. It is simply easier and more cost-efficient for a company to settle an SEC FCPA enforcement (notwithstanding whatever dubious and untested legal theory it is based on) than to participate in long, protracted litigation with its principal government regulator.”).

102. See DIAZ ET AL., *supra* note 95, at 4.

103. See Dodd-Frank Act § 922(h), 124 Stat. 1376, 1845 (2010); 17 C.F.R. § 240.21F-2(b) (2011).

104. See DIAZ ET AL., *supra* note 95, at 8.

105. See discussion *supra* Part II.

106. DIAZ ET AL., *supra* note 95, at 8.

from the potential for exploitation. However, a review of the academic literature on internal compliance programs and whistleblowing provides evidence that the concerns of bypassing effective internal compliance programs and the dire consequences prophesied are likely overblown. Additionally, it is still not at all clear whether internal compliance programs are effective in detecting or deterring fraud, particularly large-scale financial fraud involving upper-level management. Thus, the threat of external whistleblowing is a potentially effective method to monitor internal compliance programs that are not enforced. By providing financial incentives for external whistleblowing in certain cases, the Dodd-Frank bounty program provides a much-needed check for the type of corporate fraud that is least likely to be reported internally, and provides balance to the focus on self-regulation.

*1. Externally Mandated or Incentivized Compliance Programs:  
Effective Self-Regulation or Ineffective Window Dressing?*

The rise of internal compliance programs in the United States as a widely accepted means of corporate regulation began at least as early as the mid-1980s,<sup>107</sup> and perhaps as early as the 1960s.<sup>108</sup> Internal compliance programs received formal approval with the adoption of the Organizational Sentencing Guidelines in 1991 (“OSGs”),<sup>109</sup> which though modified, are still in use today.<sup>110</sup> Through the potential for sentencing leniency, these guidelines provide incentives to corporations with effective internal compliance and ethics programs.<sup>111</sup> The centerpiece of these internal compliance programs is typically the development, and hopefully implementation, of a formal code of ethics.

Given that internal compliance programs have experienced broad acceptance and adoption in the corporate community for quite some

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107. See Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 497 (2003) (noting that fifty-five defense contractors agreed to adopt ethics codes and internal ethics officers in a bid to fend off federal regulators in a defense contracting scandal).

108. See Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1579-82 (1990) (stating the initial catalyst for corporate internal compliance structures as the price fixing scandals in the 1960’s involving companies, including General Electric, in the heavy electrical equipment industry).

109. Krawiec, *supra* note 107, at 497.

110. See *supra* note 91 & discussion Part III.A.

111. See *id.*



time, it would be reasonable to assume that there is significant evidence of their efficacy in deterring illegal or unethical behavior. Unfortunately, this is not the case.<sup>112</sup> Although these programs have been widely adopted for years, there is very little empirical evidence to substantiate the assumption that they are effective in deterring fraud or illegal conduct.<sup>113</sup>

In 2003, Professor Krawiec noted the existence of studies supporting the effectiveness of internal compliance programs, but also pointed out their methodological problems. Professor Krawiec demonstrated that they relied upon either self-reporting in surveys or hypothetical questions in lab settings, as opposed to studying actual employee conduct in real-world settings.<sup>114</sup> Additionally, she noted that the findings in these studies were contradicted by a large number of other studies, which found no significant relationship between internal ethics codes implemented in these programs and employee conduct.<sup>115</sup> Little has changed in the intervening years, and in conducting research for this Article, the authors found that studies conducted to date still do not clearly indicate that internal compliance programs are an effective deterrent to fraudulent or illegal conduct.<sup>116</sup>

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112. See Krawiec, *supra* note 107, at 512–13 (“There has been very little research, however, that seeks to determine whether these structures deter illegal conduct. Instead, most research on internal compliance structures has focused on the percentage of companies using various structures, analysis of the substantive content of ethics and conduct codes, employee surveys of their perceptions of their company’s conduct codes, and self-reporting of conduct code violations.”).

113. *Id.* at 510–15.

114. *Id.* at 511–15.

115. *Id.* However, she does note that many of these studies also suffer from some of the same methodological problems as those finding that compliance programs are effective.

116. See Yuval Feldman & Orly Lobel, *Decentralized Enforcement in Organizations: An Experimental Approach*, 2 REG. GOVERNANCE 165, 168 (2008) (“There is a dearth of empirical studies that integrate both the institutional and behavioral aspects of social enforcement. While there have been significant recent developments in the legal protections offered to whistle-blowers, the mechanisms and incentive structures under which individual enforcement operates have remained largely indecipherable.”); see also David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1790 (2007) (“A recent review of studies on codes of ethics shows that approximately half of the studies found that codes were effective in reducing unethical behavior, and half did not find a significant relationship. Thus, these studies do not establish clear support for whether or not codes of ethics directly reduce unethical behavior.”).

In a 2007 study, Professors Kaptein & Schwartz reviewed 79 empirical studies on the effectiveness of codes of ethics, and found mixed results: 35% found that they were effective; 16% found only a weak relationship in deterring unethical behavior; 33% found that there was no significant relationship; and 14% found mixed results.<sup>117</sup> More recently, Professor Kaptein conducted a study on whether the existence of a code of ethics reduced unethical conduct, and on the effectiveness of various aspects of codes of ethics.<sup>118</sup> The five dimensions studied were: (1) the existence of a code of ethics; (2) the frequency of communication activities regarding the code of ethics; (3) the quality of said communications; (4) the content of the code of ethics; and (5) the embedment of the code into the organization by management.<sup>119</sup> By evaluating effectiveness across these multiple dimensions, he was able to study both the relative importance of each factor and how the factors interacted with each other.<sup>120</sup>

Professor Kaptein found that the mere presence of a code of ethics had very little explanatory value on the absence of unethical behavior.<sup>121</sup> When none of the other independent variables were present, the mere presence of a code of ethics had a slight negative relationship to unethical behavior.<sup>122</sup> However, when the other variables were considered, the relationship became insignificant, and in some scenarios, even had a positive relationship to occurrences of unethical behavior.<sup>123</sup> The variable that had the biggest positive impact in deterring unethical behavior was the positive example set by senior and local management who embedded the content of the code into the organization by modeling ethical behavior in their own actions.<sup>124</sup> The presence of the code itself had little to no effect, while the modeling of ethical behavior by management did. This leads to the conclusion that the more important and effective deterrent to fraud is managers who are ethical

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117. Muel Kaptein & Mark Schwartz, *The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model*, 77 J. BUS. ETHICS 111, 113 (2007).

118. Muel Kaptein, *Toward Effective Codes: Testing the Relationship with Unethical Behavior*, 99 J. BUS. ETHICS 233, 234 (2011).

119. *Id.* at 234–37.

120. *See id.* at 238–39.

121. *Id.* at 244.

122. *Id.* at 245.

123. *Id.*

124. *Id.* at 247.

and enforce ethical standards, and not the mere presence of formal codes and compliance programs.

Additionally, the federal policy of encouraging self-regulation through internal compliance programs may actually create a perverse incentive for what is often referred to as “cosmetic compliance.” This phenomenon involves a situation where an entity sets up formal internal compliance controls that are largely ineffective or unenforced, and instead act as mere window dressing for the purposes of obtaining leniency in case of regulatory enforcement.<sup>125</sup> Weaver, Trevino, & Cochran have found that ethics and compliance programs motivated by external factors only (such as negative media coverage or governmental pressure through mechanisms such as the OSGs) often lead to formal ethics programs that are easily decoupled from the everyday business operations of the company and bear the indicia of cosmetic compliance.<sup>126</sup> These decoupled compliance programs have formal reporting mechanisms and policies, but are not integrated into the everyday business affairs of the organization. They have little impact on regular business decisions and actions.<sup>127</sup> Because they are decoupled from the daily operations of the business, these externally driven compliance programs are not a priority or concern for upper-level management and are thus largely ineffective in establishing ethical and compliant behavior in a company.<sup>128</sup>

The current government incentivized internal compliance regime only effectively addresses the formal processes and mechanisms of compliance programs, but does little to address the internal ethical norms and culture of the firm.<sup>129</sup> Since 2004, the OSGs have required that effective compliance programs “promote an organizational culture that encourages ethical conduct and a commitment to compliance with

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125. Krawiec, *supra* note 107, at 492.

126. See Gary R. Weaver et al., *Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures, and Corporate Ethics Practices*, 42 ACAD. MGMT. J. 539, 541, 547 (1999) (“An *easily decoupled* structure or policy provides the appearance of conformity to external expectations while making it easy to insulate much of the organization from those expectations. Although the structure or policy exists, there is no guarantee that it will regularly interact with other organizational policies and functions or that employees will be accountable to it.”).

127. *Id.* at 540.

128. *Id.*

129. See Hess, *supra* note 116, at 1806.

the law” and provide minimum standards for doing so.<sup>130</sup> However, these minimum standards relate to formal oversight, communication and response requirements rather than addressing the more informal mechanisms through which culture is built in an organization.<sup>131</sup> Compounding this problem is the fact that it is difficult for a court or regulatory body to determine whether an internal compliance program has been legitimately implemented and enforced, or if the program was in place merely to give the appearance of legitimacy.<sup>132</sup>

Effective procedures and processes are certainly important for internal compliance programs, and their implementation should be encouraged or required by government policy. However, legal requirements and government policy are inherently limited in their ability to directly affect ethical culture in an organization.<sup>133</sup> Formal requirements and processes for internal compliance and ethics programs are not in and of themselves sufficient, or even effective, in deterring illegal behavior when a company retains a corporate culture that allows or encourages corrupt behavior.<sup>134</sup> Accordingly, in order for whistleblowing to be effective, a balance must be struck between corporate self-reporting/internal compliance and the ability for whistleblowers to report directly to the government.<sup>135</sup>

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130. U.S. Sentencing Guidelines, 18 U.S.C. App’x § 8B2.1(a)(2), (b) (2006).

131. *Id.* § 8B2.1(b); see Peter Verhezen, *Giving Voice in a Culture of Silence: From a Culture of Compliance to a Culture of Integrity*, 96 J. BUS. ETHICS 187, 187–88 (2010).

132. See Krawiec, *supra* note 107, at 492; see also Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 113–14 (noting that because of the complex incentive structures and behavioral factors that influence implementation of compliance programs, it is difficult to find objective indicators for the administrative and judicial system to evaluate their effectiveness).

133. Hess, *supra* note 116, at 1806.

134. See David Hess & Cristie L. Ford, *Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem*, 41 CORNELL INT’L L.J. 307, 317-18 (2008) (noting the example of Baker Hughes, Inc., which in 2001 was required as part of a cease and desist order to develop internal accounting controls to prevent improper bribe payments, but in 2007 was accused again of paying bribes, and in a deferred prosecution agreement admitted to paying bribes in Kazakhstan as late as November of 2003); see also Linda Klebe Treviño et al., *Managing Ethics & Legal Compliance: What Works and What Hurts*, 41 CAL. MGMT. REV. 131, 131 (1999) (“In this study, we found that specific characteristics of the formal ethics or compliance program matter less than broader perceptions of the program’s orientation toward values and ethical aspirations.”).

135. See Feldman & Lobel, *supra* note 51, at 1157.

## 2. Understanding the Motivations for Whistleblowing

To evaluate the potential effects of the Dodd-Frank whistleblower provisions on internal reporting, one must also understand why employees report (or fail to report) wrongdoing, and specifically when an employee is most likely to circumvent internal compliance processes and blow the whistle externally. When an employee encounters wrongdoing in the workplace, following the formal internal compliance process or blowing the whistle externally are not the only options available. Employees may sit idly by and do nothing, confront the violator directly or report to a manager or supervisor.<sup>136</sup> Understanding why employees blow the whistle as opposed to taking other available actions is difficult because it involves the interaction of internal motivations (such as individual employees' sense of morality, altruism or self-interest), as well as organizational and environmental considerations (such as ethical culture, internal governance policies, organizational environment and regulatory environment).<sup>137</sup> Numerous factors can play a part in the decision, such as the magnitude of the harm, the organizational status of the violator and the level of moral outrage at the conduct.<sup>138</sup>

The motivations and behaviors of whistleblowers have been relatively under-researched.<sup>139</sup> Professors Miceli & Near attribute this lack of empirical research partially to significant challenges both conceptually and methodologically in researching this area.<sup>140</sup> For example, in order to obtain data on actual whistleblowing events, researchers must find individuals with knowledge of unlawful or unethical conduct in their company and persuade them to agree to identify themselves to the researcher.<sup>141</sup> Researchers find it difficult to

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136. See Muel Kaptein, *From Inaction to External Whistleblowing: The Influence of the Ethical Culture of Organizations on Employee Responses to Observed Wrongdoing*, 98 J. BUS. ETHICS 513, 514–15 (2011) (discussing generally the various response that employees may have to observed wrongdoing).

137. See Feldman & Lobel, *supra* note 116, at 166–69.

138. *Id.* at 175.

139. *Id.* at 168; see also Marcia P. Miceli & Janet P. Near, *Standing Up or Standing By: What Predicts Blowing the Whistle on Organizational Wrongdoing*, 24 RES. PERSONNEL & HUM. RESOURCES MGMT. 95, 124 (2005) (“Very little controlled research on whistleblowing has been published, particularly in top journals; with more research, we might have more new directions to report.”).

140. See Miceli & Near, *supra* note 139, at 125–29.

141. *Id.* at 126.

locate these individuals and obtain this data because of the potential negative consequences of blowing the whistle. Additionally, the earlier studies conducted on the motivations of whistleblowing are of fairly limited value, as they focus on individual motivational considerations rather than the interaction of internal individual factors with external organizational and environmental factors.<sup>142</sup> However, there are two recent studies on whistleblowing behavior which provide some insight into how organizational and governmental factors affect whistleblowing.

In a 2008 study, Professors Feldman and Lobel simultaneously examined numerous factors commonly present in organizations to determine their impact on reporting misconduct both internally and externally.<sup>143</sup> The study was conducted using a survey wherein participants answered questions regarding five different scenarios of misconduct—theft, financial fraud, environmental misconduct, safety violations and harassment.<sup>144</sup> The participants answered questions as if they were the employee discovering each scenario.<sup>145</sup> The questions measured various factors surrounding the observed misconduct, such as degree of moral outrage, perceived social norms regarding the misconduct and the method of reporting selected.<sup>146</sup>

The study turned out some noteworthy findings regarding whistleblowing. First, internal reporting tends to be used for “less important” matters involving lower level employees, such as employee theft, rather than more extensive problems, such as environmental problems or financial fraud.<sup>147</sup> Second, the situation in which the subjects were least likely to engage in any type of reporting, whether internally or externally, was financial fraud committed by management.<sup>148</sup> The study concluded that this was because any type of reporting in this scenario necessarily requires implicating management, and thus employees must be willing to pay a high price to report any such conduct.<sup>149</sup> Third, the study found that external reporting was associated with an escalation of the intensity of illegality of the conduct, and the more widespread the illegality was throughout the organization

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142. Feldman & Lobel, *supra* note 116, at 169; *see also* Marcia P. Miceli et al., *Who Blows the Whistle and Why?*, 45 INDUS. & LAB. REL. REV. 113, 114 (1991).

143. *See* Feldman & Lobel, *supra* note 116, at 169–70.

144. *Id.*

145. *Id.*

146. *See id.*

147. *Id.* at 171.

148. *Id.*

149. *See id.* at 175.

(particularly with management), the less likely it was to be reported internally.<sup>150</sup> For example, where employees know or suspect that the payment of bribes is commonplace and/or endorsed by upper-level management, they will be less likely to report any illicit payments through internal compliance channels because of the belief that any such reporting would be futile.

Additionally, this study found that when an organization emphasizes internal compliance, it can have a positive effect on the willingness of employees to internally report illegal behavior and a negative effect on external reporting.<sup>151</sup> While this can serve as an effective means of policing misconduct when the internal compliance program is legitimate, where management is complicit in or otherwise benefits from the misconduct, this can lead to management illicitly emphasizing internal reporting solely to prevent external discovery of the misconduct.<sup>152</sup> Professor Langevoort proffers two examples where this may be the case.<sup>153</sup> First, if society does not sufficiently enforce the law by imposing an adequate penalty, it can be more economically efficient for a company to allow a certain level of profitable violation.<sup>154</sup> Second, if managers are not held personally liable and their payment structure is not properly aligned with the interests of the company, they can personally benefit from profitability associated with illegal conduct with little or no commensurate penalty.<sup>155</sup>

In a more recent study, Feldman and Lobel expanded their research to include the consideration of various regulatory incentives, including monetary bounties, on whistleblowing.<sup>156</sup> This study measured the effectiveness of four types of regulatory incentives for whistleblowing: (1) protection from retaliation; (2) a legal duty to report; (3) fines for failure to report; and (4) monetary incentives for reporting.<sup>157</sup> All participants in the study's survey received the same fact pattern of misconduct, and each was asked to predict their own reaction as well as

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150. *Id.* at 181.

151. *Id.* at 175.

152. *Id.* at 180.

153. *See* Langevoort, *supra* note 132, at 80.

154. *Id.*

155. *Id.*

156. *See* Feldman & Lobel, *supra* note 51, at 1176.

157. *Id.*

the reaction of others in light of various combinations of the four regulatory incentives listed above.<sup>158</sup>

As one would expect, the perceived severity of the misconduct had a significant effect on the likelihood to report.<sup>159</sup> When the severity of the misconduct is perceived as low, external incentives matter much more in the motivation to report, because the internal motivation of moral outrage is missing.<sup>160</sup> For these respondents, offering a large monetary reward or imposing a legal duty to report and granting a large monetary reward provided a very strong incentive for blowing the whistle.<sup>161</sup>

However, whenever the internal moral motivation to report was high, offering a large monetary award was not as strong of an incentive for reporting.<sup>162</sup> For these respondents, other external incentives, such as a legal duty to report and protection from retaliation, were reported as a stronger incentive than a high reward.<sup>163</sup> This suggests that there may be a limited “crowding out” effect, whereby offering a large monetary incentive for whistleblowing is counter-productive because it undermines the internal ethical and moral motivations for reporting wrongdoing.<sup>164</sup> This conclusion recognizes that while people do respond to monetary incentives as classic economics predicts, these are not the only motivators of human behavior.<sup>165</sup>

The study results also showed that the respondents tended to undermine the role of money in their own decision to report, while believing it would be very influential in others decisions to report.<sup>166</sup> The respondents perceived that the imposition of a legal duty to report would be a dominant factor in their own reporting decision.<sup>167</sup> However, the results showed that in the scenario where a legal duty imposed plus a large monetary reward was offered versus the scenario where only a

158. *Id.* at 1188.

159. *See id.* at 1193–95.

160. *Id.*

161. *See id.*

162. *Id.*

163. *Id.*

164. *Id.* at 1180.

165. *See id.* at 1193-95; *see also* Lawrence M. Friedman, *Coming of Age: Law and Society Enters an Exclusive Club*, 1 ANN. REV. L. & SOC. SCI. 1, 14 (2005) (“There is no question that human beings do react to the carrot and the stick. However, people are not blindly mechanical cost-benefit machines . . .”).

166. *See* Feldman & Lobel, *supra* note 51 at 1199.

167. *Id.*



large monetary reward was offered, the legal duty provided only a marginal increase in reporting.<sup>168</sup> This indicates that there is a tendency to underestimate the perceived effect that a monetary reward has on the decision to blow the whistle.<sup>169</sup>

Overall, the study found that a monetary reward is an important incentive for reporting, particularly when the conduct is not perceived as being overtly morally offensive.<sup>170</sup> The size of the bounty is critical, as small monetary awards were not a strong incentive and actually decreased the rate of reporting when there was no moral outrage at the conduct reported.<sup>171</sup> Generally, where the perceived moral outrage of the wrongdoing was high, the external incentives for reporting were less important. Nonetheless, external monetary incentives still provided an increase in reporting in such situations.<sup>172</sup>

These studies have their limitations; both studies rely upon survey data of self-reported reactions to hypothetical factual situations, as opposed to analyzing actual examples of whistleblowers reporting misconduct.<sup>173</sup> Additionally, in order to determine the level of moral outrage, the second study relied upon the subjective perception of one fact pattern, rather than using multiple fact patterns to obtain a broader sample of which violations people found morally offensive.<sup>174</sup> The second study also relied on hypothetical survey results of when a

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168. *Id.*

169. *See id.* at 1200, 1203 (“In fact, high rewards were highly influential at the experimental stage, but those high rewards were ranked as the least influential factors when respondents were consciously estimating what factors influenced their own decisions to report.”).

170. *See id.* at 1202 (“When the ethical significance attached to the reporting act is absent, the level of monetary compensation offered through the regulatory system is decisive.”).

171. *Id.*

172. *Id.*

173. *See id.* at 1188; *see also* Feldman & Lobel, *supra* note 116, at 180–81; *see also* Miceli & Near, *supra* note 139, at 126–27 (“As we have described in depth previously . . . , laboratory and scenario studies, while quite useful for many other topics, are not the solution for whistle-blowing. Like the longitudinal or multi-source design, they address certain problems, but create others that are equally if not more likely to be ‘fatal’ to internal validity, and raise questions of external validity as well. For example, it is well-understood that social desirability or a wish to please the experimenter leads many people to say they would do the ‘right thing’ when it is described on paper, when in reality they would not.”).

174. *See* Feldman & Lobel, *supra* note 51, at 1188.

respondent would be motivated by a bounty as opposed to individuals actually faced with the opportunity to receive a bounty for reporting. Therefore, there is a distinct possibility that the respondents underestimated the role that a financial incentive could play in people's decisions, as Professors Feldman and Lobel admit.<sup>175</sup> Nevertheless, these studies are the most thorough and recent empirical studies on whistleblowing incentives. When considered together, they provide important insights into the potential effect that the bounty provisions of the Dodd-Frank Act may have on whistleblowing and internal compliance programs.

While internal reporting procedures may be effective in some situations, they are not an effective reporting mechanism for all types of misconduct. Respondents favored internal reporting in smaller, "less important" instances of misconduct, but internal reporting is the least likely when management is involved in the misconduct at issue.<sup>176</sup> Additionally, the type of misconduct least likely to be reported at all, whether internally or externally, was financial fraud by management.<sup>177</sup> This suggests that for the very type of fraud that the Dodd-Frank Act is most concerned with policing,<sup>178</sup> management could be incentivized to focus on internal reporting not to stop the conduct, but to discourage government discovery and intervention.<sup>179</sup> Further, this suggests that in order to encourage employees to be willing to take the risk of implicating management in wrongdoing, additional government incentives such as a bounty may be effective in increasing external reporting of managerial level financial fraud, which is otherwise unlikely to be reported.<sup>180</sup>

Despite the potential for underreporting on the effect of financial incentives inherent in Feldman and Lobel's second study,<sup>181</sup> it still showed that monetary incentives can increase external self-reporting.<sup>182</sup> This is especially the case when the misconduct is not of a particularly egregious nature,<sup>183</sup> and has important implications for the external reporting of financial fraud. Certain types of financial fraud, such as

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175. *Id.* at 1207.

176. Feldman & Lobel, *supra* note 116, at 171.

177. *Id.*

178. *See* discussion *supra* Introduction.

179. *See* Feldman & Lobel, *supra* note 116, at 180–81.

180. *Id.*

181. *See* Feldman & Lobel, *supra* note 51, at 1188.

182. *See id.* at 1202.

183. *Id.*

violations of accounting standards, are highly technical, and thus not inherently morally outrageous, or they exist in a legal grey area where the conduct can be argued as legal or moral.

Additionally, when an organization has created a culture where corrupt behavior is acceptable, individual employees can become desensitized to the conduct such that it becomes commonplace and no longer shocking, despite remaining appalling to those outside the situation.<sup>184</sup> Much of the financial fraud that occurred in the recent financial crisis would fit this description.<sup>185</sup> In these situations, fraud could be of a significant size and scope and damaging to the economy, but unlikely to be reported or dealt with internally.<sup>186</sup> The bounty provisions of Dodd-Frank provide an economic incentive for external reporting of this type of fraud, which has otherwise been difficult to uncover until substantial societal harm has already occurred.

## 2. *The Dodd-Frank Whistleblower Provisions as a Check on Ineffective Internal Compliance Programs*

In light of the above analysis, the bounties provided under Dodd-Frank appear reasonably tailored to supplement internal reporting, not bypass it. Some have proposed that in order to avoid the potential for undermining internal compliance and ethics programs, the SEC should require whistleblower provisions under Dodd-Frank to first report any misconduct through internal compliance channels before reporting to the SEC.<sup>187</sup> While such a requirement would help preserve internal

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184. See Hess, *supra* note 116, at 1797; see also Hess & Ford, *supra* note 134, at 319–325 (explaining how paying bribes can become institutionalized into a culture and employees begin to rationalize the behavior such that they become routine and no longer cause any moral outrage).

185. See, e.g., Wyatt, *supra* note 9 (discussing the SEC's intent to pursue additional financial fraud cases stemming from the mortgage backed securities created during the financial crisis). Given the complex nature of the mortgage backed securities created during the financial crisis and their widespread use and acceptance, it is highly doubtful that most of the lower level employees involved in their structuring and offering understood them completely or understood any fraud that may have been involved in their offering.

186. Feldman & Lobel, *supra* note 116, at 171.

187. See e.g., Ebersole, *supra* note 11, at 151; see also Bruce Carton, *Pitfalls Emerge in Dodd-Frank Whistleblower Bounty Provision*, SECURITIESDOCKET.COM (Sept. 9, 2010), <http://www.securitiesdocket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision/>.

reporting, it would also subject employees who are not confident in their company's internal compliance to report through a channel that they know or suspect may not be effective or taken seriously.<sup>188</sup> The whistleblowing process is an emotionally draining one.<sup>189</sup> Reporting through ineffective internal channels may subject a whistleblower to social ostracization or other psychological mistreatment by fellow employees and management, which can be extremely demoralizing. The final SEC rules strike the appropriate balance between internal and external reporting by incentivizing, but not requiring, reporting through internal compliance channels.<sup>190</sup>

Under the final SEC rules, whistleblowers will still be considered for an award even if they first report through internal compliance with their employer, and their employer subsequently reports to the SEC.<sup>191</sup> In order to trigger this provision, the whistleblower must also submit the information to the SEC on the required forms within 120 days of the internal report.<sup>192</sup> This provides the company with sufficient time to evaluate the claims made by the whistleblower and determine whether to inform the whistleblower that no violation has taken place, or self-report the violation to the SEC.

As an additional incentive for whistleblowers to internally report, the final rules expressly set forth various factors that the SEC may consider in determining the amount of award to a whistleblower.<sup>193</sup> Participation in internal compliance systems, which includes internal reporting as well as assisting in internal investigations, may increase a whistleblower's overall award.<sup>194</sup> Conversely, the SEC may consider any interference with internal compliance channels, including providing any materially false, fictitious or fraudulent statements or reports to internal compliance, as a factor that may decrease the award given to a whistleblower.<sup>195</sup>

The required size of the monetary sanction to trigger a bounty also serves as a level of protection against bypassing internal compliance. The studies discussed above indicate that a small reward is not a significant motivator for blowing the whistle, and that for minor matters,

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188. See *supra* Part III.B.1.

189. Feldman & Lobel, *supra* note 51, at 1158–59.

190. See 17 C.F.R. §§ 240.21F-4, .21F-6 (2011).

191. See *id.* § 240.21F-4(c)(3).

192. See *id.*

193. See *id.* § 240.21F-6.

194. See *id.* § 240.21F-6(a)(4).

195. See *id.* § 240.21F-6(b)(3).

employees prefer to report internally.<sup>196</sup> The bounty provisions of Dodd-Frank are not triggered unless there is a monetary sanction of at least \$1 million.<sup>197</sup> Thus, employees will not be motivated to bypass internal compliance reporting unless they believe the misconduct is large and widespread enough to trigger such a sanction, the very type of fraud that is the least likely to be reported internally.<sup>198</sup> This floor on the monetary sanction not only ensures that the whistleblower will receive a substantial reward if a successful action is brought (which is required to provide sufficient incentive), but also helps ensure that employees will not bypass internal compliance on small matters. The floor allows internal compliance programs to maintain an ongoing role of policing misconduct and encouraging internal reporting, which cuts off problems before they become substantial.

These final SEC rules, in conjunction with the statutory structure, adequately address critiques that the bounty provisions will force companies to self-report in order to win the race to report,<sup>199</sup> will disincentivize cooperation with regulatory authorities<sup>200</sup> and incentivize frivolous tips to the SEC.<sup>201</sup> To the extent that an organization has an effective internal compliance program that is embraced and believed in by employees, the whistleblowing mechanism in the rules provides an incentive for employees to first report internally. It also gives adequate time to the organization to determine whether the decision to self-report should be made. The opportunity to increase the whistleblower's share of the sanction as their reward<sup>202</sup> helps offset the incentive to bypass internal reporting in an attempt to increase the size of the sanction. Under any whistleblower structure, there will be frivolous tips. However, if the organization has a robust compliance process in place, in conjunction with a cultural norm of internally reporting and dealing with misconduct, organizations have ample opportunity to address the merits of a complaint with the employee before it is reported.

Far from undercutting internal compliance programs, these whistleblower provisions provide a check on ineffective internal compliance programs. While a court or regulator may not be in the best

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196. See discussion *supra* Part III.B.II.

197. Dodd-Frank Act § 922(b)(1), 124 Stat. 1376, 1842 (2010).

198. See discussion *supra* Part III.B.II.

199. See discussion *supra* Part III.A.1.

200. See discussion *supra* Part III.A.2.

201. See discussion *supra* Part III.A.3.

202. 17 C.F.R. § 240.21F-6(a)(4) (2011).

position to adequately assess whether an internal compliance program is truly effective,<sup>203</sup> employees within an organization are uniquely positioned to gauge the ethical climate of the organization and determine whether reporting internally will be futile or result in affirmative action to remedy the problem. The decision to blow the whistle is a complex one, and aligning incentives to maximize proper reporting while also minimizing frivolous reporting is difficult.<sup>204</sup> While experience will tell us where these whistleblower provisions fall short (as they undoubtedly will in some regard), the final rules drafted by the SEC represent well-crafted regulations that strike a balance between internal and external reporting. By allowing, but not directly incentivizing, employees to report directly to the SEC rather than through internal compliance structures, these rules provide a measure of much needed accountability to corporate internal compliance programs without undercutting them.

C. DEALING WITH DODD-FRANK:  
CREATING AND INCENTIVIZING AN ETHICAL CULTURE TO DRIVE  
INTERNAL COMPLIANCE AND REPORTING.

The best method for dealing with Dodd-Frank is for organizations to move past focusing only on the formal aspects of the structure of their compliance programs, and to integrate their ethics and compliance programs into the fabric of their organizational culture.<sup>205</sup> As with so many things in life, this is easier said than done. Attorneys and compliance professionals tend to focus on “check-the-box” requirements in drafting and designing internal compliance programs, focusing more on strict legal requirements rather than on the organizational implications and efficacy of the program.<sup>206</sup> But changing the

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203. See Krawiec, *supra* note 107, at 491.

204. Feldman & Lobel, *supra* note 51, at 1157–59 (“Because of its inherent risks, whistle-blowing must be incentivized through regulatory policies that will encourage individuals to break the code of silence in corrupt organizations. However, identifying and understanding the various predictors of social enforcement in organizations is highly complex, as predictors are comprised of individual, organizational, and state-level factors.”).

205. See Weaver et al., *supra* note 126, at 541; see also Tom Tyler et al., *The Ethical Commitment to Compliance: Building Value-Based Cultures*, 50 CAL. MGMT. REV. 31, 32 (2008).

206. See, e.g., Hess, *supra* note 116, at 1791–92 (noting the difference between “compliance based” programs, which focus on deterrence through formal compliance programs designed to detect and punish violations, and “integrity based” programs,

organizational culture is much more difficult than simply drafting a new policy or implementing a new process. By understanding what drives ethical behavior of employees in organizations, attorneys and other compliance professionals can implement compliance processes and interact with organizational constituents in a way that will maximize the opportunity to develop a culture of ethical decision-making and internal reporting.

*1. Focus on Management Commitment,  
Communication and Congruency*

Research shows that organizational culture starts from the “tone at the top.”<sup>207</sup> When the CEO and other high-level managers do not express a commitment to ethics and are uninvolved in compliance programs, the compliance programs are less likely to have an effect on employee behavior.<sup>208</sup>

However, it is not enough for management to simply express a commitment to compliance—the commitment must be visible and there must be effective communication of this commitment between the employees and management.<sup>209</sup> High-level managers tend to self-identify closely with their organization, and thus often have a more sanguine view of the ethical climate than do lower-level employees working in the trenches.<sup>210</sup> Additionally, top managers often do not communicate frequently with lower-level managers, and vice-versa.<sup>211</sup> This two-way lack of communication can create problems. For example, a CEO may have a commitment to ethical behavior and compliance, but this commitment is not communicated to the employees adequately, and is not visible to them. Conversely, lower level employees may know of

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which focus on establishing organizational values and integrating ethics into decision-making).

207. Linda Klebe Trevino, *Out of Touch*, 70 BROOK. L. REV. 1195, 1198 (2005) (“Research has found that the CEO’s ‘commitment to ethics’ influences the scope, orientation, and integration of formal ethics/compliance programs.”); see also Weaver et al., *supra* note 126, at 547 (“Our findings support theoretical claims that senior management’s personal commitment to ethics is an essential part of what drives organizations to proactive, social responsible performance.”).

208. Trevino, *supra* note 207, at 1198–1200.

209. See *id.*

210. *Id.* at 1208.

211. *Id.*

unethical or unlawful practices that the company is engaged in while upper-level management naively believes everything is fine.<sup>212</sup>

In addition to the importance of communication, a recent study found that when there is a high level of congruency in senior management, employees are more likely to call an internal whistleblowing hotline, and less likely to blow the whistle externally.<sup>213</sup> Thus, it is important that employees not only have a commitment to ethics communicated to them by management, but that top management communicate and display their behavior in accordance with the ethical norms of the company.

Of course, attorneys and other compliance professionals are limited in their ability to control management or influence it to behave in an ethical manner or communicate their values. Nevertheless, compliance programs can be structured such that communication channels regarding organizational ethics allow for the flow of information as easily as possible from the top down, and from the bottom up, on a regular basis. Most internal compliance programs focus on formal communication channels, such as hotlines or internal reporting procedures, while informal communications channels are often viewed as ineffective.<sup>214</sup> Formal communication channels are important, however, informal communications can also be critical in encouraging employees to report wrongdoing.<sup>215</sup> Compliance managers should encourage management to utilize informal methods of communication to engage in discussion and dialogue on ethics throughout the organization.

Managers can increase their influence and learn by engaging employees at all levels in informal dialogue on ethics and compliance issues and taking advantage of the speed of informal information flow.<sup>216</sup> Informal, low-pressure communications can also be much less

212. See *id.* at 1209.

213. See Muel Kapstein, *From Inaction to External Whistleblowing: The Influence of the Ethical Culture of Organizations on Employee Responses to Observed Wrongdoing*, 98 J. BUS. ETHICS 513, 517–23 (2011) (defining congruency as “the extent to which managers apply organizational standards to their own behavior”).

214. See *id.* at 527.

215. See *id.* (noting that the majority of the respondents in the study favored some type of informal reporting of wrongdoing—81% favored reporting to a manager and 52% favored direct resolution, while only 44% favored calling a formal ethics hotline).

216. Suzanne M. Crampton et al., *The Informal Communication Network: Factors Influencing Grapevine Activity*, 27 PUB. PERSONNEL. MGMT. 569, 570 (1998) (“Generally speaking, studies indicate that informal networks transmit messages faster than formal ones. This means that information reaches its destination before formal communication networks begin to communicate with employees. The characteristic of



stressful to employees, freeing them up to discuss issues more openly.<sup>217</sup> Informal communications can also convey, in a very sincere and tangible manner, management's commitment to running an ethical organization, and show how management structures their own conduct in adherence to the organization's ethical norms.<sup>218</sup> Additionally, engaging in this type of dialogue before a violation is reported through formal compliance mechanisms increases the likelihood that a potential legal or ethical violation can be remedied before it occurs or grows into a larger or more widespread problem.

## 2. *Integrate Compliance Functions into Daily Business Practices*

As noted by Weaver, Trevino, & Cochran, formal compliance programs can become easily decoupled from regular business affairs, rendering them ineffective.<sup>219</sup> Thus, in designing and implementing an internal compliance program, care needs to be taken that the program is integrated into the organization's ongoing business affairs such that it becomes an integral part of the organization's identity and operations. In this way, employees can be pushed to consider ethical and legal ramifications as part of the standard decision-making process when carrying out business functions.

An example of such an integrated policy, provided by Weaver, Trevino, & Cochran, is a health care products company they examined. The company made one-third of every manager's annual raise dependent upon how well the manager carried out ethical ideals, as evaluated by superiors, peers, and subordinates.<sup>220</sup> Such a policy helps ensure that managers are considering ethics and compliance issues when making decisions—their livelihood depends on it. In order to be effective, integration need not be this formal, however. For example, informal discussions with employees when making decisions can spur employees to integrate ethics into their decision-making processes. A routine dialogue of simple questions such as “How will this decision affect the environment?”; How will this decision affect how the public

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accuracy has also been researched. Studies attest that most information transmitted by the grapevine is accurate.”)

217. See Verhezen, *supra* note 131, at 187–88.

218. See *id.*

219. See Weaver et al., *supra* note 126, at 539–41.

220. *Id.* at 541.

thinks about our company?"; "Is this legal? Even if it is, is it right?"; or "Am I proud of this decision? Would I be ashamed if my friends or family knew about it?", can help build ethical norms within an organization.<sup>221</sup> When employees know that the company culture requires them to justify decisions along ethical dimensions as well as more traditional business metrics, they will be more likely to instinctually integrate these considerations into their thought processes.

### CONCLUSION

The 2008 financial crisis created broad societal costs, some of which stemmed from corporate fraud and malfeasance.<sup>222</sup> The Financial Crisis Inquiry Commission formed by Congress determined that the crisis was avoidable, and had strong criticisms for lax government regulators.<sup>223</sup> While a failure of government regulation should shoulder some of the blame of the crisis, the individuals and organizations who were the primary actors should shoulder the most. Apparently, the "strong compliance systems set up under Sarbanes Oxley"<sup>224</sup> by companies were not able to prevent the behavior that led to this crisis. In light of these failures and lack of strong evidence that internal compliance programs are effective in deterring illegal conduct,<sup>225</sup> the criticisms that the whistleblower provisions of Dodd-Frank will undermine internal compliance programs ring hollow.

Rather, as laid out in this Article, evidence indicates 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.<sup>226</sup> Internal compliance programs are an important regulatory mechanism that can benefit both the organizations that utilize them and

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221. Verhezen, *supra* note 131, at 192.

222. See, e.g., Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 158–59 (2010) (noting the difficulty in determining the exact cost of bailout programs, but noting that some reports in the media had reported the cost as high \$5 trillion and \$7 trillion, even before additional stimulus funds were used in 2009).

223. See Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. TIMES, Jan. 25, 2011, at A1, available at <http://www.nytimes.com/2011/01/26/business/economy/26inquiry.html>.

224. See U.S. CHAMBER OF COMM., *supra* note 11.

225. See *supra* discussion Part III.B.1.

226. See *supra* discussion Part III.B.1.

society. However, like any regulatory framework, incentivizing internal compliance has the potential for abuse. The whistleblower provisions of Dodd-Frank provide a much-needed check on this potential for abuse, while still respecting the valuable role that internal compliance programs can serve.