

2011

## The New Financial Incentives and Expanded Anti-Retaliation Protections for Whistleblowers Created by Section 922 of the Dodd-Frank Act: Actual Progress or Just Politics?

Vanessa Castellina

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/bjcfcl>

---

### Recommended Citation

Vanessa Castellina, *The New Financial Incentives and Expanded Anti-Retaliation Protections for Whistleblowers Created by Section 922 of the Dodd-Frank Act: Actual Progress or Just Politics?*, 6 Brook. J. Corp. Fin. & Com. L. (2011).

Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol6/iss1/7>

This Note is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Journal of Corporate, Financial & Commercial Law by an authorized editor of BrooklynWorks.

## NOTES

# THE NEW FINANCIAL INCENTIVES AND EXPANDED ANTI-RETALIATION PROTECTIONS FOR WHISTLEBLOWERS CREATED BY SECTION 922 OF THE DODD- FRANK ACT: ACTUAL PROGRESS OR JUST POLITICS?

### INTRODUCTION

In early December 2008, Bernie Madoff was arrested for allegedly orchestrating a \$50 billion Ponzi scheme.<sup>1</sup> This news shocked everyone, and many wondered how a fraud of such magnitude could go without being detected for so long.<sup>2</sup> In the days following Bernie Madoff's arrest, the initial shock grew into anger as the public learned that the Securities and Exchange Commission (SEC or the Agency) had been warned numerous times that Madoff was committing fraud.<sup>3</sup>

One person in particular, Harry Markopolos, warned the SEC about Madoff five times.<sup>4</sup> Markopolos, now an independent certified fraud examiner, first heard of Madoff while working at a rival firm.<sup>5</sup> After conducting research on the trading strategy that Madoff claimed he used, Markopolos became convinced that Madoff's returns were not real. In 2005, he sent a detailed letter to the SEC explaining why he thought "Madoff

---

1. See *United States v. Madoff*, 586 F. Supp. 2d 240, 244, 244 n.1 (S.D.N.Y. 2009); *Ponzi Schemes – Frequently Asked Questions*, SEC, <http://www.sec.gov/answers/ponzi.htm> (last visited Aug. 30, 2011). The SEC defines Ponzi scheme as:

[A]n investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.

*Id.*

2. See, e.g., Terry Keenan, *This Ponzi Scheme is Crème de la Crème*, N.Y. POST, Dec. 14, 2008, at 35.

3. See, e.g., Amir Efrati, Tom Lauricella & Dionne Searcey, *Top Broker Accused of \$50 Billion Fraud Sons Turned in Madoff After He Allegedly Told Them His Investment-Advisory Business for the Wealthy Was 'Giant Ponzi Scheme'*, WALL ST. J., Dec. 12, 2008, at A.1.

4. *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enter. of the H. Comm. on Fin. Servs.*, 111th Cong. 5 (2009) [hereinafter *Madoff Hearing*] (statement of Harry Markopolos, CFA, CFE, Chartered Fin. Analyst and Certified Fraud Examiner).

5. See *id.* at 5, 27, 106–07.

Securities [was] the world's largest Ponzi Scheme."<sup>6</sup> Four years later, on February 4, 2009, Markopolos testified before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises regarding the failure of the SEC to detect Madoff's Ponzi scheme.<sup>7</sup> During his testimony, Markopolos presented recommendations to correct the internal problems of the SEC.<sup>8</sup> Additionally, he recommended the creation of "a whistleblower program to compensate people from within the industry who know about . . . fraud . . . to step forward."<sup>9</sup>

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).<sup>10</sup> After years of being ignored, it seems that Markopolos's advice was finally followed: Section 922 of the Dodd-Frank Act creates a financial incentive for persons to report fraud to the SEC.<sup>11</sup>

Offering financial incentives for whistleblowers who aid the SEC in detecting corporate and securities fraud is not a new approach.<sup>12</sup> Prior to the passage of the Dodd-Frank Act, the SEC had a bounty program for informants who provided the SEC with tips regarding insider trading.<sup>13</sup> That program was created pursuant to the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), which was enacted in response to the publicity of several high-profile insider trading schemes.<sup>14</sup> The Dodd-Frank

---

6. Letter from Harry Markopolos, CFA, CFE, Chartered Fin. Analyst and Certified Fraud Examiner, to the SEC (Nov. 7, 2005), *available at* <http://www.jdsupra.com/post/documentViewer.aspx?fid=54539da2-994e-43b5-b271-19fbb7e723e3>.

7. *Madoff Hearing*, *supra* note 4, at 5.

8. *Id.* at 5–8.

9. *Id.* at 42.

10. President Barack H. Obama, Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), *available at* <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act> [hereinafter Remarks].

11. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841–49 (2010) (codified at 15 U.S.C. § 78u–6 (2010)).

12. The SEC has had a reward program for insider trading informants since 1989. *See* Securities Exchange Act of 1934, Release No. 34-26994, 43 SEC DOCKET 1963, 1964 (June 30, 1989) [hereinafter *Applications for Bounty Awards*]. Section 806 of the Sarbanes-Oxley Act of 2002 created anti-retaliation protections for employees of public companies who reported fraudulent activity by their employers to the SEC. Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), Pub. L. No. 107-204, § 806, 116 Stat. 745, 802–04 (codified at 18 U.S.C. § 1514A (2002)). Lastly, many scholarly articles have called for additional incentives and protections for those who provide tips to the SEC and other agencies. *See* Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2251 (Dec. 2010); Beverley H. Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change*, 44 AM. BUS. L.J. 1, 2–3 (2007); Mary Kreiner Ramirez, *Blowing the Whistle on Whistleblower Protection: A Tale of Reform Versus Power*, 76 U. CIN. L. REV. 183, 185–88 (2007).

13. *See generally Applications for Bounty Awards*, *supra* note 12 (discussing the bounty program).

14. *See, e.g.,* Neil V. Shah, Note, *Section 20A and the Struggle for Coherence, Meaning, and Fundamental Fairness in the Express Right of Action for Contemporaneous Insider Trading Liability*, 61 RUTGERS L. REV. 791, 791–92 (2009).

Act also expands the anti-retaliation protections for whistleblowers that were created by the Sarbanes-Oxley Act of 2002 (SOX) which was enacted in response to several high-profile corporate frauds, including Enron,<sup>15</sup> WorldCom,<sup>16</sup> and Tyco.<sup>17</sup>

This note examines the SEC's previous whistleblower reward program and the prior anti-retaliation protections offered by SOX, and argues that the Dodd-Frank Act's financial incentives and anti-retaliation protections for whistleblowers do not address the SEC's internal problems, and therefore, seem to be more of a political reaction than meaningful measures to increase the SEC's ability to detect fraud. In Part I, this note will first discuss the role of whistleblowers in detecting corporate fraud. Then, Part II will examine the circumstances that led to the enactment of the ITSFEA, the specifics of the whistleblower program that it created at the SEC, and the outcome of this program. Next, the circumstances that led to the enactment of SOX, the specifics of the anti-retaliation protections created by SOX, and the effect of these protections will be explored in Part III. Part IV will analyze the circumstances that led to the enactment of the Dodd-Frank Act, the specifics of the new whistleblower anti-retaliation protections, the financial incentives created by this law, and what the SEC is doing to implement the new program. Pulling together the information put forth in previous sections, Part V will highlight the trend of Congress and the SEC to reform the laws after a recession and revelation of high-profile fraud. Part VI argues that the SEC was not lacking tips from whistleblowers, but rather it was the SEC's internal problems that weakened its ability to detect fraud. Finally, Part VII suggests that instead of creating the new whistleblower program, the SEC should have focused on creating better internal procedures for reviewing external tips and

---

15. Enron was an American energy trading company that engaged in accounting fraud. Enron's accounting practices falsely inflated the company's revenues by hiding large liabilities. When the company could no longer continue this practice, it was forced to file for Chapter 11. See *Special Report: Corporate America's Woes, Continued – Enron: One Year On*, THE ECONOMIST, Nov. 30, 2002, at 69. Enron's accounting scandal, in part, led to the enactment of the Sarbanes-Oxley Act of 2002. See, e.g., Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L.J. 321, 321–25 (2007).

16. WorldCom was a large American telecommunications firm that committed massive accounting fraud, causing the company to file for Chapter 11 bankruptcy on July 21, 2002. At the time, it was the largest bankruptcy in American history. *WorldCom's Bankruptcy Mess*, THE ECONOMIST, July 22, 2002, at 1. WorldCom's accounting scandal contributed to the decision to enact the Sarbanes-Oxley Act of 2002. See, e.g., Nicholson, *supra* note 15, at 321–25.

17. Tyco's Chief Executive Officer and Chief Financial Officer were both found guilty of "grand larceny and conspiracy, falsifying business records and violating general business law," after being accused of using corporate funds for their personal use and misrepresenting the company's financial situation. See Krysten Crawford, *Ex-Tyco CEO Kozlowski Found Guilty: Second Trial Ends in Guilty Verdicts for Former Tyco Chief and the Company's Ex-CFO Swartz*, CNNMONEY.COM (June 21, 2005), [http://money.cnn.com/2005/06/17/news/newsmakers/tyco\\_trialoutcome/index.htm](http://money.cnn.com/2005/06/17/news/newsmakers/tyco_trialoutcome/index.htm). The Tyco scandal contributed to the government's decision to enact the Sarbanes-Oxley Act of 2002. See, e.g., Nicholson, *supra* note 15, at 321–25.

implementing technology that would make the Agency more proactive in detecting fraud.

### I. THE ROLE OF A WHISTLEBLOWER IN DETECTING CORPORATE AND SECURITIES FRAUD

Corporate fraud often refers to schemes designed and carried out by corporate officers or employees in order to conceal the actual financial condition of the corporation from the public.<sup>18</sup> Securities fraud includes schemes involving false or misleading information about securities and potential returns in order to attract investors.<sup>19</sup> Both crimes cause harm to the individuals who are directly affected, and to society, since they diminish trust.<sup>20</sup>

The deceptive and secretive nature of corporate and securities fraud makes them difficult to detect, especially for people who do not have access to a company's internal files.<sup>21</sup> Alexander Dyck, Adair Morse, and Luigi Zingales conducted a study of 216 alleged fraud cases against U.S. corporations from 1996 to 2004,<sup>22</sup> and "attribute[d] 34% of the fraud detections to internal governance . . . ."<sup>23</sup> While internal governance detected more fraud than any other specific factor in the study, about 66% of cases were detected by those outside of the corporation—the SEC (7%), employees (17%), non-financial market regulatory organizations (13%), the media (13%), auditors (10%), equity holders (3%), and private parties who

---

18. Reports & Publications, FBI, 2009 Financial Crimes Report (Oct. 1, 2008–Sept. 30, 2009), <http://www.fbi.gov/stats-services/publications/financial-crimes-report-2009/>.

19. *Id.* Securities fraud is not limited to these schemes. Other types of securities fraud include insider trading, broker embezzlement, and late-day trading. *Id.*

20. See generally Nicholson, *supra* note 15, at 328–31 (discussing white-collar criminals).

21. See Dyck, Morse & Zingales, *supra* note 12, at 2214.

22. Dyck, Morse, and Zingales relied on data collected by the Stanford Securities Class Action Clearinghouse collection. This database includes all suits filed against U.S. firms for corporate fraud pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934 between 1996–2004. To exclude frivolous cases from the database, Dyck, Morse, and Zingales applied the following six filters: (1) they only included alleged frauds that ended after the Private Securities Litigation Reform Act of 1995 was enacted; (2) only large domestic firms were included; (3) they excluded all cases that were dismissed; (4) for cases that were settled, only those cases that were settled for more than \$3 million were included; (5) for cases that were settled for more than \$3 million, those that seemed to be settled to avoid negative publicity were also eliminated; and (6) only frauds that involved firm management were included. As a result, the study included 216 cases of *alleged* fraud. *Id.* at 2217–18. In order to determine who brought the claim, Dyck, Morse, and Zingales searched Factiva to collect and code data from articles. *Id.* at 2218–21. One bias that was noted was that early detected frauds were not included in the sample since this information was not publicly available. *Id.* at 2224. The main goal of the study, however, was to find "the most effective *external* mechanisms that help *detect* corporate fraud when there is a failure of internal mechanisms." *Id.* The main finding of the study was that detecting fraud often depends on a "wide range of (often improbable) actors." *Id.* at 2251. The study also found that the existing incentives for certain whistleblowers, such as employees, were weak. *Id.* Finally, the authors suggested that monetary incentives might have a significant role in promoting whistle-blowing. *Id.*

23. *Id.* at 2224–25 ("We identify a case as one of *internal* governance when the revealer of fraud is firm management . . . or the board of directors.").

pursued litigation (3%).<sup>24</sup> Therefore, the most important finding of their study<sup>25</sup> is that in most cases, the detection of fraud occurs through “a complex web of market actors that complement each other.”<sup>26</sup> The goal of whistleblower legislation has been to encourage information sharing across this “web,” particularly between insiders and the government. This has been done using a variety of mechanisms, including offering whistleblowers protection from retaliation and monetary incentives.<sup>27</sup>

## II. INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988 (ITSFEA)

The first program that offered financial incentives for informants to the SEC was created by the ITSFEA,<sup>28</sup> and implemented by the SEC in 1989.<sup>29</sup> As discussed below, this statute was enacted in response to the increase of high-profile insider trading cases during the mid-1980s.<sup>30</sup> As such, the program was limited to informants of insider trading.<sup>31</sup> Although it seemed promising when it was first implemented, the program quickly became dormant.<sup>32</sup>

### A. CIRCUMSTANCES THAT LED TO THE CREATION OF THE LAW

The early 1980s were marked by a severe recession that caused economic uncertainty for many.<sup>33</sup> In response to the recession, the White House and Congress enacted policies of deregulation with the hope of spurring the economy.<sup>34</sup> Around the same time, however, several high-profile insider trading scandals, including some involving White House administration officials and some of the most well-known men in the financial industry, came to light.<sup>35</sup> Perhaps the biggest scandal of the decade

24. *Id.* at 2214, 2225.

25. *Id.* at 2251.

26. *Id.*

27. 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, 1153 (2010).

28. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4679 (codified at 15 U.S.C. § 78u-1 (1988)) amended by Dodd-Frank Act, Pub. L. No. 111-203, § 923(2)(B), 124 Stat. 1376, 1849-50 (2010) (codified as amended at 12 U.S.C. § 78u-6 (2010)).

29. See *Applications for Bounty Awards*, *supra* note 12.

30. Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, 82 IND. L.J. 575, 583 (2007).

31. See *Applications for Bounty Awards*, *supra* note 12, at 1964-65.

32. 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, 1165 (1999); SEC, OFFICE OF INSPECTOR GENERAL, No. 474, ASSESSMENT OF THE SEC'S BOUNTY PROGRAM (2010) [hereinafter ASSESSMENT].

33. See Joo, *supra* note 30, at 576.

34. See *id.*

35. *Id.*

involved Ivan Boesky, “a world-class arbitrageur” who used insider information from Dennis Levine, a well-known merger specialist, to profit from corporate takeovers.<sup>36</sup> These scandals caused many to believe that such behavior was commonplace.<sup>37</sup> In response to the scandals, public anxiety about the economy, and perhaps to legitimize itself, Congress passed the ITSFEA.<sup>38</sup>

### B. THE ITSFEA AND THE SEC’S WHISTLEBLOWER PROGRAM FOR INSIDER TRADING

The ITSFEA expanded the scope of the existing laws that regulated insider trading: Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), SEC Rule 10b-5,<sup>39</sup> and the Insider Trading Sanctions Act of 1984.<sup>40</sup> Through this new legislation, the SEC gained the authority to bring claims against controlling persons, create a bounty program for whistleblowers, and cooperate with foreign governmental authorities.<sup>41</sup> The SEC’s authority to pay bounties to whistleblowers was codified by § 21A(e) of the Exchange Act.<sup>42</sup> Under the new law, the SEC could pay a reward to “a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who tipped information to an insider trader, or from a person who directly or indirectly controlled an insider trader.”<sup>43</sup> The SEC was also granted the sole discretion to determine whether to reward the whistleblower with a bounty.<sup>44</sup> If the SEC decided to grant a reward, it could not “exceed 10 percent of the amount recovered from a civil penalty pursuant to a court order.”<sup>45</sup>

---

36. Shah, *supra* note 14, at 797–98. It is rumored that the Gordon Gecko character in Oliver Stone’s movie *Wall Street* (Twentieth Century Fox 1987) was loosely based on Ivan Boesky. Randy James, *Insider Trading*, TIME.COM (Nov. 9, 2009), <http://www.time.com/time/magazine/article/0,9171,1938727,00.html>.

37. See, e.g., *Poll Finds Majority Thinks Insider Trading is Common*, WALL ST. J., June 6, 1986, at 1.

38. Joo, *supra* note 30, at 583–84.

39. See Shah, *supra* note 14, at 793–95.

40. Joo, *supra* note 30, at 578–80. The Insider Trading Sanctions Act increased the penalty, from \$10,000 to \$100,000, that the SEC could receive under the Exchange Act. *Id.* at 578.

41. Shah, *supra* note 14, at 798–99. The law also created duties for broker-dealers and investment advisers to create programs to prevent insider trading. Additionally, criminal penalties were increased, and private rights of action for those who engaged in trades with insider traders were created. *Id.*

42. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4679 (codified at 15 U.S.C. § 78u-1 (1988)) amended by Dodd-Frank Act, Pub. L. No. 111-203, § 923(2)(B), 124 Stat. 1376, 1849–50 (2010) (codified as amended at 12 U.S.C. § 78u-6 (2010)).

43. ASSESSMENT, *supra* note 32, at ii.

44. *Id.*

45. *Id.*

### C. CRITIQUE OF THE SEC'S INSIDER TRADING BOUNTY PROGRAM

After the insider trading bounty program went into effect, the SEC quickly received over twenty-five tips, several of which the “head of the SEC’s enforcement division [described as] . . . ‘helpful, extremely helpful.’”<sup>46</sup> Within a couple of years, however, the optimism for the program declined, and in 1992, the SEC Enforcement Director William McLucas said that the program was unhelpful to SEC’s enforcement.<sup>47</sup> He argued that although the SEC received “a lot of nut letters,” it did little to motivate true informants.<sup>48</sup> To date, the SEC’s bounty program for whistleblowers reporting insider trading has paid out just under \$1.2 million to six complainants, including a \$1 million reward that was paid out in the summer of 2010, right after the Dodd-Frank Act was signed into law.<sup>49</sup>

In its most recent review of the program, the Office of Inspector General of the SEC found that the Agency had received a small number of requests from those seeking a reward.<sup>50</sup> Additionally, the program was unknown to many people, including SEC employees.<sup>51</sup> The report also found that the program was not user-friendly, and the SEC did not have a uniform set of rules in place to determine when and in what amounts bounties should be given.<sup>52</sup> Lastly, the report revealed that the SEC did not follow up with informants regarding their tips, and the files were often not complete and were typically not tracked within the office.<sup>53</sup> Overall, the program was considered unsuccessful.<sup>54</sup>

---

46. Ferziger & Currell, *supra* note 32, at 1165 (citing Gregory A. Robb, *SEC Backs Rewards for Insider Data*, N.Y. TIMES, June 29, 1989, at D1).

47. *Id.*

48. *Id.*

49. ASSESSMENT, *supra* note 32, at 5 (discussing that \$159,537 was paid through the SEC’s insider trading program from its inception until March 2010). Gil Rudawsky, *SEC Pays Informants \$1 Million in Insider-Trading Case*, DAILYFINANCE.COM (July 23, 2010), <http://www.dailyfinance.com/2010/07/23/sec-pays-informants-1-million-in-insider-trading-case/>. The \$1 million reward was paid in an insider trading case against Pequot Capital Management. The case was stalled until Glen Kaiser and Karen Kaiser provided the SEC with emails from Karen Kaiser’s ex-husband, David Zilkha. The emails implied that Zilkha, who was a Microsoft employee who later accepted a job at Pequot, was providing Arthur Samberg, the Chief Executive Officer of Pequot, with insider information about Microsoft. Samberg used information provided by Zilkha to benefit Pequot. The emails from Karen Kaiser provided the link that the SEC was missing. As a result, the case was settled by Pequot and Sambert for \$17 million. *Id.*

50. ASSESSMENT, *supra* note 32, at 4. Interestingly, Ferziger and Currell point out that even without awarding bounties, the SEC still gets tips from informants. From 1985 to 1986, one-third of enforcement actions brought by the SEC were initiated by informants. Ferziger & Currell, *supra* note 32, at 1189.

51. ASSESSMENT, *supra* note 32, at 4. See also Ferziger & Currell, *supra* note 32, at 1161.

52. ASSESSMENT, *supra* note 32, at 4.

53. *Id.*

54. See *id.* See also Ferziger & Currell, *supra* note 32, at 1165.

### III. THE SARBANES-OXLEY ACT OF 2002

Section 806 of SOX created anti-retaliation provisions for employees of a public company who report fraud to the SEC.<sup>55</sup> As discussed below, SOX and § 806 came about after the corporate scandals of 2000 and 2001.<sup>56</sup> The goal of § 806 was to encourage employees of public companies to report information pertaining to fraud to the SEC by offering anti-retaliation protections.<sup>57</sup> Yet, some data shows that since SOX was enacted, the number of employees who reported fraud to the SEC actually decreased.<sup>58</sup> Additionally, many employee claims for retaliation under SOX failed.<sup>59</sup>

#### A. CIRCUMSTANCES THAT LED TO THE CREATION OF THE LAW

During the mid-1990s, changes in communication and information technology contributed to a growing economy, especially in the “dot.com” industry.<sup>60</sup> Nevertheless, “[s]tarting in the second quarter of 2000, the bubble burst,” and the market rapidly declined.<sup>61</sup> As stock prices plummeted and the market unraveled, evidence of fraud at some well-known public corporations was uncovered.<sup>62</sup>

Perhaps the most shocking case of corporate fraud to be uncovered during this time occurred at Enron, “one of the fastest growing U.S. corporations of the 1990s.”<sup>63</sup> Enron used fraudulent accounting practices to hide losses, and as a result, the stock price remained higher than it was worth.<sup>64</sup> Finally, in the third quarter of 2001, Enron reported a \$618 million loss,<sup>65</sup> and by December 2001, the company filed for bankruptcy.<sup>66</sup> As a result, all of Enron’s employees lost their jobs and savings, and investors

---

55. Sarbanes-Oxley Act, Pub. L. No. 107-204, § 806, 116 Stat. 745, 802–04 (2002) (codified at 18 U.S.C. § 1514A (2002)), *amended by* Dodd-Frank Act, Pub. L. No. 111-203, § 922(c)(1)(a)(i), 124 Stat. 1376, 1848 (2010) (codified as amended at 18 U.S.C. § 1514A(b)(2)(D) (2010)).

56. Earle & Madek, *supra* note 12; Ramirez, *supra* note 12, at 196–97.

57. See Kevin Rubinstein, *Internal Whistleblowing and Sarbanes-Oxley Section 806: Balancing the Interests of Employee and Employer*, 52 N.Y.L. SCH. L. REV. 637, 638 (2007/08).

58. Dyck, Morse & Zingales, *supra* note 12, at 2250.

59. See generally Earle & Madek, *supra* note 12, at 20 (discussing whistleblower protection).

60. William H. Donaldson, Chairman, SEC, Testimony before the S. Comm. on Banking, Housing & Urban Affairs: Concerning Implementation of the Sarbanes Oxley Act of 2002 (Sept. 9, 2003), *available at* <http://www.sec.gov/news/testimony/090903tswhd.htm> [hereinafter Donaldson Testimony].

61. *Id.*

62. *Id.*

63. Ramirez, *supra* note 12, at 196.

64. Letter purportedly from Enron employee Sharron Watkins sent to Enron Chairman and CEO Kenneth Lay regarding Enron accounting practices (Aug. 2001), *available at* <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf>. See also Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN’S L. REV. 875, 875–76 (2002).

65. Baynes, *supra* note 64, at 880.

66. *Id.*

lost large sums of money.<sup>67</sup> Then, Sherron Watkins, an employee of Enron, testified at the congressional hearings about the fraudulent accounting practices used by the company and detailed the anonymous letter she wrote to Enron's Chief Executive Officer, warning him of the fraud.<sup>68</sup> Watkins became a national figure, and was named one of Time Magazine's "Persons of the Year [for] 2002" for her courage to "blow the whistle."<sup>69</sup>

Within the next year, other large-scale corporate frauds came to light including those at WorldCom, Adelphia, and Tyco.<sup>70</sup> As a result of these scandals, investor confidence decreased, and the markets dropped.<sup>71</sup> As Mary Kreiner Ramirez, Associate Professor of Law at Washburn University School of Law, notes, "[b]y summer of 2002, the political and economic context as well as political and economic interests demanded action."<sup>72</sup> Congress put its attention toward creating legislation to once again increase confidence in the financial markets by improving financial reporting and protections for whistleblowers.<sup>73</sup> After receiving overwhelming support by Congress, President George W. Bush signed SOX into law on July 30, 2002.<sup>74</sup>

## B. SOX AND § 806 WHISTLEBLOWER PROVISIONS

SOX is a comprehensive law that led to changes in corporate responsibility, enhanced financial disclosures,<sup>75</sup> and "expanded criminal jurisdiction and penalties."<sup>76</sup> Additionally, § 806 bolstered protections for employees of public companies who blow the whistle on corporate fraud.<sup>77</sup> Pursuant to this section, an employer may not "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment" because the employee provided the SEC with information that he reasonably thought to be fraudulent

---

67. Nicholson, *supra* note 15, at 322.

68. Baynes, *supra* note 64, at 877-78.

69. Richard Lacayo & Amanda Ripley, *Persons of the Year 2002: The Whistleblowers*, TIME.COM (Dec. 30, 2002), <http://www.time.com/time/magazine/article/0,9171,1003998,00.html>. The article also named two other famed whistleblowers, Cynthia Cooper, who was an internal auditor at WorldCom, and Colleen Rowley of the FBI. *Id.*

70. See Donaldson Testimony, *supra* note 60.

71. *Federal Reserve's Second Monetary Policy Report for 2002: Hearing Before the Comm. on Banking, Housing & Urban Affairs*, 107th Cong. 8 (2002) (statement of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.), available at <http://www.federalreserve.gov/boarddocs/hh/2002/july.testimony.htm>.

72. See Ramirez, *supra* note 12, at 196-97.

73. Earle & Madek, *supra* note 12, at 2-4.

74. *Id.* at 4.

75. Donaldson Testimony, *supra* note 60.

76. Ramirez, *supra* note 12, at 197.

77. Sarbanes-Oxley Act, Pub. L. No. 107-204, § 806, 116 Stat. 745, 802-04 (2002) (codified at 18 U.S.C. § 1514A (2002)), amended by Dodd-Frank Act, Pub. L. No. 111-203, § 922(c)(1)(a)(i), 124 Stat. 1376, 1848 (2010) (codified as amended at 18 U.S.C. § 1514A(b)(2)(D) (2010)).

behavior by the employer.<sup>78</sup> Under § 806, an employee who was adversely treated by an employer only had “90 days after the date on which the violation occur[ed]” to “fil[e] a complaint with the Secretary of Labor.”<sup>79</sup> Since the law was enacted, the Department of Labor delegated the review of such claims to the Occupational Safety and Health Administration (OSHA).<sup>80</sup> If the claimant does not receive a decision within 180 days, he or she can bring the claim to a U.S. federal district court for de novo review.<sup>81</sup> The remedy for such action can include reinstatement, back pay with interest, and compensation for fees incurred because of the discrimination.<sup>82</sup>

### C. CRITIQUE OF § 806 OF SOX

Initially, the whistleblower protections provided by § 806 of SOX were praised.<sup>83</sup> Within three years, however, many were criticizing the law for not protecting whistleblowers as expected.<sup>84</sup> In their study, Dyck, Morse, and Zingales noticed that after SOX was enacted, although there was an increase in fraud detection among auditors, as well as an increase in SEC interventions,<sup>85</sup> the rate of whistle-blowing by employees dropped from 18% to 13%.<sup>86</sup> Furthermore, other studies found that very few of the employees who filed claims for retaliation with the Department of Labor had been successful.<sup>87</sup>

There have been a few reasons given as to why SOX did not encourage or protect whistleblowers as expected.<sup>88</sup> Some believe that the anti-retaliation measures did not provide a strong enough incentive for people to report fraud and risk their careers.<sup>89</sup> Others have argued that the procedural

---

78. *Id.*

79. *Id.*

80. Secretary’s Order 5-2002; Delegation of Authority and Assignment of Responsibility to the Assistant Secretary for Occupational Safety and Health, 67 Fed. Reg. 65,008 (Oct. 22, 2002).

81. Sarbanes-Oxley Act § 806, 116 Stat. 803 (codified at 18 U.S.C. § 1514A(b)(1)(B)), amended by Dodd-Frank Act § 922(c)(1)(a)(i), 124 Stat. 1848 (codified as amended at 18 U.S.C. §§ 1514A(b)(2)(D)).

82. *Id.* § 803–04 (codified at 18 U.S.C. § 1514A(b)(1)(C)) amended by Dodd-Frank Act § 922(c)(1)(a)(i), 124 Stat. 1848 (codified as amended at 18 U.S.C. §§ 1514A(b)(2)(D)).

83. See, e.g., Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 68 (2007).

84. *Id.* at 67; Jisoo Kim, Comment, *Confessions of a Whistleblower: The Need to Reform the Whistleblower Provision of the Sarbanes-Oxley Act*, 43 J. MARSHALL L. REV. 241, 250–51 (2009).

85. Dyck, Morse & Zingales, *supra* note 12, at 2249–50.

86. *Id.* at 2250.

87. See Moberly, *supra* note 83, at 90–100; Earle & Madek, *supra* note 12, at 20–23.

88. See Dyck, Morse & Zingales, *supra* note 12, at 2250–51 (suggesting that anti-retaliation provisions of SOX should be enhanced by including financial incentives); Kim, *supra* note 84, at 251 (arguing that the ninety-day statute of limitations to bring an anti-retaliation claim was not a long enough timeframe); Ramirez, *supra* note 12, at 211 (noting that “[p]ractitioners observe that both the investigators and supervisors lack disposition, training, and experience to adequately assess [SOX] claims because they are outside their area of competence”).

89. Dyck, Morse & Zingales, *supra* note 12, at 2250–51.

requirements for anti-retaliation claims—especially the ninety-day statute of limitations—were too stringent.<sup>90</sup> Finally, some believe that OSHA’s inexperience in assessing securities fraud claims<sup>91</sup> made the process long and at times, wasteful.<sup>92</sup> Overall, § 806 of SOX has not received good reviews.

#### IV. THE DODD-FRANK ACT OF 2010

##### A. CIRCUMSTANCES LEADING UP TO THE NEW LAW

Beginning in 2001, extremely low mortgage rates led to a “record-setting level of home sales,” and there was a general improvement in the economy.<sup>93</sup> By 2005, the housing market was still strong, but signs of an impending decline in the market were starting to surface.<sup>94</sup> During the second half of 2006, and throughout 2007, foreclosure rates soared.<sup>95</sup> Many of these foreclosures were on subprime mortgages,<sup>96</sup> which had been repackaged into mortgage-backed securities,<sup>97</sup> causing the problem to spread to the financial sector and credit markets.<sup>98</sup> As a result, Lehman Brothers and American International Group, two of Wall Street’s best known and oldest institutions, went bankrupt in September 2008.<sup>99</sup> Upon

---

90. See Kim, *supra* note 84, at 251.

91. *Id.* at 253–54. In order to determine whether the retaliation claim is valid, OSHA has to first determine whether the employee had a reasonable belief that the employer was committing fraud, which requires a thorough understanding of securities fraud. *Id.* See also Ramirez, *supra* note 12, at 210–11.

92. Kim, *supra* note 84, at 253–54.

93. See Kathleen Madigan with Christopher Palmieri, Ann Therese Palmer & Dean Foust, *After the Housing Boom: What the Coming Slowdown Means for the Economy – and You*, BUSINESS WEEK, Apr. 11, 2005, at 78–86; Ryan Barnes, *The Fuel that Fed the Subprime Meltdown*, INVESTOPEDIA.COM (Sept. 4, 2007), <http://www.investopedia.com/articles/07/subprime-overview.asp#axzz1WeUpdh2T>.

94. See Madigan et al., *supra* note 93.

95. See Barnes, *supra* note 93.

96. Subprime loans carry a higher rate of interest than prime loans, and are often issued to borrowers with less than ideal credit histories in order to compensate for the higher risk of default. *Subprime Lending*, DEPT. OF HOUSING & URBAN DEV., [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/fair\\_housing\\_equal\\_opp/lending/subprime](http://portal.hud.gov/hudportal/HUD?src=/program_offices/fair_housing_equal_opp/lending/subprime) (last visited Aug. 31, 2011).

97. Mortgage-backed securities have been defined as:

[D]ebt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

*Mortgage-Backed Securities*, SEC, <http://www.sec.gov/answers/mortgagesecurities.htm> (last modified July 23, 2010).

98. See *Housing Woes Take Bigger Toll on Economy than Expected: Paulson*, AFP (Oct. 16, 2007), <http://afp.google.com/article/ALeqM5hWSjWmGJ4YXTh3PM5kOC7csTT48g>.

99. See Robert Gavin, *Historic Bailout, Looming Questions; Can America Afford It? Some See Cost Over \$1 Trillion; Others Predict Much Less*, BOSTON GLOBE, Sept. 21, 2008, at A.1.

learning of these bankruptcies, other financial firms became weary of lending to one another, bringing the credit markets to a near halt.<sup>100</sup> To get the credit and financial markets back to normal, the federal government bought around \$700 billion of the troubled mortgage securities.<sup>101</sup>

Like the recessions previously mentioned, during this most recent recession, many frauds were revealed.<sup>102</sup> Bernie Madoff was arrested on December 11, 2008,<sup>103</sup> a day after he confessed to his sons that he had been running a massive Ponzi scheme for years.<sup>104</sup> Six months later, Allen Stanford, a well-known Texas financier, was also arrested for allegedly running an \$8 billion fraud that consisted of selling certificates of deposit through his Antigua bank.<sup>105</sup> Investors were told that their money was placed in financial instruments monitored by twenty analysts and audited by the Antigua regulators; however, the money was put in a portfolio that was managed by Stanford and the Chief Financial Officer of the company.<sup>106</sup> The portfolio invested mainly in private equity and real estate.<sup>107</sup>

When people began to feel the effects of the subprime mortgage crisis throughout the country, and news of these frauds spread, the American public was once again anxious and angry.<sup>108</sup> Congress held hearings regarding the financial crisis<sup>109</sup> and Madoff's Ponzi scheme,<sup>110</sup> as many called for reform of the financial markets and the SEC.<sup>111</sup> As a result, the Dodd-Frank Act was signed into law by President Obama on July 21, 2010, with the intent of providing financial stability to the capital markets.<sup>112</sup>

## B. THE DODD-FRANK ACT AND § 922 WHISTLEBLOWER PROVISIONS

Section 922 of the Dodd-Frank Act expands the previous whistleblower protections and incentives for those who report corporate or securities fraud to the SEC.<sup>113</sup> Under the new law, whistleblowers who provide the SEC with "original information" that leads to a recovery exceeding \$1 million

---

100. *See id.*

101. *See id.*

102. *See Madoff Hearing, supra* note 4, at 2.

103. *United States v. Madoff*, 586 F. Supp. 2d 240, 244, 244 n.1 (S.D.N.Y. 2009).

104. *See Efrati et al., supra* note 3.

105. *See* Laurel Brubaker Calkins & Andrew M. Harris, *Stanford Arrested by FBI Outside Girlfriend's Home (Update 3)*, BLOOMBERG, June 19, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arjf3pKnYGx8>.

106. *See id.*

107. *See id.*

108. *See Top Bankers Face Grilling by Dubious Congress*, MSNBC.COM (Feb. 11, 2009), [http://www.msnbc.msn.com/id/29134559/ns/business-economy\\_at\\_a\\_crossroads](http://www.msnbc.msn.com/id/29134559/ns/business-economy_at_a_crossroads).

109. *See id.*

110. *See generally Madoff Hearing, supra* note 4.

111. *See* Timothy Geithner & Lawrence Summers, *A New Financial Foundation*, WASH. POST, June 15, 2009, at A.15.

112. Remarks, *supra* note 10.

113. Dodd-Frank Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841-49 (2010) (codified at 15 U.S.C. § 78u-6 (2010)).

can receive a reward of 10–30 percent of the recovery.<sup>114</sup> The law defines “original information” as information that:

(A) is derived from the independent knowledge or analysis of a whistleblower; (B) is not known to the [SEC] from any other source, unless the whistleblower is the original source of the information; and (C) is 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, unless the whistleblower is a source of the information.<sup>115</sup>

The SEC has the sole discretion of how much the whistleblower should receive<sup>116</sup> depending on the information provided,<sup>117</sup> the degree of help provided by the whistleblower,<sup>118</sup> the SEC’s interest in deterring violations of securities law,<sup>119</sup> and any other relevant information the SEC decides to establish.<sup>120</sup> A whistleblower may appeal the SEC’s decision to not grant an award to a U.S. court of appeals within thirty days after the SEC issues its decision.<sup>121</sup>

If the whistleblower anonymously submits information and anonymously makes a claim for a reward, he or she must be represented by an attorney.<sup>122</sup> Before the reward is given, however, a whistleblower must disclose his identity and any other information necessary to the SEC.<sup>123</sup> All rewards will be paid from the Investor Protection Fund,<sup>124</sup> which has been established in the U.S. Treasury.<sup>125</sup>

In addition to the financial incentives, the new law also strengthens the anti-retaliation provisions of SOX.<sup>126</sup> An employee who believes he or she has been retaliated against can bring the suit straight to a U.S. district court.<sup>127</sup> Additionally, the statute of limitations to bring a claim is now six years from the date of the violation,<sup>128</sup> or three years after the employee knew or should have known the material facts relating to the violation.<sup>129</sup>

Any member of the SEC, a relevant regulatory agency, the Department of Justice, a self-regulatory organization, the Public Company Accounting

---

114. *Id.* § 922(a)(1) & (b)(1).

115. *Id.* § 922(a)(3).

116. *Id.* § 922(c)(1)(A).

117. *Id.* § 922(c)(1)(B)(i)(I).

118. *Id.* § 922(c)(1)(B)(i)(II).

119. *Id.* § 922(c)(1)(B)(i)(III).

120. *Id.* § 922(c)(1)(B)(i)(IV).

121. *Id.* § 922(f).

122. *Id.* § 922(d)(2)(A).

123. *Id.* § 922(d)(2)(B).

124. *Id.* § 922(g)(2)(A).

125. *Id.* § 922(g)(1).

126. *Id.* § 922(h)(1).

127. *Id.* § 922(h)(1)(B)(i).

128. *Id.* § 922(h)(1)(B)(iii)(1)(aa).

129. *Id.* § 922(h)(1)(B)(iii)(1)(bb).

Oversight Board, or a law enforcement organization is not eligible for the reward.<sup>130</sup> Additionally, a person who is convicted of a crime in relation to the tip given is ineligible for a reward.<sup>131</sup> Furthermore, a whistleblower who knowingly and willfully provides false information to the SEC will not receive the reward.<sup>132</sup>

Finally, the new law also requires the SEC to submit a report to the Senate Committee on Banking, Housing, and Urban Affairs, and the House of Representatives Committee on Financial Services regarding the whistleblower program.<sup>133</sup> The report must include how many awards were granted and the types of cases for which the awards were granted for each year,<sup>134</sup> among other disclosures.<sup>135</sup> As a result of the new whistleblower provisions, the insider trading bounty program has been rescinded.<sup>136</sup>

## V. REACTIVE ENFORCEMENT

As demonstrated above, the pattern seems to be that when a recession occurs, fraud is uncovered,<sup>137</sup> which costs investors and angers the general public.<sup>138</sup> Reform is usually demanded, and Congress answers with more legislation,<sup>139</sup> which has included programs to incentivize and protect whistleblowers of insider trading and corporate and securities fraud.<sup>140</sup> When the market improves, however, the government and regulators seem to become more complacent and often fail at protecting investors.<sup>141</sup> Adam Pritchard, Professor at the University of Michigan Law School, has noted that “[t]his political cycling between policies of benign neglect and hysterical overreaction suggests that the SEC, far from serving as a shelter

---

130. *Id.* § 922(c)(2)(A).

131. *Id.* § 922(c)(2)(B).

132. *Id.* § 922(c)(2)(D).

133. *Id.* § 922(g)(5).

134. *Id.* § 922(g)(5)(A).

135. The report must also include information regarding the Investor Protection Fund, created by the Dodd-Frank Act and used to fund the activities of the Inspector General of the SEC and pay out whistleblower rewards. *Id.* § 922(g)(5)(B)–(G).

136. Rescission of Rules Pertaining to the Payment of Bounties for Information Leading to the Recovery of Civil Penalties for Insider Trading, 75 Fed. Reg. 57,384 (Sept. 21, 2010) (to be codified at 17 C.F.R. pt. 201).

137. See A.C. Pritchard, *The SEC at 70: Time For Retirement?*, 80 NOTRE DAME L. REV. 1073, 1078 (2005); see also *Madoff Hearing*, *supra* note 4, at 2.

138. See Pritchard, *supra* note 137, at 1078. See also Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 10–11 (2002).

139. See Pritchard, *supra* note 137, at 1078; see also Ribstein, *supra* note 138, at 11.

140. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4679 (codified at 15 U.S.C. § 78u-1 (1988)) amended by Dodd-Frank Act, Pub. L. No. 111-203, § 923(2)(B), 124 Stat. 1376, 1849–50 (2010) (codified as amended at 15 U.S.C. § 78u-6 (2010)); Sarbanes-Oxley Act, Pub. L. No. 107-204, § 806, 116 Stat. 745, 802–04 (2002) (codified at 18 U.S.C. § 1514A (2002)).

141. See Pritchard, *supra* note 137, at 1078.

against the vagaries of the political winds, acts more like a weathervane, swinging wildly with change in the political atmosphere.”<sup>142</sup>

Pritchard believes that the SEC, because of its status as an independent agency, is very susceptible “to the political whims of [Congress],” leading to less effective policies.<sup>143</sup> Additionally, both Stephen Choi, Professor of Law at New York University Law School, and Pritchard note that reactive regulation is not only subjected to political opportunism, but is also subject to “[a]vailability and [h]indsight [b]iases.”<sup>144</sup> In other words, both Congress and the SEC rely too heavily on recent events, and “place too much weight on the probability of past events that actually occurred relative to those that did not.”<sup>145</sup> Therefore, legislating in reaction to a crisis is not the ideal.<sup>146</sup> Reactive legislation leads to ineffective, and at times, costly policy changes.<sup>147</sup>

## VI. WERE THE NEW FINANCIAL INCENTIVES AND EXPANDED ANTI-RETALIATION PROTECTIONS FOR WHISTLEBLOWERS NECESSARY?

The new whistleblower provisions are very broad, but it seems that Congress has incorporated into the law what many believed was lacking in the prior programs.<sup>148</sup> First, the new program offers a large financial incentive for any type of corporate or securities fraud reported that leads to at least a \$1 million fine.<sup>149</sup> This is an expansion of the insider trading bounty program and requires that the minimum reward be 10 percent of the recovery,<sup>150</sup> as compared to the previous maximum of 10 percent.<sup>151</sup> Additionally, the new anti-retaliation provisions include a longer statute of limitations, which can now be filed directly in federal court, rather than with OSHA.<sup>152</sup> Because of the increase in incentive to report and protection after reporting, the SEC has reported that many tips have already been

142. *Id.* at 1083. *See also* Joan MacLeod Heminway, *Reframing and Reforming the Securities and Exchange Commission: Lessons from Literature on Change Leadership*, 55 *VILL. L. REV.* 627, 627 (2010).

143. Pritchard, *supra* note 137, at 1076.

144. Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 *LEWIS & CLARK L. REV.* 85, 123 (2006).

145. Pritchard, *supra* note 137, at 1079.

146. *Id.* at 1081. *See also* Heminway, *supra* note 142, at 627.

147. *See* Pritchard, *supra* note 137, at 1081. *See also* Heminway, *supra* note 142, at 627.

148. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841-49 (2010) (codified at 15 U.S.C. § 78u-6 (2010)); Feldman & Lobel, *supra* note 27; Dyck, Morse & Zingales, *supra* note 12, at 2251; Earle & Madek, *supra* note 12; Ramirez, *supra* note 12, at 208-13, 217-18.

149. Dodd-Frank Act § 922, 124 Stat. 1841-49 (codified at 15 U.S.C. § 78u-6).

150. *Id.*

151. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4679 (codified at 15 U.S.C. § 78u-1 (1988)) *amended by* Dodd-Frank Act § 923(2)(B), 124 Stat. 1849-50 (codified as amended at 15 U.S.C. § 78u-6).

152. Dodd-Frank Act § 922(c)(1)(A)(i), 124 Stat. 1848 (codified at 18 U.S.C. § 1514(b)(3)(D)).

received.<sup>153</sup> Therefore, the new whistleblower provisions seem to address the criticism that previous laws were not broad enough. But were they actually necessary?

It has been suggested that previous whistleblower laws did not offer enough incentives and anti-retaliation protections for people to come forward with information.<sup>154</sup> Yet, prior to the passage of the Dodd-Frank Act, it was not unusual for the SEC to receive about 1,000 tips from informants per day.<sup>155</sup> Although many of these tips were frivolous, some were not. People were willing to report fraud without financial incentives from the SEC.<sup>156</sup> Specifically, Markopolos gave a twenty-one page detailed account of why Madoff was likely conducting a Ponzi scheme.<sup>157</sup> He said that he gave the SEC all they needed to know, but the Agency ignored him.<sup>158</sup> Although Markopolos's information spurred an investigation, the SEC investigators concluded that Madoff's business was legitimate.<sup>159</sup> Likewise, the SEC had leads regarding Stanford's Ponzi scheme, but did not investigate them thoroughly.<sup>160</sup> Therefore, it seems like the failure to catch these frauds did not lie with the lack of tips received by the SEC, but rather with the SEC itself.<sup>161</sup>

#### A. PROBLEMS WITHIN THE SEC

Over the past few years there have been articles written describing internal problems of the SEC that hinder its ability to detect fraud.<sup>162</sup> Some believe that the SEC is too influenced by the financial industry.<sup>163</sup> Others believe that the SEC failed to detect fraud because it was lacking good procedures and experienced investigators.<sup>164</sup> Yet some, including the SEC itself, believe that the Agency's failures are due to underfunding and

---

153. See Jessica Holzer & Fawn Johnson, *Larger Bounties Spur Surge in Fraud Tips*, WALL ST. J., Sept. 7, 2010, at C.3.

154. See Dyck, Morse & Zingales, *supra* note 12, at 2250–51; Earle & Madek, *supra* note 12; Ramirez, *supra* note 12, at 219–20.

155. Bruce Carton, *Details Emerge on SEC Office of Market Intelligence*, COMPLIANCEWEEK.COM (Feb. 9, 2010), <http://www.complianceweek.com/Article/5789/details-emerge-on-sec-office-of-market-intelligence>.

156. *Id.*

157. *Madoff Hearing*, *supra* note 4, at 116.

158. See *id.* at 5.

159. See H.R., COMM. ON OVERSIGHT & GOV'T REFORM, MINORITY STAFF REPORT-THE SEC: DESIGNED FOR FAILURE 5 (2010) [hereinafter MINORITY STAFF REPORT].

160. See SEC, OFFICE OF INSPECTOR GENERAL, No. OIG-526, INVESTIGATION OF THE SEC'S RESPONSE TO CONCERNS REGARDING ROBERT ALLEN STANFORD'S ALLEGED PONZI SCHEME 1 (2010) [hereinafter STANFORD INVESTIGATION].

161. See MINORITY STAFF REPORT, *supra* note 159, at 1–2.

162. See Heminway, *supra* note 142, at 627–28; Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 785–86 (2009); Pritchard, *supra* note 137, at 1077–92.

163. See Pritchard, *supra* note 137, at 1089–91.

164. See *Madoff Hearing*, *supra* note 4, at 5. See MINORITY STAFF REPORT, *supra* note 159, at 5–6.

understaffing.<sup>165</sup> Finally, others believe that the SEC's lack of technology for reviewing all the data it receives has contributed to its inability to detect fraud.<sup>166</sup>

### 1. Regulatory Capture

Regulatory capture occurs when a regulatory agency that was created to act in the public's interest begins to act in ways that are more beneficial to the industry it is supposed to be regulating.<sup>167</sup> Despite being an independent agency, there is evidence that the SEC has been influenced by industry lobbyists, especially during a bull market.<sup>168</sup> Pritchard argues that this influence has led to regulations which benefit the bigger players and names in the securities markets.<sup>169</sup> In addition to being influenced by the industry through the political process, there has been a revolving door between the Agency and the private sector, as many people who worked for the SEC have left to work in the private financial industry.<sup>170</sup>

Evidence of this regulatory capture can be seen in both the Madoff and Stanford cases. There have been suggestions that the SEC did not thoroughly investigate Madoff because of his prominence in the industry.<sup>171</sup> Additionally, the SEC's Inspector General's report on Stanford revealed that although examiners found red flags and suggested opening an investigation, top officials decided to stop investigating Stanford on numerous occasions.<sup>172</sup> A head enforcement agent that was instrumental in those decisions later left the Agency and tried to represent Stanford three times.<sup>173</sup> Therefore, it seems that interactions between the SEC's employees and those in the private financial sector can at times inhibit the Agency's ability to detect fraud.

### 2. Procedural and Policy Problems

Prior to the SEC reforms that began in early 2010, the SEC did not have a streamlined system in place for receiving and investigating tips.<sup>174</sup> Because of this disarrayed system and the increasing number of tips the Agency was receiving, it was harder for the Agency to distinguish the

---

165. See MINORITY STAFF REPORT, *supra* note 159, at 18; Michael Schroeder, *SEC Gets a Raise, But Will It Be Enough?*, WALL ST. J., Aug. 12, 2002, at C.1.

166. See MINORITY STAFF REPORT, *supra* note 159, at 11–14.

167. See generally Pritchard, *supra* note 137, at 1079–92.

168. *Id.* at 1090.

169. *Id.* at 1089–92.

170. Tom McGinty, *SEC 'Revolving Door' Under Review – Staffers Who Join Companies They Once Regulated Draw Lawmakers' Ire; Ms. King and Getco*, WALL ST. J., June 16, 2010, at C.1.

171. *Madoff Hearing*, *supra* note 4, at 7.

172. STANFORD INVESTIGATION, *supra* note 160, at 16.

173. *Id.* at 27.

174. See Carton, *supra* note 155.

legitimate from the frivolous.<sup>175</sup> Furthermore, the SEC had a policy that evaluated the enforcement division by the number of cases it filed rather than the quality and complexity of the fraud it detected.<sup>176</sup>

When the SEC's Inspector General conducted an investigation of the SEC's Division of Enforcement and its failure to detect Madoff's Ponzi scheme, it found many systematic issues related to the lack of guidance on how to properly and completely analyze tips.<sup>177</sup> Additionally, the Inspector General's report on Stanford found that top SEC officials in the Agency's Fort Worth office often avoided complex cases, like Stanford, and instead focused on smaller and easier cases.<sup>178</sup> This was done to improve their "stats" since the heads of the Agency in Washington judged the regional offices by the number of cases brought.<sup>179</sup> As a result, the Agency's lack of review procedures for tips, as well as its focus on the quantity rather than the complexity of cases, has played a role in its failure to detect the Madoff and Stanford frauds.

### 3. Lack of Experienced Employees Who Understand Capital Markets

The SEC has been criticized for being dominated by lawyers.<sup>180</sup> Although lawyers are necessary to interpret and enforce securities laws and the SEC rules, lawyers tend to be bad managers.<sup>181</sup> Poor management was one of the reasons that the SEC failed to detect Madoff's Ponzi scheme.<sup>182</sup> Additionally, lawyers often do not have a strong financial industry background.<sup>183</sup> As financial instruments become more complex, so does investigating for fraud; therefore, those with expertise in the financial markets might prove to be better at fraud detection.<sup>184</sup> Furthermore, in his report regarding the SEC's failure to uncover Madoff's Ponzi scheme, the SEC's Inspector General noted that the SEC's examinations of Madoff's business were often conducted by teams of inexperienced staff members.<sup>185</sup> Specifically, the report says that the inexperienced staff during one examination "failed to appreciate the significance of the evidence in [Markopolos's] complaint," and they were "confused about certain critical

---

175. *See id.*

176. *See* STANFORD INVESTIGATION, *supra* note 160, at 17.

177. *See* SEC, OFFICE OF INSPECTOR GENERAL, No. OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, 20-42 (2009) [hereinafter MADOFF INVESTIGATION].

178. *See* STANFORD INVESTIGATION, *supra* note 160, at 17.

179. *See id.*

180. *See* MINORITY STAFF REPORT, *supra* note 159, at 1.

181. *See id.*

182. *See id.*

183. *See* MINORITY STAFF REPORT, *supra* note 159, at 1; *Madoff Hearing*, *supra* note 4, at 14.

184. *See Madoff Hearing*, *supra* note 4, at 14.

185. *See* MADOFF INVESTIGATION, *supra* note 177, at 23-24, 36, 237-46.

and fundamental aspects of Madoff's operation."<sup>186</sup> It will be very difficult, and even impossible, for people to detect fraud if they do not have a basic understanding of the business models and industry that they are investigating.<sup>187</sup>

#### 4. Understaffed and Underfunded

Another problem, usually cited by the SEC, is that the Agency has been understaffed and underfunded.<sup>188</sup> Some refute this argument noting that the SEC's budget has tripled between 2000 and 2010, and yet its problems remain.<sup>189</sup> Without enough financial resources, the SEC cannot hire as many people as necessary to regulate the growing financial industry.<sup>190</sup> Additionally, it has trouble retaining more experienced people, as many of its employees often leave to go work in the private sector where the salaries are better.<sup>191</sup>

#### 5. Lack of Technology

The SEC collects a great amount of disclosure data from companies in order to make sure the companies are complying with the law and not defrauding investors.<sup>192</sup> While the amount of information received by the SEC has increased in recent years, the Agency's information technology has not improved to meet the Agency's needs.<sup>193</sup> Although many in the private sector use risk-monitoring software to screen documents for errors, note year-to-year changes, and calculate important financial ratios, the SEC employs many people to review documents manually.<sup>194</sup> This is a timely procedure, and as a result, the SEC does not have the ability to do an industry-wide data analysis.<sup>195</sup> Accordingly, the SEC has become reliant on external sources such as tips, complaints, and news stories.<sup>196</sup> As mentioned above, however, the process for reviewing tips has also been problematic.<sup>197</sup>

---

186. *Id.* at 24.

187. See MINORITY STAFF REPORT, *supra* note 159, at 1; STANFORD INVESTIGATION, *supra* note 160, at 16.

188. Schroeder, *supra* note 165.

189. See MINORITY STAFF REPORT, *supra* note 159, at 1.

190. Schroeder, *supra* note 165.

191. See McGinty, *supra* note 170; Michael Lewis & David Einhorn, Op-Ed, *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 4, 2009, at WK.10.

192. See MINORITY STAFF REPORT, *supra* note 159, at 11–12.

193. See *id.* at 12.

194. See *id.*

195. See *id.* at 13.

196. See *id.*

197. See Carton, *supra* note 155.

### B. DO THE NEW WHISTLEBLOWER PROVISIONS ADDRESS THE AFOREMENTIONED PROBLEMS?

It seems that the reason the SEC was unable to detect Madoff's and Stanford's Ponzi schemes was due to policy and operations problems within the Agency, and not because the Agency lacked information and tips regarding the fraud. The SEC was already undergoing internal reforms, setting better procedures for investigating tips, and training employees.<sup>198</sup> Why then, would the SEC and Congress create a whistleblower program that offers very high financial incentives and anti-retaliation protections? It seems that it might have been another instance of Congress feeling that it must do something in the face of public anger.<sup>199</sup>

Although the new financial incentives may increase the number of tips the SEC receives,<sup>200</sup> there is no guarantee that they will receive quality information.<sup>201</sup> The increase in tips may overwhelm the SEC, as more resources will have to be expended on sifting through the increasing number of claims and trying to determine which are legitimate.<sup>202</sup> Also, before the financial incentives were offered, those who reviewed tips in the Agency were sometimes skeptical of the information.<sup>203</sup> Now that there are financial incentives, this skepticism may heighten. As has happened in the past at the SEC, more tips may prove to be a burden rather than helpful information.<sup>204</sup>

### VII. A MORE PRUDENT AND PROACTIVE APPROACH

Reforms were undoubtedly needed within the SEC's Division of Enforcement, especially in relation to the investigation of whistleblower

---

198. See SEC, OFFICE OF INSPECTOR GENERAL, No.467, PROGRAM IMPROVEMENTS NEEDED WITHIN THE SEC'S DIVISION OF ENFORCEMENT 3 (2009) [hereinafter PROGRAM IMPROVEMENTS].

199. See Heminway, *supra* note 142, at 628; Pritchard, *supra* note 137, at 1078; Ribstein, *supra* note 138, at 11.

200. See Feldman & Lobel, *supra* note 27, at 1202; Bruce Carton, *Pitfalls Emerge in Dodd-Frank Bounty Provision*, SECURITIESDOCKET.COM (Sept. 9, 2010, 3:37 PM), <http://www.securitiesdocket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision/>; Holzer & Johnson, *supra* note 153 (noting a surge in fraud tips made to the SEC in the months after the Dodd-Frank Act was passed).

201. See Ferziger & Currell, *supra* note 32, at 1165 (discussing how the Insider Trading Bounty Program was promising, but ultimately attracted mainly frivolous tips); Holzer & Johnson, *supra* note 153 (noting that Stephen Cohen, an SEC official, states that the SEC has received "very high-quality tips" in the months following the passage of the Dodd-Frank Act, but also noting concerns that the new whistleblower program will cause frivolous cases).

202. See Carton, *supra* note 200.

203. See MADOFF INVESTIGATION, *supra* note 177, at 36 (noting that the enforcement staff dismissed Markopolos's tip because he was a competitor of Madoff and they thought he "was looking for a bounty").

204. See Ferziger & Currell, *supra* note 32, at 1165.

complaints.<sup>205</sup> Yet, rather than creating large financial incentives and anti-retaliation provisions for whistleblowers, the SEC should have focused on making smaller, internal changes. Additionally, the SEC should consider taking a more proactive approach by enhancing its information technology, creating a database of all the information it receives from companies, and conducting industry-wide data analyses rather than increasing its reliance on whistleblowers to provide the Agency with leads.<sup>206</sup>

#### A. PRUDENT REFORMS REGARDING WHISTLEBLOWER TIPS

The SEC recognized the need to make internal changes before the passage of the Dodd-Frank Act.<sup>207</sup> In January 2010, the Agency announced it would be creating an Office of Market Inspection within the Division of Enforcement, which would deal solely with investigating the hundreds of thousands of tips the Agency receives each year.<sup>208</sup> Perhaps it would have been better to give the SEC time to get the new office and procedures in place before offering financial incentives that could greatly increase the amount of tips received.

Furthermore, the SEC should have been given the power to pay bounties to whistleblowers who provide information that leads to successful enforcement. Rather than creating a new mandatory payment of 10–30 percent of a settlement, perhaps the Insider Trading Bounty Program, which gave the SEC discretion to reward an informant up to 10 percent of a settlement,<sup>209</sup> could have been extended to all informants. Although this program has been considered a failure, its failure seemed to be due to the fact that very few people knew about it and that the SEC rarely rewarded informants.<sup>210</sup> Therefore, the SEC could address these problems by publicizing the reward program and rewarding informants when they provided helpful information. Additionally, requiring an annual report on the program from the SEC to congressional committees, as the Dodd-Frank Act does,<sup>211</sup> is a good way for Congress to make sure that the program is being utilized.

---

205. See MINORITY STAFF REPORT, *supra* note 159, at 5–7 (discussing the failure of the SEC to properly investigate complaints against Madoff); STANFORD INVESTIGATION, *supra* note 160, at 16 (discussing the failure of the SEC to properly investigate complaints against Stanford); ASSESSMENT, *supra* note 32, at iii (noting the SEC's weaknesses in reviewing tips pursuant to the Insider Trading Bounty Program).

206. See MINORITY STAFF REPORT, *supra* note 159, at 13–14.

207. See PROGRAM IMPROVEMENTS, *supra* note 198, at 3.

208. See Carton, *supra* note 155.

209. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4679 (codified at 15 U.S.C. § 78u-1 (1988)) amended by Dodd-Frank Act, Pub. L. No. 111-203, § 923(2)(B), 124 Stat. 1376, 1849–50 (2010) (codified as amended at 12 U.S.C. § 78u-6 (2010)).

210. See ASSESSMENT, *supra* note 32, at 6–7.

211. Dodd-Frank Act § 922, 124 Stat. 1845 (codified at 15 U.S.C. § 78u-6).

Moreover, the SEC's Division of Enforcement should try to attract employees who are experienced with investigating securities fraud,<sup>212</sup> and who have knowledge of the capital markets.<sup>213</sup> Competitive salaries will help attract employees of high caliber, and may even help close the revolving door between the Agency and the financial industry.<sup>214</sup> This would make the Agency more independent and less susceptible to industry capture.<sup>215</sup> Likewise, the Agency should offer incentive bonuses to those in the Division of Enforcement when they are instrumental in detecting fraud and getting a settlement.<sup>216</sup>

### B. A MORE PROACTIVE APPROACH

While whistleblowers undoubtedly play an important part in detecting fraud,<sup>217</sup> the SEC should not become too reliant on tips from outsiders.<sup>218</sup> The Agency should try to implement more proactive measures for detecting fraud.<sup>219</sup> The SEC should update its information technology and streamline its systems so that all of the regional offices have access to the same information.<sup>220</sup> Additionally, the SEC should use software to scan documents for errors and create a database for all the information they receive, which would give them the ability to do industry-wide data analyses.<sup>221</sup> Although technology is not infallible, having these systems in place would make the review process quicker and better enable the SEC to detect trends and anomalies in the market.<sup>222</sup> The Agency should also create risk profiles based on the elements that previous schemes had in common.<sup>223</sup> These technological updates may lessen the SEC's need to rely on outside informants.<sup>224</sup> Even if these changes do not lessen the SEC's reliance on tips, these technological enhancements will still be beneficial because the data they produce can help the Agency prioritize and review tips that it receives.<sup>225</sup>

---

212. See MINORITY STAFF REPORT, *supra* note 159, at 1; MADOFF INVESTIGATION, *supra* note 177, at 36 (noting that the person who was assigned to investigate Markopolos's tip had no experience with Ponzi scheme investigations).

213. See MINORITY STAFF REPORT, *supra* note 159, at 1; *Madoff Hearing*, *supra* note 4, at 14.

214. See McGinty, *supra* note 170; Schroeder, *supra* note 165.

215. See McGinty, *supra* note 170.

216. See *Madoff Hearing*, *supra* note 4, at 33.

217. See Feldman & Lobel, *supra* note 27; Dyck, Morse & Zingales, *supra* note 12, at 2214.

218. See MINORITY STAFF REPORT, *supra* note 159, at 14.

219. See *id.* at 11.

220. See *id.* at 13–14.

221. See *id.*

222. See *id.*

223. See *id.*

224. See *id.* at 14.

225. See *id.* at 13–14.

**CONCLUSION**

The new whistleblower provisions of the Dodd-Frank Act offer great financial incentives and anti-retaliation protections to those who provide tips about corporate and securities fraud to the SEC. Although the new law sounds good in theory, it might have been unnecessary. The SEC missed Madoff's fraud not because it did not receive enough tips, but rather because they failed to properly investigate the tips they did receive. Therefore, a law that can potentially lead to a great increase in claims, many of which might be frivolous, will only make the SEC's task more onerous. A more prudent reform that focused on improving the SEC's internal procedures and technology for reviewing tips would have been a better approach. Improving internal procedures and technology will not only help the SEC review tips, but will also enable the Agency to become less dependent on informants and more proactive and independent in detecting fraud.

Vanessa Castellina\*

---

\* B.A., Fordham University, 2006; J.D. candidate, Brooklyn Law School, 2012. I would like to thank Janine Stanisz, Amy Craiger, Nidhi Geevarghese, and the entire staff of the Brooklyn Journal of Corporate, Financial & Commercial Law for their hard work and editing. Finally, to my family and friends, thank you for your constant love and support.