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Testimony before the United States House of Representatives
Committee on Financial Services

"Regulatory Reforms to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs"

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

Thank you for the opportunity to submit testimony on behalf of the National Whistleblower Center ("NWC"), a nonprofit, non-partisan, tax exempt organization founded in 1988. This testimony concerns § 823 of the Committee Discussion Draft of the Financial Choice Act of 2017 ("Discussion Draft"), the section that directly impacts the whistleblower protections afforded under the Securities and Exchange Act ("SEA").

Discussion Draft § 823 purports to exclude opportunistic individuals from the SEA's reward provisions if they are "culpable" for the violation for which they are reporting. This amendment is not needed and, in fact, would undermine the SEA's highly successful whistleblower law.

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[2] For nearly 30 years, the National Whistleblower Center has provided testimony and expert advice to Congressional and regulatory officials on matters related to advancing whistleblower protections. NWC proposals have been adopted in various U.S. whistleblower laws, including in the Whistleblower Protection Enhancement Act, Sarbanes-Oxley Act, and Dodd-Frank Act. Last year, the NWC's program to protect whistleblowers who disclose international wildlife trafficking was awarded a Grand Prize in the highly competitive Wildlife Crime Tech Challenge—an initiative of the U.S. Agency for International Development, in partnership with the Smithsonian Institution, National Geographic Society, and TRAFFIC.

Under the rules already approved by the U.S. Securities and Exchange Commission ("SEC" or "Commission"), "culpable" whistleblowers are excluded from profiting from their own misconduct. The SEC's current rule is consistent with similar restrictions in other reward and whistleblower anti-retaliation laws. There is simply no reason to adopt the amendment set forth in the Draft Discussion document. Conversely, there are numerous reasons not to adopt the amendment, as it is overbroad and would seriously undermine other aspects of the SEC's whistleblower program. Section 823 would harm investors, make investigations more costly and difficult, undercut the confidentiality provisions in both the SEA and the Sarbanes-Oxley Act ("SOX"), and prejudice employees seeking to do the "right thing" by taking the risk of losing their jobs and careers by lawfully reporting securities fraud to the appropriate authorities.

For these reasons, we ask that § 823 of the Discussion Draft be removed from the bill.

I. THE SEC WHISTLEBLOWER PROGRAM IS HIGHLY SUCCESSFUL AND SHOULD NOT BE UNDERMINED.

The Commission's whistleblower program has been highly successful. Almost $1 Billion has been recovered by investors and the U.S. Treasury directly tied to the original information provided to the SEC under the Dodd-Frank Act's whistleblower program. There are no administrative or judicial decisions criticizing the SEC's whistleblower program, let alone any ruling attacking that program for paying "culpable" whistleblowers money derived from the frauds they commit. As explained in Part II, such payments are already prohibited under the SEC's program.

On April 30, 2015, the former SEC Chair Mary Jo White, in remarks at the Ray Garrett, Jr. Corporate and Securities Law Institute-Northwestern University School of Law Chicago, Illinois, explained that the whistleblower program was working well:

> [*T*]*he SEC's whistleblower awards program . . . has proven to be a game changer. . . it is past time to stop wringing our hands about whistleblowers. They provide an invaluable public service, and they should be supported.*
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> *It has been nearly four years since the SEC implemented its whistleblower program. . . I am here to say that the program is a success . . . We have seen enough to know that whistleblowers increase our efficiency and conserve our scarce resources.*
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> *As the program has grown, not only have we received more tips, but we also continue to receive higher quality tips that are of tremendous help to the Commission in stopping ongoing and imminent fraud, and lead to significant enforcement actions on a much faster timetable than we would be able to achieve without the information and assistance from the whistleblower. The program has also created a powerful incentive for companies to self-report wrongdoing to the SEC – companies now know that if they do not, we may hear about the conduct from someone else.*
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> *The bottom line is that is that responsible companies with strong compliance cultures and programs should not fear bona fide whistleblowers, but embrace them as a constructive part of the process to expose the wrongdoing that can harm a company and its reputation. Gone are the days when corporate wrongdoing can be pushed into the dark corners of an organization.*

It is absolutely critical that this Committee take no action that would restore the "days when corporate wrongdoing can be pushed into the dark corners of an organization." The SEA whistleblower law targets these "dark corners" and incentivizes key sources of information that have greatly aided the SEC's enforcement policies. Section 823 would undermine this progress, and constitutes a mistaken and troubling step backwards.

II. THE SEC ALREADY ENFORCES A RULE PROHIBITING CULPABLE EMPLOYEES FROM PROFITING FROM THEIR MISCONDUCT.

The SEC engaged in an extensive rulemaking process in 2010-11 regarding the Dodd-Frank Act's whistleblower law. One of the major issues addressed by the Commission was the eligibility of "culpable" individuals to obtain a reward. The Commission correctly reviewed how other laws resolved these matters, and specifically looked at the False Claims Act (the oldest, and most successful, whistleblower reward law in history, signed into law on March 2, 1863 by President Abraham Lincoln). The Commission, without any major objection, instituted a rule that prohibited culpable whistleblowers from obtaining a reward. *See* 17 C.F.R. § 240.21F-16.

This rule now requires the SEC to *exclude* from the definition of collected proceeds "any monetary sanctions that the whistleblower is ordered to pay, or that are ordered against any entity whose liability is based substantially on conduct that the whistleblower directed, planed, or initiated." 17 C.F.R. § 240.21F-16. In other words, if a whistleblower caused the underlying violation for which he or she reported, the whistleblower gets no reward. Thus, the very premise for which § 823 is predicated would serve no necessary purpose since current law already addresses this issue consistent with every other major whistleblower reward law.

The Commission carefully considered the type of overbroad "per se exclusion for culpable whistleblowers" set forth in § 823, and categorically rejected this approach. Instead, the Commission adopted a rule that would encourage the reporting of misconduct committed by other persons, but prohibit whistleblowers from profiting from their own misconduct. The final rule approved by the Commission *prevents* culpable whistleblowers "from financially benefiting from their own misconduct or misconduct for which they are substantially responsible," but would still incentivize whistleblower to disclose misconduct for which they were not personally responsible. *See* 76 *Federal Register* at 34331 (June 13, 2011).

The wording of this SEC rule, and its underlying purpose, is very significant. The rule draws a distinction between mere participants who are ordered to perform work and those who "direct" "plan" or "initiate" the illegal conduct. The justifications for this distinction are well established. If mere participants are excluded from the whistleblower law, law enforcement would lose most, if not all, of their best sources. The law is designed to encourage "insiders" with information to come forward and report corporate wrongdoing.

But under § 823 there is no distinction between a secretary of who may simply mail a letter related to an illegal scheme, and the manager who concocted the scheme and ordered the secretary to send the letter. Most well-placed whistleblowers are insider participants in the

improper schemes. It is just their information that is needed to turn-in those who orchestrated, initiated or planned the frauds. It is their information that is needed to uncover and understand the scope of the illegal conduct, and identify who may be criminally responsible for cover-ups. Without these sources the SEC and Department of Justice would lose its ability to detect clandestine frauds, and protect investors and the public from these crimes. This is precisely the intent behind other very successful whistleblower laws, such as the False Claims Act, and it was the explicit intent behind the FCA when President Lincoln signed it into law.

Section 823, if enacted, would have a devastating impact not just on whistleblowers, but on the ability of law enforcement to obtain the evidence it needs to protect investors. The Commission's explanation for enacting the current rule prohibiting culpable whistleblowers from obtaining a reward is to incentivize those with knowledge to report the planners and initiators of criminal schemes and help SEC detect clandestine activity it would otherwise be unable to uncover. The SEC was clear about the intent behind hits rule. The Commission wanted to incentivize participants, but also "*prevent() culpable whistleblowers from financially benefiting from their own misconduct or misconduct for which they are substantially responsible. . . As commenters noted, the original Federal whistleblower statute—the False Claims Act—was premised on the notion that one effective way to bring about justice is to use a rogue to catch a rogue.*"[3]

The Commission quoted directly from Senator Jacob M. Howard's explanation as to why the Civil War Congress enacted the False Claims Act: '

> *I have based (the provisions of False Claims Act) on the old-fashioned idea of holding out a temptation and 'setting a rogue to catch a rogue,' which is the safest and most expeditious way of bringing rogues to justice.*

SEC Final Rule, 76 Fed. Reg. at 34350 (2011), *quoting from* Cong. Globe, 37th Cong., 3d Sess. 955–56 (1863) (emphasis added).[4]

The Commission explained that its rule was predicated on the "*basic law enforcement principle*" that it is "*difficult for law enforcement authorities to detect and prosecute*" "*sophisticated securities fraud schemes*" "*without insider information and assistance from participants in the scheme or their coconspirators*." The Commission further explained that "*insiders regularly provide law enforcement authorities with early and invaluable assistance in identifying the scope, participants, victims, and ill-gotten gains from these fraudulent schemes.*"[5]

Despite recognizing the importance of insider information, the Commission still precluded insiders from profiting from their own frauds, or frauds for which they planned and initiate: "*The rationale for this limitation is that the common understanding of a whistleblower is one who*

[3] The SEC's comments on its rules were published in 76 *Fed. Reg.* at 34350 (2011) (emphasis added), and are *available at* https://www.kkc.com/assets/site_18/files/sec/sec78u-6.pdf.

[4] *Id.*

[5] *Id.*

reports misconduct by another person and it would be contrary to public policy for whistleblowers to benefit from their own misconduct."[6]

Since enacting this rule there have been no reported cases where a culpable whistleblower has been paid a reward based on his or her own misconduct, nor have there been any reports that the current rule is not working. All SEC-issued reward decisions are subject to review by the SEC Commissioners, which is a bi-partisan group of regulators. No Commissioner has issued a dissenting opinion complaining about an abuse of this rule, or that a culpable whistleblower profited from his or her own misconduct.

Instead, the Commission has praised the entire whistleblower program (which has already recovered nearly $1 billion for damaged investors and taxpayers) and stated, on the record, that the program is working well. *See* Part I.

If the program is not broken, why break it?

III. THE SEC HAS OTHER RULES PROHIBITING CULPABLE WHISTLEBLOWERS FROM OBTAINING A REWARD.

In addition to the explicit prohibition on culpable whistleblowers outlined above, the Commission has other rules that either prohibit, completely bar, or discourage truly culpable whistleblowers from profiting from their own frauds.

The first such rule is § 240.21F–15 which states that whistleblowers are not granted "amnesty" when they report violations. In other words, a whistleblower can be arrested based on the information he or she reports through the Dodd-Frank Act's whistleblower program. This is a strong discouragement, aimed precisely at persons truly culpable for the misconduct. It is difficult to image that a person who planned and initiated a fraud would then turn in that very fraud, knowing that he or she could be indicted for the very conduct reported.

The second prohibition, reflected in both the SEC rules and the underlying statute, prohibits (without exception) individuals who are convicted of a criminal violation, related to any law for which a reward could be paid, to obtain a reward. 15 U.S.C. § 76u-6(c)(2)(B). The False Claims Act contains a similar prohibition.

A third prohibition prohibits the payment of a reward to any whistleblower who obtained his or her information "by a means or in a manner that is determined by a United States court to violate applicable Federal or state criminal law." § 240.21F-4((b)(4)(iv). If you violate a law (i.e. initiate a fraud) to obtain information about the fraud, you cannot collect a reward.

A fourth prohibition concerns how the Commission sets the amount of a reward. The SEC may take into consideration an employee's "culpability" when accessing the amount of a reward, even if the individual is not convicted of a criminal offense, and even if the individual was simply a minor participant in a fraud. § 240.21F-6(b)(1).

Finally, SEC regulations permit the Commission to deny a reward to anyone who "knowingly or willfully" makes "any false, fictitious, or fraudulent statement or representation" or who

[6] *Id.*

"otherwise" acts to "hinder the Commission or another authority." § 240.21F-8(c)(7). In other words, if a whistleblower lies about his or her own culpability, that individual can be denied a reward, even if otherwise he or she would be fully eligible.

In approving these rules governing its whistleblower program, the SEC created numerous checks on unethical individuals who would attempt to profit from their own misconduct, or lie to the Commission about their culpability.

IV. THE "DUTY TO PREVENT" REQUIREMENT IS A RADICAL DEPARTURE FROM ALL FEDERAL WHISTLEBLOWER LAWS AND WOULD UNDERMINE WHISTLEBLOWER PROTECTIONS.

Section 823 contains a "duty to prevent" violations. This requirement creates a near-impossible burden on employee-whistleblowers by requiring them to first report suspected violations internally. It is well documented that simply trying to report a violation up the chain-of-command is extremely difficult, and can result in retaliation. Significantly, under the current law numerous whistleblowers have experienced retaliation for internally reporting violations to their supervisors or a company's internal compliance program. Various courts, including the United States Court of Appeals for the Fifth Circuit, have ruled that whistleblowers who report concerns internally are *not protected* under the SEA's anti-retaliation law. In other words, under this interpretation of the SEA (which the entire Wall Street community has embraced), a whistleblower who tries to prevent a violation from taking place within a company can be fired, and will have no protection under the SEA.

Moreover, mandating a "duty to prevent" would undermine the Sarbanes-Oxley Act's provision that guarantees confidentiality to internal whistleblowers who report violations to a company's audit committee. Under SOX, employees have a right to make these reports confidentially. But forcing employees to actively try to "prevent" a violation would effectively destroy the ability of employees to maintain confidentiality. The employer would know who tried to "prevent" the fraud, and this would effectively identify who the whistleblower was. This would be especially true if the employee was required not simply to object to the illegal practice, but actually required to takes steps to "prevent" the illegal conduct. Clearly, the more prudent path would be to report the crimes to the appropriate law enforcement authority, instead of trying to take the law into one's own hands.

Of the nearly 60 whistleblower laws enacted by Congress since 1970, *none* of these laws have a "duty to prevent." The fact that Congress has never added a mandatory "duty to prevent" to any of the scores of whistleblower laws, including those covering miner safety, airline safety, government fraud and abuse, nuclear safety, transportation safety etc., speaks for itself that such a provision is both unnecessary and potentially destructive of the goal to encourage reporting.

V. THE REASONS WHY THE SEC WHISTLEBLOWER PROGRAM WORKS ARE SCIENTIFICALLY AND EMPIRICALLY DEMONSTRABLE.

The underlying reasons for the SEC program's success are well established. In January 2017, the University of Toronto's Rotman School of Management held a conference focusing on fraud detection within publicly traded companies. The conference covered essential information necessary to understand how whistleblowing works in practice, and why laws such as the False

Claims Act and the SEC's whistleblower program are remarkably successful. The full summary of the conference and supporting materials is available online at bit.ly/UTorontoSeminar, and we strongly encourage all Members of this Committee to review these scholarly proceedings before taking any action which may undercut the SEC's whistleblower program.

University of Toronto Professor Alexander Dyck chaired the conference at the University of Toronto. Professor Dyck serves as the Manulife Financial Chair in Financial Services, Professor of Finance and Business Economics, Rotman School of Management and Director, Capital Markets Institute. He is a world-renowned expert on fraud detection methodology, and was the principle author in the key study on the impact of whistleblowing on fraud detection. His research on fraud detection (which included studying reporting behaviors under the False Claims Act), originally published in 2008 by the University of Chicago Booth School of Business, is the seminal work on this subject and should be carefully studied.[7] *See* "Who Blows the Whistle on Corporate Fraud?" (Alexander Dyck, University of Toronto; Adair Morse, University of California, Berkeley and Luigi Zingales, University of Chicago).

Among his critical findings are:

- "Employees clearly have the best access to information. Few, if any, fraud can be committed without the knowledge and often the support of several of them."
- "[I]n 82 percent of cases, the whistleblower was fired, quit under duress, or had significantly altered responsibilities. In addition, many employee whistleblowers report having to move to another industry and often to another town to escape personal harassment. . . . Given these costs, however, the surprising part is not that most employees do not talk; it is that some talk at all."
- "Monetary incentives seem to work well, without the negative side effects often attributed to them."

Professor Dyck's study focused on how to get those with the best information about fraud to report the misconduct. Professor Dyck and his co-authors pointed out the positive role that rewards can play in promoting accountability and exposing frauds:

> *A natural implication of our findings is that the use of monetary rewards providing positive incentives for whistle blowing is the possibility of expanding the role for monetary incentives. As the evidence in the healthcare industry shows, such a system appears to be able to be fashioned in a way that does not lead to an excessive amount of frivolous suits. The idea of extending the qui tam statute*[8] *. . . is very much in the Hayekian spirit of sharpening the incentives of those who are endowed with information.*

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[7] Linked in the conference proceedings, *available at*: http://www.rotman.utoronto.ca/FacultyAndResearch/ResearchCentres/CapitalMarketsInstitute/Events/PastEvents/Whistleblowers.

[8] The term "*qui tam*" refers to the provision within the False Claims Act that permits employees to obtain a financial reward if their original information results in a successful enforcement action. The reward is paid directly from the monies obtained from the wrongdoer, at no expense to the taxpayers.

Another presenter at the University of Toronto conference was Andrew Call, an Associate Professor at the W.P. Carey School of Business at Arizona State University.[9] He presented findings from his study concerning the impact whistleblowers have on the quality of government investigations. *See,* Call, et al., "Whistleblowers and Outcomes of Financial Misrepresentation Enforcement Acts," *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2506418. His findings scientifically demonstrate that if a whistleblower comes forward with evidence of fraud, the probability of a successful investigation and prosecution is enhanced, and the likelihood of a guilty finding is increased. His findings provide additional scientific proof supporting Professor Dyck's work, which objectively demonstrates that whistleblowing serves the public interest and must be enhanced and incentivized.

Peter Dent, Partner, Deloitte, LLP, also presented at the University of Toronto conference. Mr. Dent provided expert analysis of the difficulties employees face when they expose wrongdoing. Mr. Dent discussed another objective, scholarly report on how whistleblowers are perceived at work. Aptly titled "Nobody Like's a Rat," this study, published by the Columbia University Journal of Economic Behavior and Organization, explained how whistleblowers are shunned and subjected to retaliation and blacklisting—which ultimately disincentivizes others from reporting fraud in their organizations.

The report's findings are most troubling, as it concluded that even organizations that are composed of honest persons will shun a whistleblower who reports dishonest behavior:

> **However, we also find that when groups can select their members, individuals who report lies are generally shunned, even by groups where lying is absent. This facilitates the formation of dishonest groups where lying is prevalent and reporting is nonexistent.**[10]

Taken together, the three studies presented at the conference objectively demonstrate, with empirical evidence, that (a) whistleblowing is the key to fraud detection; (b) whistleblowers help trigger better government investigations with stronger enforcement outcomes; and that (c) whistleblowers will suffer retaliation and blacklisting, and thus badly need strong protections and incentives.

These studies help explain why the current SEC program has been highly effective: The program incentivizes those with inside information to report, and therefore engenders a strong fraud detection program. The sources of information are well-placed and help the government target its investigations into serious frauds for which solid evidence of wrongdoing can be obtained (with help from the "insider"). Finally, by permitting whistleblower to proceed confidentially and anonymously the SEC program provides the single best protection against retaliation – the SEC does not identify the whistleblower, or the fact that there even is a whistleblower, to the company, and thus the company cannot retaliate.

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[9] *See,* footnote 5.

[10] *See* "Nobody likes a rat: On the willingness to report lies and the consequences thereof." (Ernesto Reuben, Matt Stephenson, Columbia Business School) (emphasis added), *available at*: http://www.sciencedirect.com/science/article/pii/S0167268113000735.

The Committee should strongly support the current SEC whistleblower program, ensure that it has all of the resources necessary to thrive, and oppose any attempt to weaken its provisions. Section 823 should be struck from the Discussion Draft and not included in any bill reported by the Committee.

Thank you for your time and consideration.