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Christina Parajon Skinner

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WHISTLEBLOWERS AND FINANCIAL INNOVATION*

CHRISTINA PARAJON SKINNER**

This Article critically examines post-financial crisis whistleblower regimes and their impact on contemporary financial markets. In particular, the Dodd-Frank whistleblower program, as implemented by the United States Securities and Exchange Commission, has received significant attention in legal, political, and popular quarters. Some praise the whistleblower program as essential to aiding the government's efforts in overcoming enforcement challenges, while others remain wary of the program's unintended effects. This Article advances the debate—in favor of whistleblowers—by offering an updated analysis of the program's benefits and costs, in light of recent trends in complexity and innovation that have made financial activity much more diffuse.

By weighing the program's utility in the postcrisis financial landscape, together with its benefits and costs, this Article argues that the SEC whistleblower program is, on balance, desirable: not only because whistleblower solutions can be effective at detecting financial misconduct in complex financial spaces, but also because they serve other valuable social and economic goals. Overall, the aim of this Article is to prompt further conversation about whistleblower programs by critically examining the crux of regulators' need for whistleblowers in the financial services arena, revisiting a conceptual cost-benefit analysis of the program, and suggesting certain aspects of the SEC program that are ripe for reevaluation and, potentially, redesign.

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INTRODUCTION

In 2012, a group of traders at JP Morgan Chase lost (at least) \$6 billion trading exotic credit derivatives.¹ Led by the infamous “London Whale”—dubbed so for taking enormous market positions—the group for years had been engaged in a high-risk, high-

1. *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 1, 3–4 (2013) [hereinafter *Senate Hearing, Whale Trades*]. “‘Derivatives’ are contractual instruments that derive their value from the values of underlying instruments or commodities upon which they are based.” JOHN C. COFFEE, JR., HILLARY A. SALE & M. TODD HENDERSON, *SECURITIES REGULATION: CASES AND MATERIALS* 25 (13th ed. 2015).

reward strategy, essentially betting on the price of certain bonds.² Eventually, when this strategy started to fare poorly, the Whale “doubled-down” on his risky position and grew their portfolio to a “perilous size.”³ Ultimately that strategy collapsed, “shock[ing] the investing public.”⁴ Investigations later discovered that the London Whale’s traders had hidden growing losses from regulatory scrutiny by manipulating internal risk-valuation models and keeping a separate accounting to downplay their deteriorating position.⁵

There has been no shortage of serious financial misconduct in global institutions and markets since the global financial crisis of 2008.⁶ In the same year as the London Whale’s losses, regulators in the United States and abroad discovered that several large, global

2. Eleazar David Melendez, *How Did JP Morgan Lose Billions in One Trade? London ‘Whale’ Explained*, INT’L BUS. TIMES (May 11, 2012), <http://www.ibtimes.com/how-did-jpmorgan-lose-billions-one-trade-london-whale-explained-698018> [<http://perma.cc/7VS6-4F6A>].

3. *Senate Hearing, Whale Trades*, *supra* note 1, at 4 (“In the first quarter of 2012, the CIO traders went on a sustained trading spree, eventually increasing [their credit derivatives portfolio] from \$51 billion to \$157 billion . . . [despite the fact that] the portfolio was rapidly losing value.”).

4. *Id.* at 1; *see* EDWARD V. MURPHY, CONG. RESEARCH SERV., R42545, WHAT IS SYSTEMIC RISK? DOES IT APPLY TO RECENT JP MORGAN LOSSES? 8 (2012), <https://www.fas.org/spp/crs/misc/R42545.pdf> [<http://perma.cc/23BH-26PU>]. JP Morgan’s \$6 billion loss did not ultimately bring that institution close to insolvency or destabilize the broader economy. Yet, given the significance and size of that financial institution, larger losses certainly could have disrupted the global credit and liquidity markets. *Id.* at 8–9 (noting that “[t]he Fed’s stress test for JP Morgan [at the time] assumed \$56 billion in loan losses in addition to assuming \$28 billion in losses in transactions”).

5. *See, e.g., Senate Hearing, Whale Trades*, *supra* note 1, at 3–8; Dan Fitzpatrick, Jean Eaglesham & Devin Barrett, *Two Charged in J.P. Morgan ‘Whale’ Trades*, WALL ST. J. (Aug. 14, 2013), <http://www.wsj.com/articles/SB10001424127887324823804579012550859130222> [<http://perma.cc/9YAU-76M9> (dark archive)]; Patricia Hurtado, *The London Whale*, BLOOMBERG QUICKTAKE (Apr. 23, 2015), <http://www.bloombergview.com/quicktake/the-london-whale> [<http://perma.cc/E98Q-HBLE>]; Ryan Tracy, *New York Fed Faulted in ‘London Whale’ Case*, WALL ST. J. (Oct. 21, 2014), <http://www.wsj.com/articles/new-york-fed-failed-to-examine-j-p-morgan-london-whale-unit-1413900070> [<http://perma.cc/YN5B-AGLD> (dark archive)]; *see also* James B. Stewart, *Convictions Prove Elusive in ‘London Whale’ Trading Case*, N.Y. TIMES (July 16, 2015), http://www.nytimes.com/2015/07/17/business/figures-in-london-whale-trading-case-escape-the-authorities-nets.html?_r=0 [<http://perma.cc/DL3X-WG3Y>] (reporting that the criminal case against the Whale has been dropped in the United Kingdom).

6. *See, e.g., Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc.*, 104 F. Supp. 3d 441, 537 (S.D.N.Y. 2015); *see also* COMM. ON BANKING, HOUS. & URBAN AFFAIRS, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. REP. NO. 111-176, at 43 (2d Sess. 2010) [hereinafter SEN. REP. ON FINANCIAL STABILITY] (explaining how complex financial products, left unchecked, fanned the flames of the crisis, owing to “[g]aps in the regulatory structure [that] allowed these risks and products to flourish outside the view of those responsible for overseeing the financial system”); Christina Parajon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559, 1576–88 (2016) (discussing misconduct as a market-wide risk).

banks had been for years manipulating international interest rate benchmarks and—in a separate scandal—the market for foreign exchange currency.⁷ Most recently, in September 2015, twelve major global banks settled civil claims that they had been conspiring to fix prices in the market for credit default swaps.⁸

With finite regulatory resources, detecting financial misconduct is a perennial challenge.⁹ Manpower constraints are, as always, a limiting factor. As William Dudley, President and CEO of the Federal Reserve Bank of New York (“New York Fed”), recently explained: “[s]upervisors simply do not have sufficient ‘boots on the ground’ to ferret out all forms of bad behavior within a giant, global, financial institution.”¹⁰ Regulators also lack real-time information and up-to-date expertise necessary to anticipate misconduct on the horizon. As financial activity becomes increasingly innovative and much more diffuse, these resource deficiencies will inevitably continue to grow.

One partial solution is to enlist help from the private sector.¹¹ In that vein, the Dodd-Frank Wall Street and Consumer Protection Act

7. THE WHEATLEY REVIEW, THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT 5 (2012); *The Libor Investigation*, WALL ST. J., <http://stream.wsj.com/story/the-libor-investigation/SS-2-32262> (last visited Mar. 4, 2016) [<http://perma.cc/6BGF-GKTE>]; Chad Bray, Jenny Anderson & Ben Protess, *Big Banks Are Fined \$4.25 Billion in Inquiry into Currency-Rigging*, N.Y. TIMES (Nov. 12, 2014), <http://dealbook.nytimes.com/2014/11/12/british-and-u-s-regulators-fine-big-banks-3-16-billion-in-foreign-exchange-scandal> [<http://perma.cc/463S-ZK7S>]; *Six Banks Fined £2.6bn by Regulators over Forex Failings*, BBC NEWS (Nov. 12, 2014), <http://www.bbc.com/news/business-30016007> [<http://perma.cc/8CZS-G5SF>].

8. Jonathan Stempel, *Big Banks Just Paid \$1.9 Billion to Settle Claims They Manipulated Another Market*, BUS. INSIDER (Sept. 11, 2015), <http://www.businessinsider.com/big-banks-in-19-billion-swaps-price-fixing-settlement-2015-9> [<http://perma.cc/ZW4J-P3GT>].

9. See, e.g., Tracy, *supra* note 5. The SEC, however, is “actively recruiting more brainpower to tackle complex product markets.” Matt Scully, *SEC: Banks May Be Shifting Asset Risk for Better Capital Treatment*, AM. BANKER (Oct. 22, 2014), http://www.americanbanker.com/issues/179_204/sec-banks-may-be-shifting-asset-risk-for-better-capital-treatment-1070747-1.html [<http://perma.cc/P3DR-FL2H> (dark archive)]. According to those with industry knowledge, those partnerships are believed to be a “game-changer.” *Id.* A 2010 study by economist Alexander Dyck and co-authors found that of 216 major incidents of financial misconduct between 1996 and 2004, the SEC detected only seven percent of them. Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2213–14 (2010).

10. William C. Dudley, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, FED. RES. BANK N.Y. (Oct. 20, 2014), <http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html> [<http://perma.cc/WPE2-FUPR>].

11. Michael Walsh, an assistant Vice President in the New York Fed’s legal and compliance group, put the point plainly: “[i]f people are expecting my group of 40 to understand every single risk without the help of the [financial] institutions, that’s an impossible task.” Justin Baer, *Top Wall Street Lawyer Slams Regulatory Environment*,

of 2010 (“Dodd-Frank”) adopted a whistleblower program, to be implemented by the Securities and Exchange Commission (“SEC” or “Commission”).¹² Whistleblowers in this scheme are rewarded with cash bounties for providing original information to the SEC that leads to a successful enforcement action. In establishing this program, Congress believed that private market insiders could aid the SEC in overcoming its resource limitations, on the rationale that individuals working within these financial institutions and markets are well equipped to detect malfeasance.¹³

Yet despite its surface appeal, reactions to the SEC whistleblower program have been mixed. On the one hand, regulators are optimistic about the program. SEC Chair Mary Jo White has praised it as “enormously successful.”¹⁴ With similar enthusiasm, former Attorney General Eric Holder spoke publicly in favor of expanding an SEC-type whistleblower program to the criminal arena.¹⁵ The private sector, however, is more reserved. Some industry stakeholders are concerned that, among other things, the program has and will interfere with internal corporate compliance initiatives.¹⁶ Others suggest that cash incentives are morally corrupting, or, at the least, promote frivolous (even vengeful) reporting. And so today, four years into the program’s existence, the question of whether the

WALL ST. J. (Mar. 18, 2015), <http://www.wsj.com/articles/top-wall-street-lawyer-slams-regulatory-environment-1426718956> [<http://perma.cc/V9G4-G9RP>].

12. The SEC promulgated its whistleblower program under section 21F of the Securities Exchange Act of 1934, 15 U.S.C. 78u-6, which was added by section 922 of the Dodd-Frank Act. See Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, sec. 922, § 21F, 124 Stat. 1376, 1841–49 (2010) (codified at 15 U.S.C. § 78u-6 (2012)).

13. See SEN. REP. ON FINANCIAL STABILITY, *supra* note 6, at 110–11.

14. Barbara Shecter, *SEC Chair Mary Jo White Praises ‘Enormously Successful’ Whistleblower Program*, FIN. POST (Oct. 16, 2014), <http://business.financialpost.com/news/fp-street/sec-chair-mary-jo-white-praises-enormously-successful-whistleblower-program> [<http://perma.cc/P3M8-MNCC>].

15. Devlin Barrett, *Holder Proposes Bigger Rewards for Wall Street Whistleblowers*, WALL ST. J. (Sept. 17, 2014), <http://www.wsj.com/articles/attorney-general-holder-to-propose-big-new-rewards-for-wall-street-whistleblowers-1410957241?alg=y> [<http://perma.cc/FWQ4-ZCQW> (dark archive)].

16. See John T. Zach & Randall W. Jackson, *The Challenge of Misplaced Whistleblower Incentives*, N.Y. L.J. (Sept. 28, 2015), <http://www.newyorklawjournal.com/id=1202738010670/The-Challenge-of-Misplaced-Whistleblower-Incentives?sreturn=20160009130751> [<http://perma.cc/VT8Y-QBQ5>] (“If reported to the company, key factual allegations can be quickly verified (or discredited), relevant individuals can be interviewed and key documentary evidence can be reviewed. The SEC’s enforcement staff, by practice necessarily influenced by past experience, cannot assess allegations with such precision or efficiency.”).

program serves the public interest—and if so, at an appropriate cost—remains open.

This Article seeks to advance the ongoing debate about whistleblower programs in two ways. First, it revisits some of the costs and benefits postulated at the beginning of the SEC program, with an analysis that is updated in light of the financial landscape today.¹⁷ Second, this Article adds a transnational regulatory dimension to the analysis in order to more completely inform the domestic debate. To those ends, the Article proceeds in three parts. Part I reorients the debate about whistleblowers by illustrating why, in this postcrisis era of innovative finance, regulators need to draw on private insiders to adequately enforce the securities laws. Three case studies in financial innovation are used to demonstrate circumstances in which whistleblowers are helpful—and sometimes indispensable—adjuncts to state power. Based on these cases, Part I argues that, as a baseline, whistleblower programs are worthy additions to the financial regulators' toolkit.

From that baseline, Part II engages in a conceptual cost-benefit analysis of whistleblower programs. It considers a few of the more salient costs of whistleblower programs: the inefficiencies they impose on the private market and (potentially) their ability to fuel antisocial relationships. Part II also considers the realized and potential benefits of whistleblower programs, such as the increased detection of misconduct, enhanced efficiency in the use of finite government resources, heightened legitimacy of the financial services sector, increased opportunity for market discipline, and improvement in industry culture. Upon weighing the costs against the benefits, Part II

17. Compare Sundar Narayanan, *Are Whistleblower Reward Programs Really a Good Idea?*, FCPA BLOG (Nov. 30, 2015, 10:08 AM), <http://www.fcpablog.com/blog/2015/11/30/are-whistleblower-reward-programs-really-a-good-idea.html> [<http://perma.cc/5EVM-FY45>], with Gordon Schnell, *Gordon Schnell: Yes, We Need Whistleblower Rewards*, FCPA BLOG (Dec. 3, 2015, 10:18 AM), <http://www.fcpablog.com/blog/2015/12/3/gordon-schnell-yes-we-need-whistleblower-rewards.html> [<http://perma.cc/756Q-UJ8D>]. For existing postcrisis literature on financial whistleblower laws, see, for example, Dave Ebersole, Comment, *Blowing the Whistle on the Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 123, 125–27 (2011); Geoffrey Christopher Rapp, *Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. REV. 73, 76–104 (2012); Amanda M. Rose, *Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate*, 108 NW. U. L. REV. 1235, 1260–85 (2014). For a general discussion of qui tam lawsuits brought under the False Claims Act, see David Freeman Engstrom, *Harnessing the Private Attorney General: Evidence from Qui Tam Litigation*, 112 COLUM. L. REV. 1244 (2012). For an excellent discussion of complexity and innovation in financial markets more generally, see Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235, 238–42 (2012).

suggests that a strong and well-incentivized whistleblower program, along the Dodd-Frank model, can advance social welfare and economic efficiency.

Part III then discusses the implications of Parts I and II. Specifically, it points to several potential design flaws or weaknesses of the Dodd-Frank whistleblower program and suggests possible, albeit preliminary, modifications to the program for regulators to consider.

I. WHISTLEBLOWERS IN A POSTCRISIS WORLD

Finance today is increasingly innovative and diffuse, which characteristics pose particular challenges for securities law enforcement.¹⁸ Where regulators lack expertise in a new and often complex financial area, misconduct can be more difficult to anticipate. Meanwhile, as financial activity spreads well beyond traditional financial institutions, monitoring these disperse spaces will also stretch regulators' resources thin.

This Part draws attention to two fast-growing areas of the financial services sector—securitization and structured finance (particularly in the shadow banking system) and financial technology—to illustrate why securities regulators, on their own, have difficulty detecting misconduct as it arises today. Through these various examples, Section I.A shows possible gaps in regulators' capacity to anticipate and detect misconduct. Section I.B then turns to the specific details of the Dodd-Frank whistleblower program and explains the program's potential to aid the SEC in narrowing these gaps.

A. *Regulatory Gaps: A Case Study*

This Section provides a brief case study in innovation and diffusion. The aim of this study is to highlight—and in some cases, foreshadow—regulatory challenges to come, as an increasing proportion of financial activity takes place beyond regulators' expertise and, in some cases, supervisory purview.

18. See, e.g., Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 298–311 (2012); Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 657–63 (2012).

1. Shadow Banking¹⁹

Traditionally, banks provide credit to consumers and companies in a relatively straightforward way: banks take short-term deposits and from those deposits make longer-term loans.²⁰ Today, however, a substantial amount of this activity—called financial intermediation—takes place through securitization.²¹ As one commentator at the Federal Reserve Bank of St. Louis noted, “[i]n modern banking, origination of loans is done mostly with a view to convert the loan into securities—a practice called *securitization*, whereby the transaction, processing and servicing fees are the intermediaries’ principal source of revenue.”²²

Unlike the basic two-step process of deposit-taking and loan-making, securitization takes place in a sequence of complex steps and—potentially—by a number of institutions: (1) a loan (e.g., a student loan, mortgage, or auto loan) is originated by a regulated commercial bank or an unregulated finance company; (2) the loan is then sold to a “warehouse bank”—called an “aggregator, seller or sponsor” (which can be the same as the originator); (3) the “administrator” creates a special purpose vehicle (“SPV”) that issues securities against these loans; (4) the underwriter (typically an investment bank) sells the securities to investors, who get payments from the securities in their order of priority.²³ As this assembly-line process suggests, securitization can be a diffuse activity. Much of it takes place outside of the traditionally regulated banking sector—or at least not under a single bank’s roof—in the so-called shadow banking system.²⁴

19. See Judge, *supra* note 18, at 659 (coining the term “fragmentation nodes” to refer to securitization and related complex financial products).

20. See ZOLTAN POZSAR ET AL., SHADOW BANKING 3 (Fed. Reserve Bank of N.Y., Staff Report No. 458, 2010) (2013).

21. In particular, credit intermediation involves (1) credit transformation, “the enhancement of the credit quality of debt issued by the intermediary through the use of priority of claims”; (2) maturity transformation, “the use of short term deposits to fund long-term loans”; and (3) liquidity transformation, “the use of liquid assets” (i.e., deposits) “to fund illiquid assets” (i.e., mortgages). *Id.* at 3–4.

22. Bryan J. Noeth & Rajdeep Sengupta, *Is Shadow Banking Really Banking?*, REGIONAL ECONOMIST, Oct. 2011, at 8, 10–11.

23. *Id.* at 11. In some cases, most of these steps can happen under the aegis of a large investment bank.

24. See Noeth & Sengupta, *supra* note 22, at 9 (“[W]hat was once accomplished under a single roof in the traditional banking system is now done over a sequence of steps in the shadow banking system, each performed by specialized entities that are not vertically integrated.”). The term “shadow banking” was first used by Paul McCulley of the PIMCO investment fund. FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT, SHADOW

In general, shadow banking intermediates credit “through a wide range of securitization and secured funding techniques, including asset-backed commercial paper (CP), asset-backed securities (ABS), collateralized debt obligations (CDOs), and repurchase agreements (repos).”²⁵ Included in the broad definition are the range of “financial intermediaries” that engage in these various credit intermediation functions, but unlike the traditional banking sector, may lack access to the Federal Reserve discount window and other public guarantees.²⁶ They include, among others, “finance companies, . . . credit hedge funds, [and] money market mutual funds.”²⁷ And unlike the traditional banking sector, the shadow banking system is expanding at a rapid pace. According to the Financial Stability Board’s (“FSB”) 2013 report, the global shadow banking sector accounted for \$71.2 trillion of assets at the end of 2012, equivalent to fifty-two percent of regulated banking assets in the report’s sample of twenty global jurisdictions plus the Eurozone overall.²⁸

BANKING AND THE FINANCIAL CRISIS 9, n.8 (2010), http://fcicstatic.law.stanford.edu/cdn_media/fcic-reports/2010-0505-Shadow-Banking.pdf [<http://perma.cc/L2US-E8Y9>].

25. POZSAR ET AL., *supra* note 20, at 1. Returning to the securitization sequence set out above, Pozsar and co-authors explain the role of various shadow banking entities in a securitization process: (1) loan origination by “finance companies”; (2) loan warehousing by “single- and multi-seller conduits”; (3) pooling/structuring of the loans into securities by broker-dealers at ABS syndicate desks; (4) ABS warehousing funded through repos; (5) pooling/structuring of ABS into CDOs by broker-dealers’ ABS desks; (6) ABS intermediation by “limited-purpose finance companies, structured investment vehicles (SIVs), securities arbitrage conduits, and credit hedge funds”; (7) funding of all of these activities through wholesale funding markets. *Id.* at 7.

26. Noeth & Sengupta, *supra* note 22, at 8.

27. Steven L. Schwarcz, *Regulating Shadow Banking*, 31 REV. BANKING & FIN. L. 619, 621 (2012). Former Federal Reserve Board Chairman Ben Bernanke defined shadow banking as “compris[ing] a diverse set of institutions and markets that, collectively, carry out traditional banking functions—but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions.” Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Some Reflections on the Crisis and the Policy Response* 3 (Apr. 13, 2012), <http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.pdf> [<http://perma.cc/2RYG-V582>]. With respect to money market funds, these institutions have become more heavily regulated by the SEC under the Investment Company Act of 1940. *See* Money Market Fund Reform, Investment Company Act Release No. 29,132, 75 Fed. Reg. 10,060, 10,060 (Mar. 4, 2010).

28. FIN. STABILITY BD., GLOBAL SHADOW BANKING MONITORING REPORT 2013, at 8, 12 (2013); *see* FIN. STABILITY BD., GLOBAL SHADOW BANKING MONITORING REPORT 2015, at 7–11 (2015). While the United States and United Kingdom have the largest shadow banking systems, shadow banking has also grown significantly in other emerging economies. IMF, RISK TAKING, LIQUIDITY, AND SHADOW BANKING, *Global Financial Stability Report*, at 66 (Oct. 2014).

The rapid growth of the securitization market is a double-edged sword. While beneficial in terms of risk spreading, the process—particularly when concentrated in the shadow banking system—can make regulatory monitoring for misconduct quite difficult. For one, securitization can give rise to a type of moral hazard. As Pozsar and co-authors have written, securitization-based credit intermediation “creates agency problems that do not exist when these activities are conducted within a bank.”²⁹ For example, with only a slice of the product to manage—and then move along—no one actor (individual or institutional) is sufficiently vested in the integrity of the whole. As discussed below, “[i]f these agency problems are not adequately mitigated, the financial system is prone to excessive lowering of underwriting standards and to overly aggressive structuring of securities.”³⁰

The financial crisis is a prime example. In the years preceding the financial crisis, the market for mortgage-backed securities (“MBS”) boomed.³¹ The underlying asset in these MBS, in many cases, consisted of subprime mortgage loans that had been originated with poor underwriting standards and diligence by the institutions that purchased them. To make matters worse, a market in derivative products was created, including collateralized debt obligations (“CDO”)—bundles of MBS collateralized by the promise to repay the underlying subprime loans³²—and credit default swaps (“swaps” or “CDS”)—used as “insurance for subprime [mortgage] exposure.”³³

29. POZSAR ET AL., *supra* note 20, at 3; *see also* David C. Wheelock & Paul W. Wilson, *Explaining Bank Failures: Deposit Insurance, Regulation, and Efficiency*, 77 REV. ECON. & STAT. 689, 690 (1995) (discussing the results from a study on bank failures in Kansas during the 1920s resulting from widespread farm mortgage defaults).

30. POZSAR ET AL., *supra* note 20, at 3.

31. MBS are structured financial products in which mortgages are bundled into tranches. *Mortgage-Backed Securities*, SEC (July 23, 2010), <http://www.sec.gov/answers/mortgagesecurities.htm> [<http://perma.cc/W9Z9-8AHR>]. Banks sell these tranches as a type of security. *Id.* Securitization, classically or legitimately, is used to spread risk. But prior to the crisis, securitization was used in an inventive way in order “not to share risk with investors, but to make an end run around capital-adequacy regulations.” *See* Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 196–97 (2009).

32. *See Definition of Collateralised Debt Obligation CDO*, FIN. TIMES, <http://lexicon.ft.com/Term?term=Collateralised-debt-obligation-CDO> [<http://perma.cc/GUV8-MWHV>].

33. René M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSP. 73, 77 (2010); *see* SEN. REP. ON FINANCIAL STABILITY, *supra* note 6, at 29–30, 43. In the Senate Committee Report, Congress pointed out that the decision not to regulate derivatives, especially credit default swaps, exacerbated the crisis. *Id.* at 29–30, 43. That report referenced statements made by the Obama Administration that “the downside of this lax regulatory regime . . . became disastrously clear during the recent financial crisis” where investors had large positions in these unregulated products that ultimately “saddled

Ultimately, investors were harmed. In some cases, banks misrepresented the nature of the underlying subprime mortgage loans.³⁴ In others, banks may have failed to disclose the magnitude of their exposure to the volatile mortgage market.³⁵ Gaps in regulatory expertise and monitoring may have been partly to blame.³⁶ As Congress noted, “[t]he system [had] operated on a wholesale misunderstanding of, or complete disregard for the risks inherent in the underlying assets and the complex instruments they were backing.”³⁷ Notably, these examples of misconduct in connection with securitized products reflect only that which was eventually uncovered in the large, well-regulated financial institutions. Misconduct at various other intermediaries in the securitization pipeline is invariably much more difficult to anticipate and detect.³⁸ As Tomasz Piskorski and co-authors point out,

[m]arket rules and regulations . . . require disclosure of information and prohibit misleading statements on the financial products being manufactured by intermediaries . . . [but] the nature of intermediation has changed dramatically over the past decade, with the introduction of more agents in the supply chain of credit . . . potentially weakening the ability of existing

our financial system with an enormous—and *largely unrecognized*—level of risk.” *Id.* at 29–30 (emphasis added) (quoting DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 47 (2009)).

34. Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 104 F. Supp. 3d 441, 453 (S.D.N.Y. 2015) (“This case is complex from almost any angle, but at its core there is a single, simple question. Did defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans.”).

35. See David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1448, 1450 (2014) (noting that although CDOs were erroneously marketed as safe products, it is difficult to tell whether these assets failed because of “improper engineering” or “the general downturn in the economy”). Also, in 2013, finance economists Tomasz Piskorski, Amit Seru, and James Witkin collected and analyzed data on mortgage asset fraud in connection with the financial crisis. Tomasz Piskorski, Amit Seru & James Witkin, *Asset Quality Misrepresentation by Financial Intermediaries: Evidence from the RMBS Market*, 70 J. FIN. 2635, 2635–36 (2015). They found “a significant propensity of reputable banks to sell misrepresented loans during the housing market boom” and that “[t]his behavior also appears to have largely escaped regulators in charge of safeguarding the rights of investors.” *Id.* at 2674–75.

36. James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture’*, 33 CAMBRIDGE J. ECON. 563, 567–68 (2009) (noting that banks “stockpile[d]” these assets despite a lack of understanding within the industry, regulators included).

37. SEN. REP. ON FINANCIAL STABILITY, *supra* note 6, at 43.

38. See Judge, *supra* note 18, at 684–90.

market arrangements and regulatory oversight to ensure truthful disclosure of asset quality.³⁹

In short, as innovation in securitization advances and expands, regulators' capacity to detect misconduct in the securitization business will continue to be stretched.

Consider just one hypothetical looming large on the horizon. Recently, the market for auto-loan ABS has grown considerably. The sector originated \$97.8 billion of loans in 2015,⁴⁰ bringing the total outstanding to somewhere around \$170 billion.⁴¹ Strikingly, issuance volume represents a twenty-five percent increase from 2014, while credit card debt and other consumer finance products have remained flat.⁴² These signs suggest that a bubble may be brewing, fueled by "competition among lenders keen on getting in on lucrative securitizations," and creating the same sorts of opportunities for misconduct that arose prior to the recent financial crisis.⁴³ In the auto-ABS market, just like most other securitized product markets, lengthy and prolix disclosure documents detail a number of complex processes in connection with originating and bundling loans, which responsibilities are spread across multiple actors along a financial product assembly line.⁴⁴ To the extent this securitization activity is, again, occurring outside of the large, well-regulated banks, regulatory resources to monitor for misconduct will likely be spread thin.⁴⁵

39. Piskorski et al., *supra* note 35, at 2635.

40. *U.S. ABS Issuance and Outstanding*, SIFMA (2016), <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-SIFMA.xls?n=84917> [<http://perma.cc/8KQM-5BJV> (staff-uploaded archive)]; see Tyler Durden, *Don't Look Now, but the Subprime Auto Bubble May Be Bursting*, ZERO HEDGE (Aug. 13, 2015), <http://www.zerohedge.com/news/2015-08-13/dont-look-now-subprime-auto-bubble-may-be-bursting> [<http://perma.cc/4UCC-EQFQ>].

41. SIFMA, *supra* note 40. According to an industry source, the total ABS market is \$1.387 trillion—\$705 billion excluding CDOs and housing-related ABSs. *Id.*

42. Durden, *supra* note 40.

43. *Id.*

44. See Judge, *supra* note 18, at 659–60.

45. Awrey, *supra* note 17, at 284 & n.272 (noting that "the Dodd-Frank Act also seeks to enhance the regulation of ABS and other securitizations—including, importantly, those offered under exemptions from the prospectus and registration requirements under the Securities Act" (emphasis omitted)); Durden, *supra* note 40; see also Dodd-Frank Act, § 941(a), § 77, 124 Stat. 1376, 1890 (2010) (codified at 15 U.S.C. § 78c(a)(77) 2012)) (defining an "asset-backed security"); *id.* § 941(b) (defining "securitizer"); *id.* sec. 942(b), § 7(c) (increasing disclosure requirements surrounding underlying assets in ABS); *Asset-Backed Securities*, SEC (Nov. 23, 2014), <https://www.sec.gov/spotlight/dodd-frank/assetbackedsecurities.shtml> [<http://perma.cc/6WFQ-ALNC>]. The Commission passed rules in August 2014, known as Regulation AB II, that require issuers of asset-backed securities (backed by auto loans among others) to disclose detailed information about the loans underlying the securities. See *Asset-Backed Securities Disclosure and Registration*,

From this vantage point, it is not surprising that regulators are concerned about the shadow banking system and debating whether more regulation is needed.⁴⁶ So far, however, much of that conversation has focused on regulators' ability simply to understand (and possibly curb) the activities of the bespoke institutions, many of which operate without the same kinds of supervision or regulations that are imposed on traditional banks (like capital adequacy requirements).⁴⁷ As the crisis well illustrated, a regulatory handle over the entire securitization process—including each of these shadow bank intermediaries—is of key importance to the stability of the financial system.⁴⁸ But the sheer size and scope of the shadow banking system makes a detailed understanding of that sector—let alone a robust capacity to detect abuses within it—difficult for regulators to accomplish alone.⁴⁹

2. Technology

The proliferation of financial technology in the past several years also presents challenges for securities regulation and enforcement. Two technological developments in particular—fintech and crowdfunding—demonstrate the ramping up of financial technology

Securities Act Release No. 9638, Exchange Act Release No. 72,982, 79 Fed. Reg. 57,184, 57,184 (Sept. 24, 2014).

46. Michael Flaherty & Howard Schneider, *U.S. Regulators Struggle in Effort to Tackle Shadow Banking*, REUTERS (Apr. 1, 2015, 1:27 PM), <http://www.reuters.com/article/2015/04/01/usa-fed-shadowbanks-idUSL3N0WY4O420150401#UHvyzRgyAYo1RG8c.97> [<http://perma.cc/9BB4-8HL8>]; see also Ryan Tracy, *SEC Official: 'Not Clear' Bank Regulation Has Made Economy Safer*, WALL ST. J. (Apr. 1, 2015, 8:29 PM), <http://blogs.wsj.com/moneybeat/2015/04/01/sec-official-not-clear-bank-regulation-has-made-economy-safer> [<http://perma.cc/7FMP-97VJ> (dark archive)] (reporting that Fed Vice Chairman Stanley Fischer “floated several ideas for regulating shadow banks, some of which might take SEC action to implement”).

47. See Huw Jones, *Regulators Lack Data to Probe Shadow Banking Sector*, REUTERS (May 2, 2014, 8:49 PM), <http://www.reuters.com/article/us-regulations-shadowbanks-idUSBREA410EM20140502#7jKILJriOZJTzoQq.97> [<http://perma.cc/NQ9E-CVP2>].

48. See EDWARD V. MURPHY, CONG. RESEARCH SERV., R43087, WHO REGULATES WHOM AND HOW? AN OVERVIEW OF U.S. FINANCIAL REGULATORY POLICY FOR BANKING AND SECURITIES MARKETS 9 (2015), <https://www.fas.org/sgp/crs/misc/R43087.pdf> [<http://perma.cc/T72S-R4SM>] (explaining that “activities being called shadow banking are often still subject to securities regulation,” but “[t]he reach of financial regulators to address policy problems in shadow banking varies from activity to activity and from class of firm to class of firm”).

49. *Id.*; cf. Matthew Goldstein, *Whistle-Blower on Countrywide Mortgage Misdeeds to Get \$57 Million*, N.Y. TIMES (Dec. 17, 2014), http://dealbook.nytimes.com/2014/12/17/countrywide-whistle-blower-to-receive-more-than-57-million/?_r=1 [<http://perma.cc/2AWH-3SB6>] (discussing the importance of whistleblowing and insider information in federal prosecutors' claims against Bank of America).

and innovation in a postcrisis world and the gaps in regulation and supervision that exist.

Financial technology includes a relatively new “fintech” sector, that is a recent wave of startups focused on technological innovation in finance, many of which are based in New York City. The products that fintech startups are creating run the gamut from financial services (like platforms providing for location-based commerce and peer-to-peer social payments) to cybersecurity (including platforms designed to combat new threats, such as cyberhacking).⁵⁰

The fintech sector has become a global attraction. In fact, global financing activity in U.S. fintech firms attracted almost \$1 billion in capital and a record 109 closed deals in the first quarter of 2014.⁵¹ Additional figures show that global investment in fintech grew *four times* faster than overall investments from venture capital firms in the past three years.⁵² From 2010 to 2014, investment in U.S. fintech rose from \$1.64 billion to \$9.89 billion.⁵³ As one industry report stated, “The financial services industry is more focused on technology innovation than at any other point in its history”⁵⁴

While many financial technology firms and products no doubt expand consumer choice and lower the price of financial services—classic economic “goods”—the sweep of financial technology presents new challenges from a regulatory perspective. For one, it may be difficult for regulators to keep pace with developments in how risk is transferred, shared, or created, as large institutions develop or partner with new technology ventures.⁵⁵ For example, some large financial firms have developed creative “third-party initiatives” with smaller fintech firms, or have themselves spun-off their own innovation labs that may technically be exempt from the established rules.⁵⁶ Thus some growth of the financial technology sector may increase financial diffusion and industry evolution in a way that strains regulatory supervision and assessment.

50. ACCENTURE & P'SHIP FUND FOR N.Y.C., *THE RISE OF FINTECH* 4 (2014).

51. *Id.*

52. *Id.*

53. Penny Crosman, *Meteoric Rise of Startups Evident at Fintech Demo Day*, AM. BANKER (June 26, 2015), <http://www.americanbanker.com/news/bank-technology/meteoric-rise-of-startups-evident-at-fintech-demo-day-1075121-1.html> [<http://perma.cc/AEH9-6L79>].

54. ACCENTURE & P'SHIP FUND FOR N.Y.C., *supra* note 50, at 4.

55. *Id.* at 5; Crosman, *supra* note 53.

56. ACCENTURE & P'SHIP FUND FOR N.Y.C., *supra* note 50, at 5. *But see* Jonathan Rogers & Peter Wilson, *Old Laws, New Models: UK Regulation of FinTech*, TAYLORWESSING (Oct. 2014), http://www.taylorwessing.com/download/article_uk_reg_fintech.html [<http://perma.cc/3SH3-G96J>] (describing the emerging regulatory framework for fintech in the United Kingdom).

More generally, technology in finance may also give rise to opportunity for consumer abuse, particularly in connection with the sale of private technology stocks—that is, before those companies go public. The SEC is watching this area closely for irregularity, specifically with respect to whether the transactions involve securities swaps and are violating registration requirements.⁵⁷ These regulators' concern is that, as a means of avoiding securities law restrictions on stock sales, certain “middlemen are designing derivatives that deliver payments . . . based on [the] stock's perceived value.”⁵⁸ But since many of these private tech companies do not widely and publicly disclose their financial information, the “[p]rices used in these private sales can be based on little more than a guess.”⁵⁹ As these financial commentators put it, “financial middlemen . . . are creating a murky, ad hoc market where the red-hot stocks of closely held technology companies trade largely out of sight of regulators, other investors and the companies themselves.”⁶⁰

Crowdfunding is another aspect of the ongoing revolution in financial technology. Crowdfunding involves “raising many small amounts of money from a large number of people”⁶¹ for small or startup businesses.⁶² The crowdfunding model of capital raising relies on Internet platforms (crowdfunding sites) to raise money from the general public, again, accumulating small contributions from many

57. See, e.g., SEC Files Subpoena Enforcement Action Against Netcirq, LLC for Failure to Produce Documents, Litigation Release No. 23,418, 2015 WL 7873435 (Dec. 3, 2015); Susan Pulliam & Telis Demos, *SEC Steps Up Probe of Pre-IPO Share Trading*, WALL ST. J. (Dec. 1, 2015), <http://www.wsj.com/articles/sec-steps-up-probe-of-pre-ipo-share-trading-1449020518> [<http://perma.cc/X89F-VR5M> (dark archive)]; see also Susan Pulliam & Telis Demos, *How Wall Street Middlemen Help Silicon Valley Employees Cash In Early*, WALL ST. J. (Mar. 27, 2015, 4:41 PM), <http://www.wsj.com/articles/how-wall-street-middlemen-help-silicon-valley-employees-cash-in-early-1427474284> [<http://perma.cc/4L4Z-M7AG> (staff-uploaded archive)] [hereinafter Pulliam & Demos, *Middlemen*]; Susan Pulliam & Telis Demos, *Regulators Probe Marketing of Hot Private Tech Shares*, WALL ST. J. (July 5, 2015), <http://www.wsj.com/articles/regulators-probe-marketing-of-hot-private-tech-shares-1436139252> [<http://perma.cc/EE4Z-D8KQ> (staff-uploaded archive)].

58. Pulliam & Demos, *Middlemen*, *supra* note 57.

59. *Id.* The prospect of fraud is certainly not only hypothetical. Already, there are three cases of alleged misleading of investors and failure to disclose fees before Facebook went public. *Id.* In March of 2015, prosecutors charged a Buffalo man with criminal fraud for persuading an investor to give \$5 million to a venture capital fund that said it would buy Uber shares, but used the money to pay other investors. *Id.*

60. *Id.*

61. Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012, 10:50 AM), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy> [<http://perma.cc/A3ZQ-LMTG> (staff-uploaded archive)].

62. See C. Steven Bradford, *Crowdfunding and the Federal Securities Law*, 2012 COLUM. BUS. L. REV. 1, 1, 5 (2012).

investors.⁶³ For small businesses, crowdfunding provides access to a pool of capital that would otherwise be difficult to obtain;⁶⁴ for investors, it makes participation in financial markets—in various forms—more accessible.⁶⁵

Like fintech, crowdfunding has also become a global phenomenon. Crowdfunding websites have popped up all over the world, including the United States, Canada, New Zealand, Europe, and Kenya.⁶⁶ In a similar vein, crowdfunding is becoming increasingly globalized—at least one British crowdfunding site has opened its investment opportunities across Europe (the first to offer cross-border investment).⁶⁷ More recently, a Canadian equity crowdfunding site also offered a cross-border equity opportunity for the first time in that country.⁶⁸ Crowdfunding comes in various forms, perhaps most commonly providing “rewards” (e.g., a product) or securities.⁶⁹

Where “investment crowdfunding” is concerned—equity stock is offered—such fundraising efforts fall under the scope of the U.S. securities laws.⁷⁰ However, in 2012, in an effort to stimulate the

63. *Id.*

64. The costs of an initial public offering (“IPO”) and “being public” are substantial. See PWC, CONSIDERING AN IPO? THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU 12–13 (2012), <https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf> [<http://perma.cc/6RXZ-QRZS>] (“The process of undertaking an initial public offering is rigorous, time-consuming, and expensive. Many companies, having spent months exhausting their human and financial resources, view the completion of an IPO as the finish line. In reality, this is just the beginning of their new life as a public company[, which includes ongoing reporting and disclosure requirements.]”).

65. See Bradford, *supra* note 62, at 5.

66. Wil Schroter, *Crowdfunding Around the World*, FORBES (July 9, 2014), <http://www.forbes.com/sites/wilschroter/2014/07/09/crowdfunding-around-the-world> [<http://perma.cc/CV7W-MYUA> (staff-uploaded archive)].

67. Kylie Maclellan, *British Crowdfunding Site to Allow Cross-Border Investment*, REUTERS (Nov. 25, 2013), <http://www.reuters.com/article/2013/11/25/us-crowdfunding-expansion-idUSBRE9A00A620131125> [<http://perma.cc/R86D-Q2Q9>].

68. Oscar Jofre, *North America’s First Simultaneous Cross Border Equity Crowdfunding Raise: Wafu*, CROWDFUND INSIDER (Oct. 6, 2014), <http://www.crowdfundinsider.com/2014/10/51067-north-americas-first-simultaneous-cross-border-equity-crowdfunding-raise-wafu> [<http://perma.cc/M7UG-DKNE>].

69. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1459–60 (2013).

70. See Ross S. Weinstein, Note, *Crowdfunding in the U.S. and Abroad: What to Expect When You’re Expecting*, 46 CORNELL INT’L L.J. 427, 427–28 (2013). The securities laws apply only to offers, sales, and purchases of securities. See, e.g., 15 U.S.C. § 77e (2012) (prohibiting offers and sales of securities without proper registration); 17 C.F.R. § 240.10b-5 (2015) (prohibiting fraud and material misstatements and omissions in connection with a purchase or sale of securities). Section 2(a)(1) of the 1933 Act includes stock, notes, and investment contracts within the definition of security. Securities Act of 1933, ch. 38, § 2(a)(1), 48 Stat. 74, 74 (codified as amended at 15 U.S.C. § 77b(a)(1) (2012)) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond,

economy and encourage small business, Congress exempted crowdfunding from certain securities law requirements with the Jumpstart Our Business Startups Act (“JOBS Act”).⁷¹ In particular, Title III of the JOBS Act created a securities offering exemption for “crowdfunding,” which relaxed some of the securities laws’ disclosure and registration requirements.⁷² As Tom Hazen points out, “[w]ithout [this] crowdfunding exemption . . . crowdfunding would not be a viable capital-raising method in light of the costs of complying with securities registration or even the more limited disclosure requirements available under the exemption set forth in SEC Regulation A.”⁷³

Congress required the Commission to make rules to implement these new exemptions. Accordingly, in March 2015, the SEC adopted a final rule, effective on or about June 19, 2015, that amended the existing Regulation A.⁷⁴ Now, pursuant to Regulation A+, small companies can offer and sell up to \$50 million (an increase from the previous \$5 million limit) in equity securities without the need to comply with traditional registration and reporting requirements.⁷⁵ As attorneys at the law firm Morgan, Lewis & Bockius succinctly describe it:

Regulation A+ offerings are unregistered public offerings in which issuers may conduct general solicitation, including

debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, [or] voting-trust certificate . . .”).

71. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315–23 (2012) (codified in scattered sections of 15 U.S.C.).

72. *Id.* sec. 302, § 4; *see also* Schwartz, *supra* note 69, at 1460–64 (discussing the relaxations and exemptions); Anna Pinedo, *It’s Not Crowdfunding!*, MOFO JUMPSTARTER (July 13, 2015), <http://www.mofojumpstarter.com/2015/07/13/its-not-crowdfunding> [<http://perma.cc/W8ZQ-BRVU>].

73. Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1738 (2012).

74. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 80 Fed. Reg. 21,806 (Apr. 20, 2015). Regulation A is a long-standing exemption allowing small companies to sell publicly traded equity securities through a truncated registration and review process and exempting these companies from ongoing reporting requirements. Small Business Initiatives, 57 Fed. Reg. 36,442, 36,443 (Aug. 13, 1992) (codified as amended in scattered parts of 17 C.F.R.); Small Business Initiatives, 57 Fed. Reg. 9768, 9770 (proposed Mar. 20, 1992) (codified in scattered parts of 17 C.F.R.).

75. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806; *see SEC Adopts Rules to Facilitate Smaller Companies’ Access to Capital*, SEC (Mar. 25, 2015), <http://www.sec.gov/news/pressrelease/2015-49.html> [<http://perma.cc/5ZHL-S66V>].

solicitation of non-accredited investors, and the securities purchased by investors in a Regulation A+ offering are not “restricted securities” under Rule 144. In addition, the Regulation A+ offering process is simpler and less costly than a registered public offering such as an IPO.⁷⁶

Additionally, in October 2015, the SEC finalized rules to allow individuals, not just accredited investors, to invest in crowdfunded securities.⁷⁷ The practical import of these exemptions is to expand consumer participation in crowdfunding by giving companies a new—and more streamlined—route to capital raising in the public market and by facilitating the trading of their securities in the secondary markets.⁷⁸

While seemingly advantageous from a market efficiency and liquidity perspective, some have expressed concern about these exemptions from a consumer protection perspective, suggesting that they have created opportunities for fraud.⁷⁹ While it is certainly too soon to tell, some anecdotal evidence so far suggests that these concerns are well founded. In June 2015, for example, the Federal Trade Commission (“FTC”) filed the first-ever crowdfunding case, charging an Oregon man with “unfair or deceptive acts” in raising \$122,000 in a Kickstarter campaign (a popular crowdfunding site).⁸⁰ He allegedly misled investors to believe that he was funding a board game project, but instead he used the capital for personal items.⁸¹ Reporting on the events and outcome of this case, Kevin Wack of the

76. MORGAN, LEWIS & BOCKIUS, SEC ADOPTS FINAL RULES ON REGULATION A+, at 2 (2015), <https://www.morganlewis.com/~media/files/publication/morgan%20lewis%20title/white%20paper/securitiessecadoptsfinalrulesregulationaapril2015.ashx?la=en> [http://perma.cc/LF44-EH7M].

77. Crowdfunding, Securities Act Release No. 9974, Exchange Act Release No. 76,324, 80 Fed. Reg. 71,388 (Nov. 16, 2015); *SEC Adopts Rules to Permit Crowdfunding*, SEC (Oct. 30, 2015), <https://www.sec.gov/news/pressrelease/2015-249.html> [http://perma.cc/SAE4-XEK4].

78. MORGAN, LEWIS & BOCKIUS, *supra* note 76, at 2; *see also* Schwartz, *supra* note 69, at 1459 (noting that the “crowdfunding of securities will help democratize the market for financing startup companies and small businesses and allow investors of modest means to make investments that had previously been offered solely to wealthy . . . investors”).

79. *See, e.g.*, Schwartz, *supra* note 69, at 1465 & n.46. *But see* Joan MacLeod Hemmingway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 937 (2011) (arguing that notwithstanding risks of investor fraud, on balance, the positive benefits of a registration exemption outweigh the possible negative consequences).

80. Complaint at 1–3, *FTC v. Chevalier*, No. 3:15-cv-01029-AC (D. Or. June 10, 2015); Angus Loten, *Man Settles with FTC over Crowdfunding Case*, WALL ST. J. (June 11, 2015), <http://blogs.wsj.com/digits/2015/06/11/man-settles-with-ftc-over-crowdfunding-case/> [http://perma.cc/WS4Y-CMHM (staff-uploaded archive)].

81. *See* sources cited *supra* note 80.

American Banker wrote: “[c]rowdfunding enables fledgling businesses to tap into a vast online pool of investment dollars, but it also has a dark side, offering a lucrative new venue for scam artists.”⁸²

This case suggests what others have for several years suspected to be true: the diffusion of participation in equity offering and investing, enabled by crowdfunding technology, creates a fertile ground for abuse. At the same time, as regulators reduce the amount of disclosure and reporting required in an effort to encourage small business growth, they further limit their ability to monitor for and anticipate such misconduct.

B. Whistleblower Programs

The foregoing case study in contemporary financial innovation illustrated the various constraints on financial regulators’ ability to supervise the financial services sector comprehensively and, thus, exposed limits on their capacity to detect putative securities law violations. In the case of structured finance, the sheer number of economic actors involved—from the origination and pooling of loans, to their packaging and the offering of securities comprised of these fixed-income assets to investors—can muddle information that regulators receive. More broadly speaking, the shadow banking system in which this process operates raises significant questions about the capacity and scope of regulators’ power. Financial technology, which is also expansive (and sometimes niche), can likewise strain regulators’ ability to monitor the array of institutions and markets involved, which evolve quickly and often on a small but numerous scale.

This Section explores one postcrisis regulatory tool that was intended to enhance securities law enforcement by leveraging assistance from private citizens: whistleblower programs.⁸³ It suggests

82. Kevin Wack, *P-to-P Regulatory Risks Exposed in Crowdfunding-Fraud Case*, AM. BANKER (June 11, 2015), <http://www.americanbanker.com/news/marketplace-lending/p-to-ps-regulatory-risks-exposed-in-crowdfunding-fraud-case-1074835-1.html> [http://perma.cc/PF77-VUHL (staff-uploaded archive)].

83. The legislative history suggests that Congress intended for the whistleblower provisions to “motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated securities laws and recover money for victims of financial fraud.” SEN. REP. ON FINANCIAL STABILITY, *supra* note 6, at 110. In hearings before the House Committee on Financial Services on July 17, 2009, Rep. Paul Kanjorski, Democrat from Pennsylvania, stated: “[W]e ought to put more cops on the beat by allowing the Commission to pay bounties to whistleblowers whose tips result in catching fraudsters.” *Industry Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Servs.*,

that, in light of the regulatory gaps explored above, whistleblowers have the potential to improve regulators' ability to anticipate and detect financial misconduct.

1. Incentives

Section 922 of the Dodd-Frank Act amended the Securities Exchange Act of 1934 ("Exchange Act"), creating section 21F, which provides incentives for whistleblowers to report violations of the federal securities laws.⁸⁴ The program is implemented by the SEC and serves the "important goals of prevention, timely detection, and effective enforcement of securities law violations."⁸⁵ In broad overview, it allows the SEC, in its discretion, to make award payments to "whistleblowers who voluntarily provide[] original information to the Commission that [leads] to [a] successful enforcement" action that recovers at least \$1 million.⁸⁶ The SEC adopted final rules to implement the Dodd-Frank program in May 2011, which rules became effective in August 2011.⁸⁷

The program is based on incentives, of which there are three. One is a cash bounty. The program provides that whistleblowers may be entitled to ten to thirty percent of any sanction collected where the amount is over \$1 million.⁸⁸ The second incentive is protection from

111th Cong. 2 (2009) (statement of Rep. Paul Kanjorski, Member, H. Comm. on Fin. Servs.).

84. Dodd-Frank Act, Pub. L. No. 111-203, sec. 922, § 21F, 124 Stat. 1376, 1842 (2010) (codified at 15 U.S.C. § 78u-6 (2012)). A whistleblower, under the SEC rules, is anyone who "provide[s] the Commission with information [that] relates to a possible violation of the Federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur." 17 C.F.R. § 240.21F-2(a)(1) (2015).

85. Kathleen L. Casey, *Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC (May 25, 2011), <https://www.sec.gov/news/speech/2011/spch052511klc-item2.htm> [<http://perma.cc/RC5V-56CU>] [hereinafter *Casey Statement*].

86. Dodd-Frank Act, sec. 922, § 21F, 124 Stat. at 1841-42.

87. See Securities Whistleblower Incentives and Protections, Exchange Act Release No. 64,545, 76 Fed. Reg. 34,300, 34,300 (May 25, 2011) [hereinafter SEC Final Rule Release]. Although the Dodd-Frank Act set many requirements of the program,

the Commission has exercised its discretion in this rulemaking to propose rules that contain several key definitional or interpretive provisions that help define the scope of the program, and procedures that whistleblowers will be required to follow to submit information to the Commission and to apply for awards under the Program

Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 63,237, 75 Fed. Reg. 70,488, 70,514-15 (proposed Nov. 3, 2010) [hereinafter Proposed Whistleblower Rule].

88. 17 C.F.R. §§ 240.21F-3(a)(4), 240.21F-5(b).

workplace retaliation.⁸⁹ Recently, the SEC has made clear that it intends to vigorously pursue employers that retaliate. As evidence of this, in April 2015, the Commission announced an award in connection with its first ever retaliation case.⁹⁰ There, a whistleblower received over \$600,000 for information regarding undisclosed trading activity in violation of the Investment Advisers Act of 1940.⁹¹ But the SEC also charged the company, Paradigm Capital Management, with retaliating against the whistleblower by removing him from his position, requiring him to investigate the misconduct he had reported, altering his job duties, and generally “marginalizing [him].”⁹² The third incentive is confidentiality; a whistleblower’s identity will not be disclosed to the public, absent limited exceptions.⁹³ A whistleblower can also submit information anonymously through an attorney.⁹⁴

The number of tips has grown in each year of the program’s existence. In fiscal year 2015, the SEC Office of the Whistleblower⁹⁵ received nearly 4,000 tips—a slight increase from the 3,620 tips in 2014 and 3,238 in 2013; and a more pronounced increase from the 3,001 tips in 2012 and 334 tips in 2011.⁹⁶ Most commonly, the SEC receives information pertaining to corporate disclosures and financials, followed by securities offering fraud and securities

89. 15 U.S.C. § 78u-6(h) (2012); 17 C.F.R. § 240.21F-2(b). The anti-retaliation provisions of the Dodd-Frank whistleblower program expanded on the whistleblower program put in place by section 806 of the Sarbanes-Oxley Act of 2002, which was also passed in response to corporate fraud. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, sec. 806, § 1514A, 116 Stat. 745, 802-04 (codified as amended at 18 U.S.C. § 1514A (2012)).

90. Paradigm Capital Mgmt., Inc., Exchange Act Release No. 74,826, 2015 WL 1907622 (Apr. 28, 2015); *see* Paradigm Capital Mgmt., Inc., Exchange Act Release No. 72,393, 2014 WL 2704311 (June 16, 2014).

91. *See* sources cited *supra* note 90; *see also* SEC Announces Award to Whistleblower in First Retaliation Case, SEC (Apr. 28, 2015), <https://www.sec.gov/news/pressrelease/2015-75.html> [<http://perma.cc/W7MP-KHBD>].

92. SEC Announces Award to Whistleblower in First Retaliation Case, *supra* note 91; *see* Alexandra Stevenson, *S.E.C. Fines Hedge Fund in Demotion of Whistle-Blowing Employee*, N.Y. TIMES (June 16, 2014, 8:37 PM), http://dealbook.nytimes.com/2014/06/16/s-e-c-fines-firm-over-whistle-blower-retaliation/?_php=true&_type=blogs&module=BlogPost-Title&version=Blog%20Main&contentCollection=Legal/Regulatory&action=Click&pgtype=Blogs®ion=Body&_r=1 [<http://perma.cc/WL4N-EWMS>] (identifying the whistleblower as former head trader James Nordgaard).

93. 17 C.F.R. § 240.21F-7(a) (2015).

94. *Id.*

95. Office of the Whistleblower, SEC, <https://www.sec.gov/whistleblower> [<http://perma.cc/FDJ3-L52W>].

96. SEC, 2015 ANNUAL REPORT TO CONGRESS ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 21 (2015) [hereinafter 2015 WHISTLEBLOWER REPORT], <https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2015.pdf> [<http://perma.cc/7PZD-CS8E>].

manipulation.⁹⁷ For example, according to the SEC's most recent annual report to Congress, several awards were made in connection with misconduct in the financial services industry, involving "Ponzi-like schemes" and "false or misleading statements" in offering memoranda, marketing materials, or price information.⁹⁸ So far, the SEC has made twenty-two awards in connection with sixteen different matters.⁹⁹

2. Expansion

Regulators have been pushing to strengthen and expand the program over the past several years. Domestically, the SEC has made clear its commitment to the program by pressing the private market to cooperate. Not only has the SEC expressed its commitment to pursuing retaliation suits,¹⁰⁰ but it has also punished companies for chilling whistleblowing in other ways. In that vein, employment contracts have been a focus. In April 2015, the SEC announced a settlement with KBR Inc. (a Houston-based engineering and construction company) regarding language in that company's confidentiality agreements that "undermine[d] the purpose of Section 21F and Rule 21F-17(a)."¹⁰¹ The SEC found that the language in the agreements, which prohibited employees from discussing internal investigations with outside parties—including, presumably, the government—violated Exchange Act Rule 21F-17(a): that "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."¹⁰²

The SEC has also been pressing for a more expansive definition of "whistleblowers" through amicus briefs in federal court.¹⁰³ In the SEC's view, where the statute's antiretaliation provisions are concerned, the definition of whistleblower includes those who report *internally*, to the firm, as well as those who report to the

97. *Id.* at 22.

98. *Id.* at 17.

99. *Id.* at 12, 16.

100. *See supra* notes 89–92 and accompanying text.

101. KBR, Inc., Exchange Act Release No. 74,619, 2015 WL 1456619 (Apr. 1, 2015).

102. 17 C.F.R. § 240.21F-17(a) (2015).

103. *See, e.g.*, Brief of the Sec. & Exch. Comm'n as Amicus Curiae in Support of the Appellant, *Berman v. Neo@Ogilvy LLC*, No. 14-4626 (2d Cir. Feb. 6, 2015), <https://www.sec.gov/litigation/briefs/2015/daniel-berman-020615.pdf> [<http://perma.cc/2YT4-87VC>].

Commission.¹⁰⁴ Finally, there has been some suggestion that the Department of Justice would like to extend whistleblower programs in the financial crime arena as well.¹⁰⁵

Whistleblower programs are also expanding abroad. On the domestic end, the SEC has been clear that it welcomes information from citizens living or residing abroad. Since the program's beginning, it has received tips from over ninety-five different countries and has made awards in three different matters where the whistleblower lived abroad.¹⁰⁶ In the Commission's view, the program has a "global scope."¹⁰⁷

The European Union has also shown some commitment to augmenting whistleblower programs. A 2014 EU Regulation on Market Abuse required that all European Union member states implement a whistleblower program in their respective jurisdictions by 2016 (with respect to violations of the market abuse directive).¹⁰⁸ The United Kingdom also recently strengthened its stance on whistleblowers. Its existing whistleblower statute, the Public Interest Disclosure Act of 1998 ("PIDA"), "protect[s] individuals who make certain disclosures of information in the public interest."¹⁰⁹ Specifically, PIDA protects individuals who make "qualifying disclosures" to their employer or another person or government entity that is responsible for the issues being disclosed.¹¹⁰ This

104. See Interpretation of the SEC's Whistleblower Rules Under Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 75,592, 2015 WL 4624264 (Aug. 4, 2015).

105. Barrett, *supra* note 15.

106. 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 12, 24.

107. *Id.* at 12.

108. Council Regulation 596/2014, 2014 O.J. (L 173) 1, 14 ¶ 74, 16, 33 (EU).

109. Public Interest Disclosure Act 1998, c. 23 (UK), <http://www.legislation.gov.uk/ukpga/1998/23> [<http://perma.cc/VHY9-P7N9>]; see David Lewis, A.J. Brown & Richard Moberly, *Whistleblowing, Its Importance and the State of Research*, in INTERNATIONAL HANDBOOK ON WHISTLEBLOWING RESEARCH 1, 359 (A.J. Brown et al. eds., 2014) [hereinafter WHISTLEBLOWING HANDBOOK].

110. Public Interest Disclosure Act 1998, c. 23, § 1 (UK), <http://www.legislation.gov.uk/ukpga/1998/23> [<http://perma.cc/VHY9-P7N9>]. A protected qualifying disclosure is one that an employee reasonably believes in good faith is in the public interest and that

tends to show one or more of the following: (a) that a criminal offence has been committed, is being committed or is likely to be committed, (b) that a person has failed, is failing or is likely to fail to comply with any legal obligation . . . , (c) that a miscarriage of justice has occurred, is occurring or is likely to occur, (d) that the health or safety of any individual has been, is being or is likely to be endangered, (e) that the environment has been, is being or is likely to be damaged, or (f) that information tending to show any matter falling within any one of the preceding paragraphs has been, is being or is likely to be deliberately concealed.

includes, for example, disclosures made to the United Kingdom's Serious Fraud Office regarding instances of past or ongoing economic crimes.¹¹¹

In the financial services context specifically, England's prudential bank regulators, the Financial Conduct Authority ("FCA") and the Bank of England Prudential Regulation Authority, have noted that whistleblowers "play an important role in helping to protect the safety and soundness of firms."¹¹² And in the summer of 2015, the FCA announced new rules for deposit-takers, certain investment firms, and insurers regarding internal whistleblower mechanisms.¹¹³ In contrast to the U.S.-SEC model, however, the new U.K. rules do not incentivize or impose a duty on employees to report "concerns" to regulators.¹¹⁴ Rather, the rules require financial firms to go beyond what is required by PIDA, to implement procedures for handling a wider range of "reportable concerns."¹¹⁵

* * *

This Part has sought to frame the debate about whistleblower programs in terms of current and anticipated challenges that innovation in the current global economic environment poses for financial regulation and enforcement. It first provided some context for why private assistance is necessary to aid public enforcement at all—because innovation, and the complexity and diffusion it brings, has and will likely continue to overwhelm regulatory resources and create fertile environments for misconduct.¹¹⁶ Then, this Part

Id.

111. SERIOUS FRAUD OFFICE, GUIDELINES ON MAKING A PUBLIC INTEREST DISCLOSURE, 2013, at 4 (UK), https://www.sfo.gov.uk/media/34779/Guidelines_on_making_a_public_interest_disclosure.pdf [<http://perma.cc/65FQ-KTEJ>].

112. BANK OF ENGLAND PRUDENTIAL REGULATION AUTHORITY & FINANCIAL CONDUCT AUTHORITY, FINANCIAL INCENTIVES FOR WHISTLEBLOWERS, 2014, ¶ 1, <https://www.fca.org.uk/static/documents/financial-incentives-for-whistleblowers.pdf> [<http://perma.cc/6SAA-QWRM>].

113. Whistleblowing in Deposit-Takers, PRA-Designated Investment Firms and Insurers 2015, PS 15/24, ¶¶ 1.1, 1.7 (UK); *FCA Introduces New Rules on Whistleblowing*, FIN. CONDUCT AUTH. (June, 10, 2015), <https://www.fca.org.uk/news/fca-introduces-new-rules-on-whistleblowing> [<http://perma.cc/SCX7-E3LY>].

114. Whistleblowing in Deposit-Takers, PRA-Designated Investment Firms and Insurers 2015, PS 15/24, ¶¶ 1.15, 2.24, 2.27.

115. See Accountability and Whistleblowing Instrument 2015, FCA 2015/46, Annex A(1) (defining a "reportable concern" as "(a) anything that would be the subject-matter of a *protected disclosure*, including breaches of *rules*; (b) a breach of the *firm's* policies and procedures; and (c) behavior that harms or is likely to harm the reputation or financial well-being of the *firm*").

116. Awrey has also noted several ways in which innovation (and complexity) contribute to regulatory asymmetries. He argues: "Complexity and innovation have

surveyed one attempted solution: whistleblower programs, both in the United States, under the aegis of the SEC, and abroad, with fledging expansion in the European Union and United Kingdom. Drawing on this framework, which casts whistleblower programs as desirable (indeed, necessary), the balance of this Article aims to strengthen the integrity and quality of postcrisis whistleblower programs by reexamining their benefits and costs in light of the contemporary marketplace.

II. A COST-BENEFIT ANALYSIS OF WHISTLEBLOWERS

Part I highlighted three areas of the global financial markets in which regulatory asymmetries—informational and expertise gaps between regulators and the private market—frustrate regulatory supervision and give rise to opportunity for misconduct. This Part evaluates whistleblower solutions from a cost-benefit perspective. Section II.A first provides some theoretical framework for a cost-benefit analysis of whistleblower programs, and the SEC whistleblower program in particular. Section II.B then engages in a conceptual analysis of the various benefits of the whistleblower program, both observable and hypothetical. Section II.C then sets out the costs and unintended consequences of a strong, highly incentivized whistleblower program. Ultimately, Part II argues that the strong U.S. model is, on balance, desirable when one weighs the benefits of whistleblower laws against their costs.

A. Framing the Analysis

Strictly speaking, independent agencies, like the Commission, are not required to engage in cost-benefit analysis—although historically (since the 1980s), the Commission has voluntarily done so as a matter of “good regulatory practice.”¹¹⁷ Yet this practice was altered slightly

combined to generate significant asymmetries of information and expertise within financial markets, thereby . . . exacerbating already pervasive agency cost problems. At the same time, the pace of innovation has left financial regulators and regulation chronically behind the curve.” Awrey, *supra* note 17, at 238–39.

117. Mary L. Schapiro, *Testimony Concerning Economic Analysis in SEC Rulemaking: Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee U.S. House of Representatives*, SEC (Apr. 17, 2012), <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171489400> [<http://perma.cc/74EM-J4P7>] [hereinafter *SEC Rulemaking Testimony*] (“When the Commission engages in rulemaking, it strives to adopt rules that further that mission without imposing unjustified costs. Understanding the potential economic consequences of rules the Commission is considering is an integral component of that process.”). There are two provisions, however, that require the SEC to consider the likely impact of its rules. One provides that the SEC “shall not adopt any rule or regulation which would impose a

after the crisis. Given the significant rulemaking burden that the Dodd-Frank Act imposed,¹¹⁸ the Commission adopted the position that little cost-benefit analysis (if any at all) was necessary in areas where Congress had left the Commission no discretion.¹¹⁹ So, for example, when section 939B of the Dodd-Frank Act required the Commission to “revise Regulation FD . . . to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings[.]”¹²⁰ the Commission did not include a cost-benefit analysis on the ground that “any costs and benefits to the economy resulting from the amendments are mandated by the [Dodd-Frank] Act.”¹²¹

Likewise, in connection with the final whistleblower rule, the Commission engaged in a cost-benefit analysis only with respect to those elements of the program where the SEC planned to exercise its discretion¹²²: (1) in defining the terms “Voluntary Submission of Information,” “Independent Knowledge,” and “Information that Leads to Successful Enforcement”; (2) an additional (i.e., non-statutory) factor used to determine the amount of the award paid to a whistleblower;¹²³ (3) a few additional criteria for award eligibility,

burden on competition not necessary or appropriate” to advance the purposes of the securities laws. 15 U.S.C. § 78w(a)(2) (2012). The other requires the SEC, when it “is engaged in rulemaking,” to “consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” 15 U.S.C. § 78c(f) (2012).

118. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, <http://www.sec.gov/spotlight/dodd-frank.shtml> (last modified Aug. 6, 2015) [<http://perma.cc/2JPD-DL4F>].

119. *SEC Rulemaking Testimony*, *supra* note 117. In 2014, the D.C. Circuit effectively conceded in the conflict minerals case that where Congress mandates a rule that is not based on investor protection—and did not do cost-benefit analysis—the Commission may not be required to do cost-benefit analysis. *See Nat’l Ass’n of Mfrs. v. SEC*, 748 F.3d 359, 369 (D.C. Cir. 2014).

120. Dodd-Frank Act, Pub. L. No. 111-203, § 939B, 124 Stat. 1376, 1887–88 (2010).

121. Removal from Regulation FD of the Exemption for Credit Rating Agencies, Securities Act Release No. 9146, Exchange Act Release No. 63,003, Investment Company Act Release No. 29,448, 75 Fed. Reg. 61,050, 61,051 (Oct. 4, 2010).

122. Regarding this final rule, Commissioner Casey stated that

[t]he Commission has taken the view that it is only required to analyze costs and benefits flowing from the Commission’s exercise of its discretionary authority. This approach is too narrow and improperly limits the scope and regulatory value of cost-benefit analysis. In the context of the current rule, this approach has led us to drastically underestimate the costs of the whistleblower program.

Casey Statement, *supra* note 85.

123. Proposed Whistleblower Rule, *supra* note 87, at 70,515. This additional factor is “whether the award otherwise enhances the Commission’s ability to enforce the Federal

namely, certain types of cooperation and the exclusion from eligibility of anyone who was a “member, officer, or employee” of a foreign government at the time information was acquired; (4) specifications regarding the procedures required to submit information and claim an award; (5) the exclusion from the \$1 million threshold of any sanctions that the whistleblower is required to pay; and (6) authority for the Commission to communicate directly with “[any] whistleblower who is a director, officer, member, agent, or employee of an entity that has counsel [and] has initiated communications with the Commission.”¹²⁴

The result was a little over five pages of cost-benefit analysis in the proposed rule.¹²⁵ Therein, the crux of the Commission’s analysis focused on the rule’s benefits, citing the “strong incentives” that the proposed definitions created for whistleblowers “to provide information early, rather than waiting to receive a request or inquiry from a relevant authority.”¹²⁶ As an additional benefit, the Commission believed that its definitions were well tailored to reduce the incidence of low-quality tips by, for example, requiring information that “significantly contributed to the success of an [enforcement] action” or “would not otherwise have been obtained and was essential to the success of the action.”¹²⁷ As for the costs, for the most part the Commission limited its analysis to potential costs the rule would impose on *whistleblowers*, with much less consideration for the costs that might arise in the financial services industry or society more broadly.¹²⁸

Since that analysis was performed, however, regulators and scholars have continued to debate the appropriate model of cost-benefit analysis in financial regulation. In general, the trend has favored more robust analysis before new rules are imposed.¹²⁹ Congress, for example, has introduced bills that would give the

securities laws, protect investors, and encourage the submission of high quality information from whistleblowers.” *Id.*

124. *Id.*

125. *Id.* at 70,514–18.

126. *Id.* at 70,516.

127. *Id.* Notably, however, the final rule loosened this standard, requiring only “original information . . . [t]hat leads to successful enforcement.” 17 C.F.R. § 240.21F-3(a) (2015).

128. See Proposed Whistleblower Rule, *supra* note 87, at 70,517–18.

129. As Professor John Coates has written, a recent “movement is afoot to impose cost-benefit analysis (CBA) on financial regulation (CBA/FR).” John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 885 (2015) (noting that the substantial reforms imposed by Dodd-Frank “reignited criticism for failure to base the changes on adequate CBA/FR”).

president authority to require independent agencies to conduct cost-benefit analysis of their financial regulation.¹³⁰ And although the D.C. Circuit Court of Appeals has held that the Commission is not required “to measure the immeasurable,”¹³¹ it arguably should still “determine as best it can the economic implications of [a] rule.”¹³² Indeed, the Commission itself has since changed its position; now, “[t]he new guidance . . . states that as a policy matter, where a statute directs rulemaking, rulewriting staff should consider the overall economic impacts, including *both* those attributable to Congressional mandates *and* those that result from an exercise of the Commission’s discretion.”¹³³ In perhaps another paradigm shift, academics have begun defending the virtues of conceptual—over strictly quantitative—cost-benefit analysis. Scholars like Professor John Coates and Professor David Zaring, while resisting “efforts to impose judicially reviewed, quantified, [cost-benefit analysis] on independent financial agencies,” have urged the importance of conceptual cost-benefit analysis, which “could lead to better policy and . . . advance the substantive project of quantitative [cost-benefit analysis] itself.”¹³⁴

At this juncture in the evolution of the cost-benefit analysis of financial regulation, academics and policy makers alike should be interested in revisiting the costs and benefits of the whistleblower program. It also seems productive to do so, given that the contours, boundaries, definitions, and trajectory of whistleblower programs globally remain in flux. Accordingly, the balance of this Part aims to

130. Independent Agency Regulatory Analysis Act of 2013, S. 1173, 113th Cong. § 3(a)(6); Independent Agency Regulatory Analysis Act of 2012, S. 3468, 112th Cong. § 3(a)(6).

131. *Nat’l Ass’n of Mfrs. v. SEC*, 800 F.3d 518, 552 (D.C. Cir. 2015) (quoting *Inv. Co. Inst. v. Commodity Futures Trading Comm’n*, 720 F.3d 370, 379 (D.C. Cir. 2013)).

132. *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005). However, as David Zaring points out,

The court’s interest in cost-benefit analysis might be said to have two degrees in intensity. The first, a requirement that the S.E.C. do one, and do it carefully, appears to have been internalized by the agency. A second, more intensive, cost-benefit analysis would require a quantification of the costs and benefits. That component has never been definitively imposed on the agency by the circuit court, and the S.E.C. appears to be willing to propose rules that lack this sort of quantitative justification.

David Zaring, *The State of Cost-Benefit Analysis at the S.E.C.*, N.Y. TIMES (July 13, 2015), <http://www.nytimes.com/2015/07/14/business/dealbook/the-state-of-cost-benefit-analysis-at-the-sec.html> [<http://perma.cc/5S64-YE49> (dark archive)].

133. *SEC Rulemaking Testimony*, *supra* note 117.

134. Coates, *supra* note 129, at 886; *see* Zaring, *supra* note 132 (explaining that “[i]f we must have costs and benefits, perhaps it is good that the S.E.C. is trying to preserve flexibility about how it defines them”).

update the Commission's initial cost-benefit analysis, so that scholars and regulators can reflect on how to move forward. To be sure, with the benefit of four years of hindsight and data, the nature of this post hoc cost-benefit analysis will be quite distinct from that which is ordinarily performed before a rule becomes final. Nonetheless, given the extent to which regulators worldwide are prepared to embrace and expand whistleblower programs, it is worthwhile to engage in a reanalysis of their costs and benefits, drawing on the United States' recent experience.¹³⁵

B. Whistleblowing and Its Benefits

In the financial regulation context, whistleblowing programs have several conceptual and observable benefits. To begin, as the Commission's experience suggests, one (arguably principal) benefit of a whistleblower program is that it can be effective in assisting the government to detect financial misconduct. There are other, perhaps less appreciated, benefits to whistleblowing programs as well, including a more efficient use of government resources, enhanced market discipline, and improved industry ethics, which can enhance the legitimacy of the industry and, along with it, consumer confidence.

1. Regulatory Gaps

In theory, whistleblowers programs are designed to aid the government in filling regulatory gaps. Whistleblowers—who are most often individuals within the financial industry¹³⁶—have the knowledge and expertise that government regulators often lack, but which is

135. Consistent with Professors Coates's and Zaring's view, Sections II.B and II.C likewise engage in a principally conceptual cost-benefit analysis. *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-151, DODD-FRANK REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION 19 (2011); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-032, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE 3, 13 (2007) ("Measuring regulatory benefits remains [a] challenge largely because of the difficulty in quantifying benefits such as improved consumer protection or financial stability [in the context of financial services regulation.] . . . While regulation provides a broad assurance of the strength of financial markets, it is difficult to measure those benefits, in part because regulations seeking to ensure financial stability aim to prevent low-probability, high-cost events."); Coates, *supra* note 129, at 894-95 (noting that "full quantification in CBA/FR is likely to be difficult because finance is at the heart of the economy, involves groups of people (firms, markets) interacting in complex, difficult-to-study ways, and is shaped by forces that change rapidly over time").

136. *See* 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 16 ("[T]o date, almost half of the award recipients were current or former employees of the company on which they reported information of wrongdoing.").

necessary to detect many cases of financial misconduct.¹³⁷ Precisely as Professor Saule Omarova has argued, “[p]rivate industry actors may be in the best position to identify and understand underlying trends in the increasingly complex financial markets and to gather and analyze, in real time, information most relevant to systemic risk management.”¹³⁸ With four years of data to draw on, it appears that, in practice, whistleblowers *are* effective at detecting misconduct.¹³⁹ In sixteen different matters,¹⁴⁰ whistleblowers have provided government regulators with inside information about past or ongoing misconduct, thereby overcoming the government’s traditional resource limitations.

Whistleblowers can help regulators overcome their resource gaps in two distinct ways. First, whistleblowers play an early-warning role. Recent examples are instructive. In the fall of 2014, the SEC paid a \$30 million award—its largest yet—to a foreign tipster for information about an ongoing fraud that, as the SEC described, would have been difficult to detect without the whistleblower’s help.¹⁴¹ Considering that whistleblower awards are calculated at ten to thirty percent of the total recovery, the fraud that whistleblower disclosed had presumably already caused losses or damage between \$100 and \$300 million. Since the fraud was “ongoing,”¹⁴² one can assume that those losses would have increased without the whistleblower’s information.

In 2015, the financial markets were again presumably spared from significant harm when a firm employee disclosed to the SEC that Bank of America’s (“BOA”) London-based affiliate was involved in extensive “dividend arbitrage” in the context of international tax laws.¹⁴³ It made several whistleblowing submissions

137. See *supra* Section I.A (discussing areas of innovative financial activity where regulatory gaps exist).

138. Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 418 (2011).

139. Full details of whistleblower cases are difficult to know because the government usually promises confidentiality in exchange for the information. However, it is possible to parse some critical facts from media reports and SEC press releases and annual reports to Congress. See, e.g., Paradigm Capital Mgmt., Inc., Exchange Act Release No. 74,826, 2015 WL 1907622 (Apr. 28, 2015) (awarding over \$600,000 to head trader who had been demoted after providing information to SEC).

140. See 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 16.

141. Rachel Louise Ensign, *SEC to Pay \$30 Million Whistleblower Award, Its Largest Yet*, WALL ST. J. (Sept. 22, 2014), <http://www.wsj.com/articles/sec-to-pay-30-million-whistleblower-award-its-largest-yet-1411406612#> [<http://perma.cc/LF3W-Z5RW> (staff-uploaded archive)].

142. *Id.*

143. Jenny Strasburg, *Bank of America’s U.S. Deposit-Taking Unit Financed Tax Trades*, WALL ST. J. (Feb. 11, 2015), <http://www.wsj.com/articles/bank-of-americas-u-s-deposit-taking-unit-financed-tax-trades-1423666493> [<http://perma.cc/L8LY-QZ42> (staff-uploaded archive)].

about BOA's "increasingly aggressive and reckless' tax-avoidance trades," which put the bank at risk of "serious financial and reputational damage."¹⁴⁴ Also in 2015, the SEC announced that another payment would be made, of about \$1.5 million,¹⁴⁵ to a compliance officer "who had a reasonable basis to believe that disclosure to the SEC was necessary to *prevent imminent misconduct* from causing substantial financial harm to the company or investors."¹⁴⁶ The language of the SEC disclosure, though necessarily vague, suggests that losses were averted thanks to the whistleblower submission. Based on these few examples, it appears that in performing this early-warning function, whistleblowers have played a part in mitigating potential market losses by muting the impact of nascent misconduct.¹⁴⁷

Second, data also suggest that whistleblowers may provide some deterrent value by increasing the chances (and possibly speed with which) misconduct is detected. The case of the "flash crash" of 2010—in which the Dow Jones suddenly dropped by one thousand points—is particularly telling.¹⁴⁸ For five years, regulators had thought that the crash was caused by the innocuous trades of a mainstream trading house, made at a time of macroeconomic unease.¹⁴⁹ In 2015, however, the Commodity Futures Trading Commission and the Department of Justice filed charges against a London-based trader, alleging that the crash was caused by his manipulative "spoofing" of a certain stock index.¹⁵⁰ Apparently, that information was learned from a

144. *Id.*

145. Order Determining Whistleblower Award Claim, Exchange Act Release No. 74,781, 2015 WL 1814377 (Apr. 22, 2015).

146. *SEC Announces Million-Dollar Whistleblower Award to Compliance Officer*, SEC (Apr. 22, 2015) (emphasis added), <https://www.sec.gov/news/pressrelease/2015-73.html> [<http://perma.cc/88XV-K578>].

147. *See supra* Part I.

148. Aruna Viswanatha, Bradley Hope & Jenny Strasburg, 'Flash Crash' Charges Filed, WALL ST. J. (Apr. 21, 2015), <http://www.wsj.com/articles/u-k-man-arrested-on-charges-tied-to-may-2010-flash-crash-1429636758> [<http://perma.cc/7R3X-AMJB> (staff-uploaded archive)].

149. *Id.*

150. *See* Civil Complaint at 2, 20, 21, Commodities Futures Trading Comm'n v. Nav Sarao Futures Ltd., No. 1:15-cv-03398 (N.D. Ill. Apr. 17, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfsaraocomplaint041715.pdf> [<http://perma.cc/8Q7A-3PVF>]; Criminal Complaint at 1, 3, United States v. Singh Sarao, No. 1:15-cr-00075 (N.D. Ill. Feb. 11, 2015), http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_complaint.pdf [<http://perma.cc/7PQA-WYDG>]; Dave Michaels, Matthew Leising & Sam Mamudi, *Flash Crash Arrest Lays Bare Regulatory Lapses at All Levels*, BLOOMBERG (Apr. 22, 2015), <http://www.bloomberg.com/news/articles/2015-04-22/flash-crash-arrest-lays-bare-regulatory-lapses-at-all-levels> [<http://perma.cc/Y2K4-FZED>].

whistleblower's submission, but was unknown to regulators for these past five years.¹⁵¹

Consistent with this anecdotal evidence, empirical evidence further suggests that whistleblowers are generally better at uncovering fraud than government supervisory authorities acting alone. Congress has reported that in the past four years whistleblowers have uncovered 54.1% of frauds in public companies, versus the 4.1% detected by the SEC and external auditors.¹⁵² In theory, then, robust whistleblower programs that effectively attract insider information should disincentivize would-be perpetrators of misconduct, assuming that such actors recognize the increased risks of detection and punishment associated with misconduct.

2. Regulatory Efficiency

There are a number of economic reasons why governments rely on the private sector to provide public services. One standard rationale for privatization or outside contracting is that private-sector actors will perform the jobs for which they are hired with greater efficiency than their government counterparts, whose government salaries and career security fail to provide the same motivating incentives. Relatedly, competitive pressures in the private sector should force private actors to perform with better quality and at lower cost than a government service provider would. In short, whereas government service providers have no reason to perform a job as efficiently as possible because the workflow is guaranteed, private-sector actors vie for government contracts and must therefore outperform the competition.¹⁵³

151. See Viswanatha et al., *supra* note 148.

152. SEN. REP. ON FINANCIAL STABILITY, *supra* note 6, at 110. On the punishment side, research has found that whistleblower involvement in a government investigation has resulted in higher sanctions, in the form of increased firm or individual fines, and greater prison sentences. Andrew C. Call et al., *The Impact of Whistleblowers on Financial Misrepresentation Enforcement Actions* 4–5 (Dec. 9, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2506418 [http://perma.cc/TC26-HAHV]. “The results of this analysis suggest whistleblower involvement in enforcement actions accounts for 27.5% of total penalties assessed in all enforcement actions from 1978–2012 and increase[d] the length of prison sentences for culpable employees by more than [twenty-five] months” *Id.* at 6. The prospect of more severe penalties could also be expected to have some deterrent effect.

153. See generally William L. Megginson & Jeffrey M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321, 321 (2001) (documenting and summarizing empirical findings on the benefits of privatization). But see Molly Ball, *The Privatization Backlash*, ATLANTIC (Apr. 23, 2014), <http://www.theatlantic.com/politics/archive/2014/04/city-state-governments-privatization-contracting-backlash>

On these rationales, state, local, and federal governments have increasingly relied on the private sector to perform some of its core responsibilities.¹⁵⁴ During and after the Reagan Administration, the executive branch took the view that the American bureaucracy had become “inefficient and bloated” in past decades and that a downsized government supplemented with public-private partnerships would be more productive and cost effective.¹⁵⁵ In many ways, this philosophy of utilizing the private sector for public services transformed the regulatory machinery of the United States. Today, many state and local governments lease toll roads, bridges, and tunnels to private contractors—as well as a range of other services, including utilities, corrections, education, and medical services.¹⁵⁶

Similar efficiency theories motivated early corporate whistleblower programs as well. Although initially resisted as “panoptic,” “whistleblowing as a source of information” about wrongdoing within the firm ultimately found its “legitimacy as countering organizational inefficiency.”¹⁵⁷ Relying, in part, on information from whistleblowers actually allowed firms to reduce employee regulation, on the ground that whistleblowers could play a cost-saving deterrence function.¹⁵⁸

Outsourcing financial supervision (in part) to private citizens can yield several economic gains in the securities law context as well. For one, it accomplishes more comprehensive monitoring at lower taxpayer cost. To prophylactically monitor *all* financial activity—particularly that which is innovative and diffuse—would be extraordinarily costly for the state to accomplish.¹⁵⁹ The federal

/361016/ [http://perma.cc/L97K-BP2A] (noting that in recent years, “the public impression of privatization as a panacea for the inherent inefficiency of government has been tarnished”).

154. See Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397, 399 (2006) (citing PAUL C. LIGHT, *THE TRUE SIZE OF GOVERNMENT* 1–3 (1999)).

155. *Id.* at 417–18; see John B. Goodman & Gary W. Loveman, *Does Privatization Serve the Public Interest?*, HARV. BUS. REV., Nov–Dec. 1991, at 26, 26; Paul R. Verkuil, *Reverse Yardstick Competition: A New Deal for the Nineties*, 45 FLA. L. REV. 1, 4–5 (1993).

156. COMM’N ON GOV’T FORECASTING & ACCOUNTABILITY, STATE OF ILL., *GOVERNMENT PRIVATIZATION: HISTORY, EXAMPLES, AND ISSUES* 9–19 (2006).

157. See WIM VANDEKERCKHOVE, *WHISTLEBLOWING AND ORGANIZATIONAL SOCIAL RESPONSIBILITY: A GLOBAL ASSESSMENT* 139 (2006).

158. See *id.*

159. See *In re Nat’l Presto Indus., Inc.*, 347 F.3d 662, 664 (7th Cir. 2003) (“Federal agencies have limited resources, and the SEC in particular is often outgunned by the affluent defendants that it sues.”); *In re SmithKline Beckman Corp. Sec. Litig.*, 751 F. Supp. 525, 535 (E.D. Pa. 1990) (“Private litigation aids effective enforcement of the securities laws because private plaintiffs prosecute violations that might otherwise go undetected due to the SEC’s limited resources.” (quoting Note, *Private Causes of Action*

government would have to employ hundreds of public-sector employees simply to learn the mechanics of new financial products, not to mention to keep enough eyes on the ground. Where global institutions and markets are concerned, there are additional transaction costs (both economic and political) involved with allocating monitoring responsibility between sovereigns. Yet private individuals who are industry insiders are already placed (and trained) to perform these kinds of monitoring tasks; whistleblower programs incentivize them to do so, for only a relatively small portion of enforcement damages collected.¹⁶⁰

Furthermore, whistleblower programs may create secondary efficiency gains. For one, to the extent regulators can rely on whistleblowers as early-warning systems, they can then also rely less heavily on other forms of top-down regulation that may be more costly for firms.¹⁶¹ Moreover, firms may realize efficiency gains to the extent that whistleblower programs make the industry safer and more stable. Misconduct in one institution often imposes significant costs on others, by damaging consumer confidence in finance or inviting more (and more costly) regulatory scrutiny and regulation to the industry as a whole.¹⁶² Accordingly, if whistleblower programs are successful in reducing misconduct in the industry writ large, eventually firm-level regulatory and legal costs may decrease.

Finally, whistleblower programs may serve public welfare goals. Public choice theory generally posits that government regulation can become dysfunctional when regulators are beholden to private interests.¹⁶³ This phenomenon, known as “capture,” bears out “the idea that powerful organizations with private interests may capture

for Investors Under SEC Rule 10b-5; A Policy, Doctrinal, and Economic Analysis, 100 HARV. L. REV. 1959, 1963 n.24 (1987)).

160. Whistleblowers are compensated through an Investor Protection Fund, established by Congress, which is funded by sanctions collected by the SEC. See 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 27.

161. See Skinner, *supra* note 6, at 1588–1610 (discussing the economic merits of relaxing quantitative forms of regulation, like capital ratios, in exchange for qualitative, misconduct-oriented supervisory regulation).

162. See *id.* (discussing the social and economic costs of misconduct).

163. See Lawrence G. Baxter, “Capture” in *Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL’Y 175, 175–76 (2011). See generally JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 76 (1989) (discussing “client politics” and the accompanying agency capture problem “when most or all of the benefits of a program go to some single, reasonably small interest (an industry, profession, or locality) but most or all of the costs will be borne by a large number of people (for example, all taxpayers)”).

the government in order to foster their private goals.”¹⁶⁴ Regulatory capture thus results when certain influential members of an industry are able to persuade state regulators to use the power of the state to establish or enforce rules at the public’s expense—by doing so, industry’s “influence” is “disproportionate to the balance of interests envisaged when the regulatory system was established.”¹⁶⁵

Some scholars have argued that finance is particularly susceptible to capture.¹⁶⁶ It is a “highly complex field, mastered only by a small class of people.”¹⁶⁷ And this class of elite, specialized professionals is incentivized “to construct interests and preferences in a way that favours *laissez-faire* regulation.”¹⁶⁸ In this vein, the public has criticized the SEC and the Department of Justice for failing to punish financial actors for the causes of the financial crisis.¹⁶⁹ Though existing accounts of capture theory do not definitively explain why this phenomenon occurs, resource limitations are, at least in part, to blame; where the regulator depends on the regulated in the industry for critical information—to understand how the industry works—the resulting rules may favor the industry’s special interests.¹⁷⁰

164. Frédéric Boehm, *Regulatory Capture Revisited—Lessons from Economics of Corruption 4* (July 2007) (unpublished manuscript), <http://www.icgg.org/downloads/Boehm%20-%20Regulatory%20Capture%20Revisited.pdf> [<http://perma.cc/2L4J-3K3C>].

165. Baxter, *supra* note 163, at 176–78.

166. See CHRIS BRUMMER, *SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY* 19, 177–78, 185 (2012); see also Kevin L. Young, *Transnational Regulatory Capture? An Empirical Examination of the Transnational Lobbying of the Basel Committee on Banking Supervision*, 19 *REV. INT’L POL. ECON.* 663, 664 (2012).

167. Douglas Sarro, *Rational Choices, but for Whom? Transnational Financial Regulation After the Crisis*, 2 *TRANSNAT’L LEGAL THEORY* 455, 460 (2011) (reviewing BRUMMER, *supra* note 166).

168. *Id.*

169. See, e.g., Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, *N.Y. TIMES MAG.* (Apr. 30, 2014), http://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html?_r=0 [<http://perma.cc/PXA9-ZA6M> (dark archive)]; Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, *N.Y. REV. BOOKS* (Jan. 9, 2014), <http://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions> [<http://perma.cc/VJ7H-FR7T>]; Andrew Ross Sorkin, *Realities Behind Prosecuting Big Banks*, *N.Y. TIMES* (Mar. 11, 2013), http://dealbook.nytimes.com/2013/03/11/big-banks-go-wrong-but-pay-a-little-price/?_r=0 [<http://perma.cc/7G3C-CZ6S>]; Matt Taibbi, *Why Isn’t Wall Street in Jail?*, *ROLLING STONE* (Feb. 16, 2011), <http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216> [<http://perma.cc/TLH6-8HJ8>].

170. See Ernesto Dal Bó, *Regulatory Capture: A Review*, 22 *OXFORD REV. ECON. POL’Y* 203, 203–04, 207, 210 (2006) (focusing in particular on Stigler’s principal-agent model, which emphasizes the asymmetric flow of information and influence between the regulator and regulated).

Whistleblower programs, however, may mitigate the costs associated with capture. Whistleblowers, though technically part of the industry, develop a fundamentally different kind of relationship with securities regulators—and for very different reasons. Whistleblowers are more likely motivated by financial rewards (or, possibly, morality) rather than a desire to curry long-term favor with regulators or influence over regulatory decision-making.¹⁷¹ Indeed, whistleblowing would not likely be an effective way to shape regulatory preferences. In theory then, to the extent regulators develop partnerships with whistleblowers to understand the industry and detect misconduct, these relationships could partially replace, or at least reduce regulators' dependence on, the kinds of reliance-based industry relations that can give rise to capture costs.

3. Market Discipline

Another benefit of whistleblower programs is their potential to improve market discipline. Market discipline generally refers to the actions of multiple actors in the marketplace—institutions, depositors, equity holders—in assessing the operations of any one individual institution and responding accordingly.¹⁷² Common examples of market discipline may include, in the most basic sense, selling one's equity shares or withdrawing deposits in response to negative information about a financial institution. Institutions can also discipline each other by, for example, refusing to lend to each other or increasing the price to do so.¹⁷³ As Kate Judge has written, banks have the ability to “discipline” other banks if they perceive them to be taking inappropriate risks.¹⁷⁴

Information is key to market discipline, as “market participants will impose meaningful discipline only to the extent that they can accurately assess the risks to which a bank is exposed.”¹⁷⁵ Misconduct, however, can distort information or reduce its flow. False or

171. *See id.* at 214–15 (discussing the concept of the “revolving door,” where industry insiders move between the public and private sector throughout their careers). *See generally* Toni Makkai & John Braithwaite, *In and Out of the Revolving Door: Making Sense of Regulatory Capture*, 12 J. PUB. POL'Y 61, 61–62 (1992) (arguing that the desire to go out the revolving door accounts for two types of empirically recognized capture: “sympathy with the particular problems that regulated firms confront in meeting standards” and “identification with the industry”).

172. *See* Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262, 1277–78 (2013).

173. *Id.* at 1288–89.

174. *Id.*

175. *Id.* at 1278; *see* Bartlett, *supra* note 18, at 382–83 (describing the disclosure requirements currently imposed on U.S. banks and calling for particular types of disclosure requirements as a means of improving market discipline).

misleading disclosures in particular—the most common type of misconduct about which whistleblowers report to the SEC—decrease market participants’ ability to exercise effective discipline by diminishing their ability to accurately assess an institution’s financial activities and exposures.

Whistleblowers, meanwhile, can increase information about a financial institution. First, whistleblowers can reduce the incidence of inaccurate financial statements. They can also indirectly funnel information to the public about the efficacy of a firm’s internal compliance system and frequency of its employees’ misconduct. Although whistleblowers’ tips are not public, if a tip yields legitimate information, then the repercussions are likely to become public knowledge. Commission investigations become visible to outsiders and regulatory actions—like lawsuits or fines—must be disclosed by a firm.¹⁷⁶ By bringing more misconduct-related information to light, whistleblowing could thus trigger a disciplining effect whereby institutions withdraw from or decline to deal with those that have been involved in or associated with serious misconduct.

With respect to large financial institutions in particular, these interbank consequences can be significant. As Judge writes,

[a] disciplining bank can reduce its actual credit exposure to the disciplined bank by refusing to extend new loans or enter into new agreements with the bank, terminating existing arrangements, and seeking to exit current arrangements [with the bank] by assigning them to a third party.¹⁷⁷

The prospect of such market discipline that might follow a whistleblower’s tip may serve as a powerful deterrent (or incentive to improve compliance) in the first instance.

4. Public Participation

Whistleblower programs also benefit the public and the markets by increasing civic participation in finance, consistent with a legal and regulatory tradition of providing the public with a role in enforcing certain laws that touch on key matters of public concern.

176. SEC Regulation S-K, Item 103, requires disclosure of “any material pending legal proceeding” or any material legal proceeding “known to be contemplated by governmental authorities.” 17 C.F.R. § 229.103 (2015). Notably, however, financial institutions may not be required to disclose SEC investigations or so-called Wells Notices, which recommend an enforcement action be taken. *See In re Lions Gate Entm’t Corp. Sec. Litig.*, No. 14-cv-5197 (JGK), 2016 WL 297722, at *4, *12–14 (S.D.N.Y. Jan. 22, 2016); *see also* JP Morgan Chase & Co., Annual Report (Form 10K) 8, 88, 297 (Feb. 24, 2015).

177. Judge, *supra* note 172, at 1289.

Broadly speaking, there is a long history in the Anglo-Saxon legal tradition of allowing private citizens to assist the state in certain enforcement matters. Perhaps the earliest example of this is the use of the *qui tam* writ, which developed in the English common law.¹⁷⁸ Beginning in the thirteenth century, *qui tam* writs enabled private parties who had suffered private wrongs to bring suits in royal courts if determined to be in the royal (i.e., public) interest.¹⁷⁹ Both in England and then later in colonial America, *qui tam* suits were used to help the state enforce public (usually criminal) laws at times when the state lacked an effective police force.¹⁸⁰ Through the use of *qui tam*, private enforcers became such important stopgaps in the state's enforcement machinery that the first statute codifying the *qui tam* writ in the fourteenth century also added incentives for private accusers to assist the state by affording them one-fourth of any share in the penalty imposed.¹⁸¹

The *qui tam* writ later served as the basis for the U.S. False Claims Act ("FCA") of 1863¹⁸²—then known as the "Lincoln Law"—which was addressed to the fraud perpetrated against the U.S. government by its suppliers during the Civil War.¹⁸³ The FCA allowed private parties ("relators") to bring suits on behalf of the United States for fraud against the federal government.¹⁸⁴ If successful, the relators received a portion of the recovery as their "bounty."¹⁸⁵ *Qui tam* suits were not much used again until the 1980s, at which point they were reincarnated in a revised False Claims Act.¹⁸⁶ Though deployed only spottily in the following decades, there were a good many FCA cases after the financial crisis.¹⁸⁷ In the past few years,

178. Note, *The History and Development of Qui Tam*, 1972 WASH. U. L.Q. 81, 83 (1972). "Qui tam" is short for "*qui tam pro domino rege quam pro se ipso*" or "he who as much for the king as for himself." *Id.*

179. *Id.* at 83–85.

180. *Id.* at 85–86, 95.

181. *Id.* at 86.

182. 31 U.S.C. §§ 3729–3733 (2012).

183. RAJEEV K. GOEL & MICHAEL A. NELSON, BOFIT, EFFECTIVENESS OF WHISTLEBLOWER LAWS IN COMBATING CORRUPTION 5 (2013), http://www.suomenpankki.fi/bofit_en/tutkimus/tutkimusjulkaisut/dp/pages/dp0913.aspx [<http://perma.cc/LM9R-VTRY>].

184. Engstrom, *supra* note 17, at 1246; see Zaring, *supra* note 35, at 1455–56.

185. Engstrom, *supra* note 17, at 1246.

186. *See id.* at 1270.

187. *See Justice Department Recovers Nearly \$6 Billion from False Claims Act Cases in Fiscal Year 2014*, DOJ (Nov. 20, 2014), <http://www.justice.gov/opa/pr/justice-department-recovers-nearly-6-billion-false-claims-act-cases-fiscal-year-2014> [<http://perma.cc/VMB2-UYLZ>]. *See generally* Memorandum from William P. Barr, Assistant U.S. Attorney Gen., to Richard L. Thornburgh, U.S. Attorney Gen., Constitutionality of the *Qui Tam* Provisions of the False Claims Act (July 18, 1989), <http://www.justice.gov/sites/default/files>

enforcement agencies have attempted to hold accountable those actors that allegedly committed fraud.¹⁸⁸ In fact, FCA suits have been used far more than criminal prosecutions to address misbehavior related to the crisis: the Justice Department recovered nearly \$5 billion from FCA actions in 2012, with \$1.4 billion of that sum related to housing and mortgage fraud.¹⁸⁹ Criminal prosecutions, on the other hand, have “been few and far between.”¹⁹⁰ Given past success with *qui tam*, Dodd-Frank’s whistleblower rules “borrow[] heavily” from the FCA.¹⁹¹

In parallel to the *qui tam* tradition, Congress has also given private citizens authority to enforce public law by other means where crucial public interests are at stake. These grants of authority are often stylized as private attorney general statutes. As Olatunde Johnson describes it, “[t]he case for the private attorney general . . . is that it supplements what even an ideally constituted, well-funded, and vigorous public enforcement agency could do.”¹⁹² “Private litigation engages the resources of a multitude of private actors in rooting out” some public law problem—classically civil rights violations.¹⁹³

In *J.I. Case Co. v. Borak*,¹⁹⁴ a suit under section 14(a) of the Exchange Act, the Supreme Court extended the private attorney general theory to the securities context,¹⁹⁵ confirming that financial law was another area of key importance to the U.S. public.¹⁹⁶ As interpreted by subsequent courts, the private attorney general theory justified not only authorizing (as with *qui tam*) but actually *subsidizing* suits that “effectuate[] a strong Congressional policy

/olc/opinions/1989/07/31/op-olc-v013-p0207.pdf [http://perma.cc/F8JG-TDEQ] (discussing a series of ongoing federal questions and background information related to *qui tam* suits pending at the time of writing).

188. See Zaring, *supra* note 35, at 1411.

189. *Justice Department Recovers Nearly \$6 Billion from False Claims Act Cases in Fiscal Year 2014*, *supra* note 187.

190. Zaring, *supra* note 35, at 1437.

191. Douglas W. Baruch & Nancy N. Barr, *The SEC’s Whistleblower Program: What the SEC Has Learned from the False Claims Act About Avoiding Whistleblower Abuses*, 2 HARV. BUS. L. REV. ONLINE 28, 28–29 (2011), <http://www.hblr.org/?p=1566> [http://perma.cc/RZA4-8GTG]. The Dodd-Frank whistleblower rules do not include a *qui tam* provision, however. *Id.* at 29.

192. Olatunde C.A. Johnson, *Beyond the Private Attorney General: Equality Directives in American Law*, 87 N.Y.U. L. REV. 1339, 1347 (2012).

193. *Id.*

194. 377 U.S. 426 (1964).

195. *Id.* at 430–31; see also *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 390–91 (1970) (equitably awarding attorney’s fees in a suit under section 14(a) of the Exchange Act).

196. See *Mills*, 396 U.S. at 396–97.

which has benefited a large class of people.”¹⁹⁷ As a result, private citizens have the power to enforce the securities laws by bringing private suits for damages under a range of statutory grants. These “rights” of action can be found in section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5,¹⁹⁸ section 22 of the Commodities Exchange Act,¹⁹⁹ and section 1962(c) of the Racketeer Influenced and Corrupt Organizations Act (“RICO”).²⁰⁰

Financial whistleblower programs could thus be seen as part of this lengthy tradition of enlisting private citizens in matters of public regulatory concern and, specifically, affording the public an opportunity to hold financial actors accountable. When viewed in that light, whistleblower programs may offer some additional benefits arising from increased public expression and participation in the enforcement of financial regulation. Specifically, giving the public a stake in holding the industry accountable—even if for self-interested reasons—may improve the industry’s legitimacy. Even if somewhat intangible, such benefits could have real economic impact to the extent they bolster consumer confidence and overall financial stability.²⁰¹

5. Financial Culture

Finally, to the extent that whistleblower programs strengthen norms against misconduct in financial institutions, these programs may also improve financial culture and ethics.

197. *La Raza Unida v. Volpe*, 57 F.R.D. 94, 98 (N.D. Cal. 1972); *see also* Civil Rights Attorney’s Fees Awards Act of 1976, Pub. L. No. 94-559, 90 Stat. 2641 (codified as amended at 42 U.S.C. § 1988(b) (2012)).

198. *See Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 200 (2d Cir. 2014) (referring to section 10(b) as “the basic antifraud provision of the U.S. securities laws”).

199. *See Loginovskaya v. Batratchenko*, 764 F.3d 266, 270 (2d Cir. 2014).

200. Section 1964(c) of the RICO statute provides for a civil cause of action by “[a]ny person injured in his business or property by reason of a violation of section 1962.” 18 U.S.C. § 1964(c) (2012).

201. The Commission also considered benefits accruing from strengthened links between market stability and consumer trust:

[O]ne of the issues that may affect capital formation in the economy is investor confidence in the sense of investors trusting in the fairness of financial markets, of which their perception of the effectiveness and comprehensiveness of the regulatory regime is an important part. If investors fear theft, fraud, manipulation, insider trading, or conflicted investment advice, their trust in the markets will be low, both in the primary market for issuance or in the secondary market for trading. This would increase the cost of raising capital, which would impair capital formation

Proposed Whistleblower Rule, *supra* note 87, at 70,518.

Whistleblowing has an inherently ethical and moral dimension. Virtue ethics were in fact one of the earliest justifications for corporate whistleblower programs in the United States. As one scholarly account notes, “public administration ethics” in the first part of the twentieth century developed a certain “canon,” which endorsed the idea of the whistleblower.²⁰² And by emphasizing or elevating the latent moral aspect of whistleblowing, regulators could leverage whistleblower programs as a means of improving the industry’s culture²⁰³—thus advancing another priority that is high on the regulatory agenda today.²⁰⁴

To do so, regulators could frame whistleblowing in terms of the industry’s professional, ethical obligations. One way to do that is by orienting whistleblower goals within the established framework of industry self-regulation. Though support for industry self-regulation has ebbed and flowed in the past few decades, it is by now an embedded feature in the architecture of financial regulation. Today, many financial systems worldwide have significant self-governing aspects that work in tandem with government oversight. In the United States, for example, self-regulatory organizations like registered stock exchanges and the Financial Industry Regulatory Association (“FINRA”) perform a number of day-to-day oversight and enforcement functions, which are ultimately overseen by the SEC.²⁰⁵

At face value, whistleblower regimes fit well within the self-regulatory paradigm as a system of informally delegated enforcement that operates by tapping into the industry’s first-hand insight into misconduct.²⁰⁶ And if approached as a matter of industry self-

202. See H. George Frederickson, *Searching for Virtue in the Public Life*, in *ETHICS IN PUBLIC MANAGEMENT* 91, 95 (H. George Frederickson & Richard K. Ghere eds., 2d ed. 2013).

203. Gwendolyn Gordon & David Zaring, *Ethical Bankers* (unpublished manuscript) (on file with the *North Carolina Law Review*).

204. See, e.g., Alberto G. Musalem, *Why Focus on Culture?*, *FED. RES. BANK N.Y.* (Nov. 23, 2015), <https://www.newyorkfed.org/newsevents/speeches/2015/mus151123> [<http://perma.cc/D7LB-L38S>].

205. See Securities Acts Amendments of 1975, Pub. Law No. 94-29, § 26(b), 89 Stat. 97, 170 (codified as amended at 15 U.S.C. § 78f (2012)) (giving the Commission power to supervise SROs); see also Eric J. Pan, *Organizing Regional Systems: The US Example*, in *THE OXFORD HANDBOOK OF FINANCIAL REGULATION* 188, 198 (Niamh Moloney, Ellis Ferran & Jennifer Payne eds., 2015) (noting that in the past “[t]he SEC would oversee the SROs, but would only intervene if it determined that the SROs were failing to carry out their respective regulatory missions”).

206. See Omarova, *supra* note 138, at 434 n.85 (arguing the merits of industry self-regulation and urging “attention to the regulatory potential of using the industry’s relative information advantage”).

regulation, whistleblower programs—like other self-regulatory measures—could contribute in a meaningful way to ethical standard setting in the financial services sector.²⁰⁷ More concretely, in a self-regulatory approach to whistleblower programs, regulators would place significant emphasis on firm-level policies and procedures—that is, by fashioning rules that seek to strengthen the whistleblowing programs that operate internal to the industry. The United Kingdom provides an interesting model, where recent reforms require certain financial firms by March 2016 to designate a “whistleblowing champion,” a non-executive director whose role is to ensure the “integrity, independence and effectiveness” of the firm’s whistleblower’s policies.²⁰⁸

This kind of regulatory innovation, which has a distinctly self-regulatory flavor, has the potential to reduce the social and professional stigma that currently surrounds whistleblowing. And finding ways to motivate firms to internalize whistleblowing as a valuable and respected practice is an important step in fomenting a culture that disapproves of misconduct. As one group of commentators noted with respect to the London Interbank Offered Rate (“LIBOR”) scandal: “It is not enough to encourage the use of the whistleblowing mechanism if . . . employees are not encouraged to also challenge social conformity.”²⁰⁹ There, part of the problem was that industry actors did not recognize that their behavior in manipulating the benchmark was wrongful.²¹⁰

Delegating whistleblower requirements and responsibilities to firms and giving them some autonomy to shape and manage the process may be an effective way to cultivate such institutional and industry buy-in to whistleblowing in a way that has not quite taken hold vis-à-vis the SEC’s (externally oriented) program. Put differently, delegated whistleblower regimes might help to *denormalize* the kinds of misconduct that seem to have become

207. *See generally* 15 U.S.C. § 78f (2012).

208. *See* Bank of England, Prudential Regulation Authority, Whistleblowing in Deposit-Takers, PRA-Designated Firms and Insurers, Policy Statement PS24/15, at 8 (Oct. 2015) (UK), <http://www.bankofengland.co.uk/pradocuments/publications/ps/2015/ps2415.pdf> [<http://perma.cc/NZ56-GRW9>].

209. PWC, THREATS TO THE FINANCIAL SERVICES SECTOR 16 (2014), <https://www.pwc.com/gx/en/financial-services/publications/assets/pwc-gecs-2014-threats-to-the-financial-services-sector.pdf> [<http://perma.cc/T8UM-C6PH>].

210. *Id.*

accepted as normal in the past several years—that is, improve the financial industry’s culture.²¹¹

C. *Whistleblowing and Its Costs*

Notwithstanding the benefits of whistleblowers, whistleblower programs are not cost free. The following Section explores the costs of whistleblower programs, particularly those that were not amply considered by the Commission in the proposed rule.²¹²

1. Firm Compliance

One of the industry’s more prominent concerns about whistleblower programs—at the program’s beginning and now—is that they can undermine internal firm compliance.²¹³ Specifically, some have suggested that government programs, which incentivize employees to report misconduct externally, work at cross-purposes to firms’ ability to address misconduct in-house.²¹⁴ The concern is that

211. Kaptein gives several reasons why organizational culture bears on an employee’s propensity to blow the whistle on wrongdoing, including because: (1) it “indicates acceptable and unacceptable behavior that employees take into account when they decide how to respond”; (2) it determines what kind of behavior is legitimate by empowering employees “to follow up reports of wrongdoing, as they and others know that responding to observed wrongdoing is consistent with the prevailing culture”; (3) and it shapes how employees respond since employees are less likely to respond to wrongdoing by blowing the whistle if they perceive it “as an effect of a failing ethical culture.” Muel Kaptein, *From Inaction to External Whistleblowing: The Influence of the Ethical Culture of Organizations on Employee Responses to Observed Wrongdoing* 8–9 (Erasmus Research Inst. of Mgmt., Paper No. ERS-2009-047-ORG, 2009), <http://repub.eur.nl/pub/16600/ERS-2009-047-ORG.pdf> [<http://perma.cc/TD9G-Q5WZ>].

212. For an excellent analysis of the costs and benefits of whistleblower programs that complements this discussion, see Rose, *supra* note 17.

213. A compliance function is “an independent function that identifies, assesses, advises on, monitors and reports on” risk associated with failure to comply with laws, regulations, and “standards of good practice.” BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: THE COMPLIANCE FUNCTION IN BANKS ¶ 10 (2003). Likewise, most corporations—especially in the financial industry—have some form of enterprise risk management, of which compliance is a part. Enterprise risk management involves systems and structures to deal with “agency cost control,” among other risks to the business. See Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 981 (2009).

214. See Ebersole, *supra* note 17, at 137 (noting this criticism and arguing that internal compliance is more effective and efficient than external reporting). The Chamber of Commerce has argued that whistleblower programs “put trial lawyer profits ahead of effective compliance and corporate governance.” *U.S. Chamber Warns New SEC Whistleblower Rule Will Undermine Corporate Compliance Programs*, U.S. CHAMBER COM. (May 24, 2011), <https://www.uschamber.com/press-release/us-chamber-warns-new-sec-whistleblower-rule-will-undermine-corporate-compliance> [<http://perma.cc/B5TB-WBNE>]. In a September 24, 2010 hearing before the House Committee on Financial Services, the Senior Vice President for Policy and Advocacy at the Society of Corporate Secretaries and Governance Professionals

the hefty cash bounties from the government will diminish an employee's incentive to approach the firm with possible misconduct issues before turning to external regulators.²¹⁵ As one Commissioner stated, “[a]n inherent risk of the approach adopted in the final rule, is that the monetary sums at stake will provide a significant enough incentive for whistleblowers to completely bypass internal reporting in favor of coming straight to the Commission.”²¹⁶ In a similar vein, former Congressman Michael Oxley wrote that the Dodd-Frank whistleblower provisions went “too far” by “incentiviz[ing] [whistleblowers] to go outside the structure of the company” and “significantly reduc[ing] the effectiveness of internal due process.”²¹⁷

In drafting the rules, the Commission did, apparently, attempt to mitigate this possible cost. As implemented, the program purports to “encourage[] [employees] to work within their company’s own compliance structure, if appropriate.”²¹⁸ Accordingly, section 21F-6(a)(4) provides that the Commission will consider, in determining the award, whether the whistleblower had reported internally.²¹⁹ Likewise, pursuant to section 21F-6(b)(3), the Commission can

urged that “employee[s] will now have a significant financial incentive to bypass raising the issue with the company at all for fear of losing the bounty.” *Executive Compensation Oversight After the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 27 (2010) (statement of Darla C. Stuckey, Senior Vice President, Policy and Advocacy, Society of Corporate Secretaries and Governance Professionals). *But see* Mary Jo White, *The SEC as the Whistleblower’s Advocate*, SEC (Apr. 30, 2015), <http://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html> [<http://perma.cc/EN3G-YRXU>] (stating that “[a]ll indications are that internal compliance functions are as strong as ever—if not stronger—and that insiders continue to report possible violations internally first”).

215. *See* Richard Carrigan & Asheesh Agarwal, *How to Save Compliance Programs After Dodd-Frank*, LAW360 (Apr. 14, 2011), <http://www.law360.com/articles/236114/how-to-save-compliance-programs-after-dodd-frank> [<http://perma.cc/2LHW-N7MF>]; Michael T. Gass & Michael R. Dube, *The Problem with Compliance Whistleblowers*, LAW360 (May 6, 2015), <http://www.law360.com/articles/651304/the-problem-with-compliance-whistleblowers> [<http://perma.cc/Q88H-XR9B>] (noting that “many argue” that awarding compliance officers as whistleblowers “undermine[s] companies’ internal compliance function”); *see also* Rose, *supra* note 17, at 1278 (discussing this critique).

216. *Casey Statement, supra* note 85.

217. B. Nathaniel Garrett, Comment, *Dodd-Frank’s Whistleblower Provision Fails to Go Far Enough: Making the Case for a Qui Tam Provision in a Revised Foreign Corrupt Practices Act*, 81 U. CIN. L. REV. 765, 766 (2012) (quoting E-mail from Mr. Michael G. Oxley, Of Counsel, Baker & Hostetler LLP, former Congressman and Chairman of the House Fin. Servs. Comm., to B. Nathaniel Garrett (Oct. 28, 2011, 2:54 PM) (on file with B. Nathaniel Garrett)).

218. 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 4.

219. 17 C.F.R. § 240.21F-6(a)(4) (2015).

reduce the award amount if a whistleblower has interfered with internal compliance.²²⁰

Still, as the program has developed, incentives to report externally in lieu of internally seem to loom larger each year. Recently, judicial and agency interpretations of the statutorily mandated aspects of the whistleblower provisions have further cemented employees' incentives to report externally rather than internally. Circuit courts are now divided over the definition of a whistleblower. Recall that section 21F(a)(6) of the Exchange Act defines "whistleblower" as "any individual who provides . . . information relating to a violation of the securities laws to the Commission."²²¹ And these whistleblowers are protected, under section 21F(h)(1)(A)(iii), against retaliation by their employers.²²² According to the SEC's interpretation of its final rule implementing the whistleblower program, however, this retaliation protection also extends to those who report *internally*, not only to the Commission.²²³

Not surprisingly, however, courts differ over that interpretation. In *Asadi v. G.E. Energy (USA), L.L.C.*,²²⁴ the Fifth Circuit held that, because the term "whistleblower" is defined by the statute, whistleblower protections extend only to those who externally report to the SEC.²²⁵ Later, the Second Circuit deferred to the SEC's interpretation of the term whistleblower in *Berman v. Neo@Ogilvy LLC*,²²⁶ holding that the Dodd-Frank Act also protects internal whistleblowers.²²⁷ One implication of this circuit split, so long as it remains, is that employees may be marginally more incentivized to report externally first—ensuring that they are protected from retaliation, especially outside of the Second Circuit's jurisdiction.

In addition, the SEC has also made clear that corporations lack any real means consistent with the Exchange Act of discouraging external reporting. As briefly mentioned earlier, in April 2015, the SEC announced that it had fined a global engineering and construction firm, KBR, \$130,000 for attempting to stifle

220. *Id.* § 240.21F-6(b)(3).

221. 15 U.S.C. § 78u-6(a)(6) (2012).

222. *Id.* § 78u-6(h)(1).

223. 17 C.F.R. §§ 240.21F-2(a)(2), 240.21F-2(b)(1)(iii); *see also* Nicholas S. Goldin, *SEC Interpretation of "Whistleblower" Definition*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 14, 2015), <http://corpgov.law.harvard.edu/2015/10/04/sec-interpretation-of-whistleblower-definition/> [<http://perma.cc/6E8X-XQ2H>].

224. 720 F.3d 620 (5th Cir. 2013).

225. *Id.* at 629–30.

226. 801 F.3d 145 (2d Cir. 2015).

227. *Id.* at 155.

whistleblowing through restrictive contractual language.²²⁸ In the course of internal investigations into illegal or unethical conduct, KBR would require employees to sign a confidentiality statement that prohibited employees from disclosing any information learned in the course of the investigation; breaches could result in disciplinary action or termination.²²⁹ KBR was required to amend the contract to include an exception for communications to federal government agencies.²³⁰ The KBR suit, according to one prominent whistleblower attorney, was a “warning shot” to U.S. corporations and indicative of more such actions to come.²³¹

Finally, in 2014 and 2015, the Commission appeared increasingly open to awarding compliance officers for their information about internal misconduct. Though aware of the conflicts this might create, the Commission suggested in its cost-benefit analysis that the costs associated with allowing awards to compliance employees could be mitigated by the requirement for “independent knowledge”; that is, information that was not acquired in the course of one’s compliance or audit duties.²³² Yet the final rule contains several exceptions that may swallow the rule.²³³ In August 2014, the Commission announced a \$300,000 award to a whistleblower with an audit and compliance function, invoking an exception for cases in which misconduct had been reported internally, but the firm took no action within 120 days.²³⁴ Later, in April 2015, the Commission announced an award of between \$1.4 and \$1.6 million to another compliance employee,²³⁵ invoking yet another exception for compliance whistleblowers who have “a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the

228. KBR, Inc., Exchange Act Release No. 74,619, 2015 WL 1481158 (Apr. 1, 2015).

229. *Id.* ¶¶ 5–8.

230. *Id.* ¶¶ 8–10.

231. Scott Higham, *SEC Finds that KBR Confidentiality Agreements ‘Stifled’ Whistleblowers*, WASH. POST. (Apr. 1, 2015), https://www.washingtonpost.com/investigations/sec-finds-that-kbr-confidentiality-agreements-stifled-whistleblowers/2015/04/01/c78f6708-d884-11e4-8103-fa84725dbf9d_story.html [http://perma.cc/F59K-AE4K].

232. 17 C.F.R. § 240.21F-4(b)(1)–(2) (2015); Proposed Whistleblower Rule, *supra* note 87, at 70,491–94.

233. 17 C.F.R. § 240.21F-4(b)(4)(v).

234. *SEC Announces \$300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company’s Wrongdoing*, SEC (Aug. 29, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812> [http://perma.cc/48K6-EZVQ]; see 17 C.F.R. § 240.21F-4(b)(v)(C).

235. *SEC Announces Million-Dollar Whistleblower Award to Compliance Officer*, *supra* note 146.

financial interest or property of the entity or investors.”²³⁶ As some commentators have noted, as the “whistleblower program matures, it is clear that the SEC is willing to use the available exceptions to reward company compliance personnel.”²³⁷ The concern with this trend is that compliance officers—those who should, more than anyone else, deal with misconduct internally—may now have incentive to abrogate this duty and go straight to the SEC.

There is significant cost to financial institutions when they are unable to manage misconduct with self-initiated investigation and internal assessment or audits, before regulatory involvement. For one, rules that encourage external reporting *instead* of internal reporting can reduce the efficacy of corporate compliance efforts. As one commentator noted:

Corporate compliance programs depend on a robust flow of information in order to be effective. Indeed, information is the lifeblood of such programs. Diverting a large portion of that flow of information to the government will impair companies’ ability to step in and interrupt violations at an early stage. This does not benefit investors, and it is at odds with the purposes of the securities laws.²³⁸

Moreover, and relatedly, programs that subvert internal reporting may also reduce the energy and strategy that financial institutions are willing to invest in compliance. As two industry lawyers have noted, “[C]ompanies that have made the commitment and incurred the expense necessary for a robust internal audit and compliance effort will be left to wonder if doing so is truly in their interest.”²³⁹ Overall, if compliance seems futile, whistleblower programs might discourage firms’ efforts to build strong programs, and “companies that have chosen not to make that commitment will not only have secured a competitive advantage, they may find themselves [a] new model.”²⁴⁰

236. 17 C.F.R. § 240.21F-4(b)(4)(v)(A).

237. Martin Weinstein, Robert Meyer & Jeffrey Clark, *Company Compliance Officer Wins a Dodd-Frank Whistleblower Award*, WILLKIE FARR & GALLAGHER LLP (Apr. 27, 2015), http://www.willkie.com/~media/Files/Publications/2015/04/Company_Compliance_Officer_Wins_a_Dodd_Frank_Whistleblower_Award.pdf [<http://perma.cc/BET5-4L8X>].

238. *Casey Statement*, *supra* note 85.

239. Gass & Dube, *supra* note 215.

240. *Id.*

2. Regulatory Resources

A second potential cost of a whistleblower program, particularly a cash-incentivized one, is that it can encourage frivolous reporting and thus overwhelm investigative resources.²⁴¹ One scholar noted at the program's outset that the SEC "already receives more tips than it can reasonably handle."²⁴²

Though one can only speculate, the data on the SEC whistleblower program suggest this may be an issue. As Commissioner Casey initially expressed, "[a]ny triage process [to manage incoming tips and complaints] will be challenging, and a high-volume flow of information will strain our existing triage resources. The staff has assured me that they'll be able to handle the incoming flow of complaints, but I fear they are not being adequately circumspect."²⁴³ Several years in, the data may confirm this concern. At the close of fiscal year 2015, the Commission has received over 14,000 tips since the program's inception but has only made twenty-two awards.²⁴⁴

These numbers may suggest that the SEC program incentivizes frivolous tips.²⁴⁵ The Commission has reported several extreme cases. For example, in May 2014, it issued a final order denying claims in connection with 143 cases; and it had previously denied fifty-three other claims from the same person.²⁴⁶ Another whistleblower, who had made twenty-five separate claims, was also denied for "knowingly and willfully ma[king] false, fictitious, and fraudulent statements and representations to the Commission over the course of several years."²⁴⁷

The cost of inundating regulators with baseless information is that it further strains the already limited investigative resources of the

241. See Garrett, *supra* note 217, at 782–83 (noting that Dodd-Frank "created incentives for reporting without requiring the whistleblower to have some 'skin in the game'" and "creates an environment where the whistleblower can easily provide a tip to the SEC and then sit back, without any further effort, to await a potential pay-day; the whistleblower only has to fill out a 6-page document to submit their tip" (quoting Ebersole, *supra* note 17, at 162–63)).

242. Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403, 412 (2010); see also Rose, *supra* note 17, at 1238, 1276 (discussing "nonmeritorious tips").

243. Casey Statement, *supra* note 85.

244. 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 1, 16, 21.

245. Alternatively, these data may also suggest that enforcement agencies simply lack the resources to pursue all of the high-quality information that whistleblowers provide.

246. 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 14.

247. *Id.*

SEC.²⁴⁸ The need not only to triage, but also to carefully evaluate on a prima facie basis the likely integrity of the information, may be wasteful of regulatory resources, which could be put to better use investigating higher quality information or enforcing more serious cases.

3. Antisocial Norms

A third potential cost of whistleblowing programs is a social one. In some quarters, enlisting private citizens to aid the government's enforcement initiatives raises concerns of a surveillance society, disloyal behavior, or confidentiality breaches.²⁴⁹ In some European and Asian countries, for instance, whistleblowing has these negative connotations. In Russia, for example, the word for whistleblower—"donos" or "donoschik"—translates to "informant" and colloquially means something similar to "snitch."²⁵⁰ For some Russians, it even connotes a relationship to the country's history of repression during Stalinist rule.²⁵¹ Likewise, in Germany, some scholars have suggested that whistleblower incentives might be associated with Gestapo-type reliance on denunciations.²⁵² And in China, efforts to establish anonymous whistleblower hotlines may conjure memories of the Cultural Revolution, where "children were encouraged to inform on their parents, neighbors on their neighbors, and students on their teachers."²⁵³

Some also believe that whistleblower programs can impose social costs within an organization by eroding corporate loyalty. A prominent 1975 article in the *Harvard Business Review* quoted the then-chairman of the board of General Motors for the view that programs to encourage whistleblowers were "enemies of business" that "create suspicion and disharmony and pry into the proprietary interests of the business."²⁵⁴ Professor Schmidt has noted more

248. See *supra* note 241 and accompanying text.

249. See generally ETHAN BROWN, SNITCH: INFORMANTS, COOPERATORS & THE CORRUPTION OF JUSTICE (2007) (describing the various ways in which "snitching" is viewed across segments of American society); MARK WORTH, WHISTLEBLOWING IN EUROPE 15–16, 71–72 (2013) (discussing common negative perceptions and reactions towards whistleblowers in a number of European countries).

250. Jasmine Martirosian, *Russia and Her Ghosts of the Past*, in THE STRUGGLE AGAINST CORRUPTION: A COMPARATIVE STUDY 81, 91 (Roberta Ann Johnson ed., 2004).

251. *Id.*

252. See WORTH, *supra* note 249, at 47–48.

253. See WHISTLEBLOWING HANDBOOK, *supra* note 109, at 40.

254. Kenneth D. Walters, *Your Employees' Right to Blow the Whistle*, HARV. BUS. REV., July–Aug. 1975, at 26, 27.

recently, “management as well as other employees tend to regard whistle blowers as disloyal.”²⁵⁵ The tension between loyalty and confidentiality on the one hand, and whistleblowing on the other, has already begun to arise in connection with the Dodd-Frank program as well. In particular, some firms have sued employees (or former employees) for common law breaches of contract or fiduciary duty (or under various federal laws) in response to employees that engage in self-discovery to shore up a whistleblower claim.²⁵⁶

Finally, some detractors have argued that whistleblower programs backed by cash bounties are “morally corrupting because they ‘monetize virtue.’”²⁵⁷ As Professor Rapp points out, the social cost is similar to that which arises in connection with a duty to rescue in tort law, “on the grounds that a financial obligation to rescue would cheapen the moral value of heroic service.”²⁵⁸

The social costs of whistleblowing are admittedly quite difficult to predict and even more challenging to quantify. In the United States at least, Congress decided (even if implicitly) that the possible costs of antisocial behavior that a whistleblowing program might encourage are outweighed by the social costs of undetected and frequent financial misconduct. Nonetheless, as the financial markets continue to globalize, whistleblower programs are likely to become an issue of increasing transnational regulatory concern and on the agenda of international financial regulation. Accordingly, U.S. regulators should be careful to bear these social costs in mind when debating whether and how far to expand whistleblower initiatives.²⁵⁹

255. Matthias Schmidt, “Whistle Blowing” Regulation and Accounting Standards Enforcement in Germany and Europe—An Economic Perspective, 25 INT’L REV. L. & ECON. 143, 151 (2005).

256. See R. Scott Oswald, *Risks in Fighting Whistleblowers Over Confidentiality*, LAW360 (Mar. 31, 2014, 6:43 PM), <http://www.law360.com/articles/523392/risks-in-fighting-whistleblowers-over-confidentiality> [<http://perma.cc/C6CN-5378> (staff-uploaded archive)] (citing such cases as examples).

257. Rapp, *supra* note 17, at 123 (quoting Barnard, *supra* note 242, at 413).

258. *Id.*

259. Tony Porter has argued, “the experience of transnational regulatory reform after the crisis indicates that the trends of the past three decades, which have involved a growth in transnational interdependence in financial transactions and governance, is continuing rather than reversing.” Tony Porter, *Introduction: Post-Crisis Transnational Financial Regulation and Complexity in Global Governance*, in TRANSNATIONAL FINANCIAL REGULATION AFTER THE CRISIS 3, 5 (Tony Porter ed., 2014).

4. Unilateral Extraterritorialism

Since the crisis, several major financial economies have either adopted or somehow reinvigorated financial whistleblower laws.²⁶⁰ Yet in practice, whistleblower programs in Europe are far afield from the SEC whistleblower model.²⁶¹ Many foreign jurisdictions remain resistant to strongly cash-motivated (and broadly defined) whistleblower laws.²⁶²

Indeed, the whistleblower apparatus in several major financial economies in Europe differs notably from the Commission's program. Take Germany, for example. Germany is a financial powerhouse of the European Union and home to the "global systemically important bank" ("G-SIB") Deutsche Bank.²⁶³ Yet would-be whistleblowers in Germany face a challenging environment, with possible professional consequences attached to blowing the whistle, and a court system that appears to place a premium on employees' loyalty to their employers.²⁶⁴ Outside the health and security contexts, Germany lacks

260. This Article mostly focuses on European countries because they are home to a significant proportion of "global systemically important banks" or "G-SIBs." See PAUL GLASSERMAN & BERT LOUDIS, OFFICE OF FIN. RESEARCH, A COMPARISON OF U.S. AND INTERNATIONAL GLOBAL SYSTEMICALLY IMPORTANT BANKS 1, 5 (2015), https://financialresearch.gov/briefs/files/OFRbr-2015-07_A-Comparison-of-US-and-International-Global-Systemically-Important-Banks.pdf [<http://perma.cc/V39S-5EXL>].

261. See *infra* notes 263–76 and accompanying text. In 2013, Transparency International found that only four European countries—the United Kingdom, Luxemburg, Romania, and Slovenia—had laws to protect whistleblowers from workplace retaliation that were considered "advanced." TRANSPARENCY INT'L, WHISTLEBLOWING IN EUROPE: LEGAL PROTECTIONS FOR WHISTLEBLOWERS IN THE EU 8 (2013). Though beyond the scope of this Article, it bears mention that there is a longstanding and ongoing debate in the corporate law literature on convergence versus divergence regarding international corporate governance standards. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001); see also CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 2–6 (Jeffrey N. Gordon & Mark J. Roe eds., 2004); Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321, 332–33 (2001); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 679–80 (1999).

262. See *infra* notes 274–76 and accompanying text; see also Chris Crowe, *International Regulators at Odds on Offering Financial Incentives to Whistleblowers*, INT'L BAR ASS'N (Oct. 30, 2014), <http://www.ibanet.org/Article/Detail.aspx?ArticleUid=a0064f1d-ed5b-4494-8d66-158f737b84f6> [<http://perma.cc/MJ96-YV64>].

263. See FIN. STABILITY BD., 2015 UPDATE OF LIST OF GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS) 2 (2015), <http://www.financialstabilityboard.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf> [<http://perma.cc/E58Q-BFAL>].

264. See TRANSPARENCY INT'L, *supra* note 261, at 47; TRANSPARENCY INT'L AUSTL., WHISTLEBLOWER PROTECTION LAWS IN G20 COUNTRIES 37 (Simon Wolfe et al. eds., 2014), <https://www.transparency.de/fileadmin/pdfs/Themen/Hinweisgebersysteme/Whistleblower-Protection-Laws-in-G20-Countries-Priorities-for-Action.pdf> [<http://perma.cc/7YQC-CQEJ>];

specific legislation that regulates or protects whistleblowing.²⁶⁵ Whistleblowers are expected—with some exception—to disclose issues internally first,²⁶⁶ and there are no cash incentives for providing information.²⁶⁷

France is similar.²⁶⁸ Also home to several G-SIBs, like BNP Paribas and Crédit Agricole Group, France historically has been resistant to whistleblower laws.²⁶⁹ French law, though it does permit reporting in finance and banking, does not actively incentivize the provision of insider information about financial misconduct.²⁷⁰

see also Listen Up! Effective Whistleblowing Management, LINKLATERS, <http://www.linklaters.com/Insights/ThoughtLeadership/Whistleblowing/Pages/Index.aspx> (last updated Mar. 2014) [<http://perma.cc/JEM7-EEQN> (dark archive)].

265. Verena Braeckeler-Kogel, *Whistleblowing in Germany*, SIMMONS & SIMMONS ELEXICA (Apr. 29, 2015), <http://aifmdinvestor.com/en/legal-topics/employment-and-benefits/24-whistleblowing-in-germany> [<http://perma.cc/MZ5G-UBY9>]; *see also* TIM MARSHALL & MICHAEL J. SHEEHAN, DLA PIPER, *WHISTLEBLOWING: AN EMPLOYER'S GUIDE TO GLOBAL COMPLIANCE* 21 (2d ed. 2015), https://www.dlapiper.com/~media/Files/Insights/Publications/2015/06/Whistleblowing_Law_Report_2015.pdf [<http://perma.cc/6AKJ-R3YG>].

266. Lydia Dorn, *Whistleblowing—What Protection Do Employees Have in Germany*, NORTON ROSE FULBRIGHT (May 15, 2014), <http://www.globalworkplaceinsider.com/2014/05/whistleblowing-what-protection-do-employees-have-in-germany/> [<http://perma.cc/E7ZA-E7PE>]; *see also* Gesetz über die Durchführung von Maßnahmen des Arbeitsschutzes zur Verbesserung der Sicherheit und des Gesundheitsschutzes der Beschäftigten bei der Arbeit, Arbeitsschutzgesetz [ArbSchG] [Labour Protection Act], Aug. 7, 1996, BGBl I at 1246–53 (Ger.); Michael Knigge, *Europe, US Take Different Approaches to Whistle-Blowing*, DW (Sept. 5, 2010), <http://www.dw.com/en/europe-us-take-different-approaches-to-whistle-blowing/a-5965148> [<http://perma.cc/H9KD-WLZE>].

267. *See* Braeckeler-Kogel, *supra* note 265 (noting that such a payment “could undermine [the whistleblowers’] credibility”).

268. In France and Germany “there are, at present, no express whistleblowing laws and to gain protection in these jurisdictions a whistleblower has to rely on piecemeal rights found in, for example, employment, anti-corruption and criminal laws.” MARSHALL & SHEEHAN, *supra* note 265, at 7.

269. *See, e.g.,* Frédéric Saffroy, *Is France Against Whistleblowing?*, SQUIRE PATTON BOGGS: LA REVUE (Jan. 20, 2006), http://larevue.squirepattonboggs.com/Is-France-against-whistleblowing_a1007.html [<http://perma.cc/U2XN-L5JN>]; *see also supra* notes 249–53 (discussing cultural reasons why states may be resistant to whistleblowing laws).

270. *See* Délibération n°2005-305 du 8 décembre 2005 portant autorisation unique de traitements automatisés de données à caractère personnel mis en œuvre dans le cadre de dispositifs d’alerte professionnelle [Deliberation No. 2005-305 of December 8, 2005 on Single Authorization of Automated Processing of Personal Data Implemented as Part of Whistleblowing Schemes], Commission Nationale de l’Informatique et des Libertés [CNIL] [National Commission for Computing and Liberties], Dec. 8, 2005, <http://www.cnil.fr/documentation/deliberations/deliberation/delib/83> [<http://perma.cc/PA6V-6K9V>]; Ann J. LaFrance & Francesca Fellowes, *Latest Regulation on Whistleblowing in France: CNIL Extends Scope of Reporting and Supports Anonymity*, SQUIRE PATTON BOGGS (Feb. 2014), <http://www.squirepattonboggs.com/insights/publications/2014/02/latest-regulation-on-whistleblowing-in-france-cn> [<http://perma.cc/CT32-7LYL>] (reaffirming that “[a]s before, the system should not

Switzerland, which hosts several G-SIBs, like UBS and Credit Suisse, may be “rocky terrain for whistleblowers.”²⁷¹ As one scholar described it,

any semblance of whistle blowing [in Switzerland] is couched in very broad and vague corporate governance rules whose overall import is a requirement that the board of directors takes appropriate measures to ensure the organisation’s compliance with the law, without specifically calling for a . . . whistle blower protection scheme.²⁷²

In fact, disclosing banking information—considered to be business secrets—to a government authority (domestic or foreign) could actually trigger criminal liability.²⁷³ Though not intended to be a comprehensive (or close to comprehensive) survey of European law on whistleblowers, this overview illustrates that in several of the European jurisdictions with substantial financial activity, whistleblowers are not affirmatively incentivized and sometimes are even exposed to negative workplace, social, or legal consequences.²⁷⁴

encourage anonymous reporting”); see also Oliver Proust, *French Revised Framework For Whistleblowing: Analysis*, DATA PROTECTION L. & POL’Y, Feb. 2011, at 4, https://www.huntonprivacyblog.com/wp-content/uploads/2011/10/DPLP_French_Revised_Framework_Proust.pdf [<http://perma.cc/586V-GSJ7>] (noting that “[t]he enactment of the Sarbanes-Oxley Act in 2002, and the rapid proliferation of whistleblowing hotlines within international organizations have compelled the European Data Protection Authorities [and French authorities] to adopt a clear position regarding such schemes”).

271. *Whistleblowing in Switzerland: Rough Terrain*, ECONOMIST (Dec. 5, 2015), <http://www.economist.com/news/business/21679456-two-court-cases-illustrate-struggles-employees-who-allege-wrongdoing-rough-terrain> [<http://perma.cc/L6J3-DQRF>]; see also John Letzing, *Swiss Whistleblower Rudolf Elmer Convicted of Violating Bank Secrecy Laws*, WALL ST. J. (Jan. 19, 2015, 9:04 AM), <http://www.wsj.com/articles/swiss-whistleblower-rudolf-elmer-convicted-of-violating-bank-secrecy-laws-1421676277> [<http://perma.cc/85TB-CE6Z> (dark archive)] (discussing the prosecution and conviction of a Swiss whistleblower for violating Swiss bank-secrecy laws).

272. Herbert Kawadza, *Analysis of Financial Services Sector Transparency Through Whistle Blowing: The Case of South Africa and Switzerland* 14 (SECO, Working Paper No. 30, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2613404 [<http://perma.cc/V2CH-5FK6>].

273. *Id.* at 15; see SCHWEIZERISCHES STRAFGESETZBUCH [STGB] [CRIMINAL CODE] Dec. 21, 1937, SR 311.0, art. 273 (Switz.), <https://www.admin.ch/opc/en/classified-compilation/19370083/201501010000/311.0.pdf> [<http://perma.cc/2EYD-8WUD>].

274. As commentators of the English system have noted, PIDA did not “set out to encourage whistleblowing—it merely aims to protect those who raise a particular type of concern.” Jeanette Ashton, *15 Years of Whistleblowing Protection Under the Public Interest Disclosure Act 1998: Are We Still Shooting the Messenger?*, 44 INDUS. L.J. 29, 39 (2015) (quoting David Lewis, *Ten Years of Public Interest Disclosure Act 1998 Claims: What Can We Learn from the Statistics and Recent Research?*, 39 INDUS. L. J. 325, 328 (2010)).

One can thus readily see considerable divergence between the Commission's whistleblower model—which proactively encourages whistleblower information—and that of its European counterparts. While there may be theoretical agreement between the United States and some European regulators that whistleblowing is desirable and effective,²⁷⁵ genuine convergence or coordination does not yet exist.²⁷⁶

In the absence of a more unified approach to whistleblower information, the Commission has effectively taken a unilateral and extraterritorial approach.²⁷⁷ Interested in receiving information from the private markets abroad, the SEC has been clear that it will extend its cash bounty to foreign citizens as well.²⁷⁸ The extraterritorialism that this regulatory divergence has spurred also has costs.²⁷⁹

275. TIM MARSHALL & MICHAEL J. SHEEHAN, DLA PIPER, WHISTLEBLOWING: AN EMPLOYER'S GUIDE TO GLOBAL COMPLIANCE 3 (1st ed. 2013), <http://www.dlapiperuknow.com/export/sites/uknow/products/files/uknow/DLA-Piper-Whistleblowing-Report.pdf> [<http://perma.cc/GM6T-SFPG>]; see WHISTLEBLOWING HANDBOOK, *supra* note 109, at 350.

276. In China, the trend is the same. Although China has a whistleblower program on the books, that law has been criticized by some as vague, overly limited, and potentially hortatory due to the lack of institutional commitment to it. See MARSHALL & SHEEHAN, *supra* note 265, at 17–18; see also Rachel Beller, Note, *Whistleblower Protection Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance? A Study of the Successes and Failures of Whistleblower Protection Legislation in the US and China*, 7 N.Y.U. J.L. & BUS. 873, 873–74, 894–98 (2011) (noting such criticism while arguing that the Chinese whistleblower program will ultimately be a success).

277. See generally Lawrence G. Baxter, William B. McGuire Professor of the Practice of Law, Duke Univ. Sch. of Law, Extraterritorial Impacts of Recent Financial Regulation Reforms: A Complex World of Global Finance 10–11 (June 28, 2014), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6044&context=faculty_scholarship [<http://perma.cc/N28Q-S4HY>] (discussing examples of extraterritoriality in the Volker Rule and derivatives reform).

278. From 2011 through September 2014, 1136 foreign nationals filed whistleblower disclosures to the SEC regarding reports on securities violations and foreign bribery. STEPHEN M. KOHN, NAT'L WHISTLEBLOWERS CTR., THE IMPORTANCE OF WHISTLEBLOWER REWARDS IN COMBATING INTERNATIONAL CORRUPTION 5 (Dec. 9, 2014), <http://whistleblowers.nonprofitsoapbox.com/storage/whistleblowers/docs/BlogDocs/anti-corruption-report.pdf> [<http://perma.cc/2VFS-LDL6>]. In fiscal year 2014, the Commission authorized a \$30 million whistleblower award that was “the fourth award to a whistleblower living in a foreign country.” SEC, 2014 ANNUAL REPORT TO CONGRESS ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 10 (2014), <https://www.sec.gov/about/offices/owb/annual-report-2014.pdf> [<http://perma.cc/VTX8-7Q43>]. The Commission received 448 tips from abroad in 2014. *Id.* at 29. In fiscal year 2015, three awards were paid to people outside of the United States, and the Commission received 421 tips from abroad. 2015 WHISTLEBLOWER REPORT, *supra* note 96, at 12, 30.

279. See Baxter, *supra* note 277, at 13–14 (listing a number of predicted challenges and noting that “our efforts to develop common minimum standards are . . . likely to move slowly forward, but at a very unpredictable pace and with numerous setbacks”).

One cost associated with unilateral extraterritorialism is that the Commission's program may simply be less effective.²⁸⁰ Regulators in one jurisdiction, like the United States, may be unable to obtain information about the activities of private economic actors in another. Consider a hypothetical based on the manipulation of LIBOR, in which several global banks colluded for years to manipulate that benchmark.²⁸¹ Both the United States and United Kingdom would have had an interest in the other regulator's ability to detect the rate manipulation much sooner. That is, inasmuch as the SEC would have liked a private citizen to inform it of the misconduct, it would arguably have been equally invested in regulatory programs that afforded the opportunity and motivation for a U.K. citizen to make that same information known to U.K. financial regulators—and vice versa. But where the Commission's program conflicts with another jurisdiction's rules for whistleblowers, foreign citizens with useful information might be dissuaded (through law or simple fear of reprisals) from providing it to the U.S. government.

A second cost of the divergence between U.S. and European models is the possibility of regulatory arbitrage. In the absence of coordination among regulators in these key financial economies, financial institutions may avert regulation entirely by shifting their activities to unregulated jurisdictions.²⁸² To illustrate this problem, consider a second hypothetical. If the United States and all European Union states were to implement whistleblower programs—but Switzerland held out—Switzerland would become what Professor John Coffee calls a “financial casino.”²⁸³ Financial institutions that view whistleblowing as costly or burdensome could move some or all of their operations to Switzerland to avoid it.²⁸⁴ But precisely because Switzerland decides not to adopt a whistleblower program, *all* states are deprived of Swiss citizens' inside knowledge about possible misconduct in Swiss financial institutions. As a hold out, Switzerland

280. See generally GEOFFREY P. MILLER & FABRIZIO CAFAGGI, *THE GOVERNANCE AND REGULATION OF INTERNATIONAL FINANCE* 58–61 (2013) (discussing the benefits of public-private ordering in the CDS market).

281. For an overview, see *Understanding the Rate-Fixing Inquiry*, N.Y. TIMES (July 28, 2014), http://www.nytimes.com/interactive/2012/07/16/business/dealbook/20120716-libor-interactive.html?_r=0 [<http://perma.cc/4Q33-7ZQM> (dark archive)].

282. See John C. Coffee, Jr., *Extraterritorial Financial Regulation: Why E.T. Can't Come Home*, 99 CORNELL L. REV. 1259, 1268–69 (2014) (“[A] nation that persists with laxer, more permissive rules may be able to attract business and profit as a result of the regulatory arbitrage that predictably would follow.”).

283. *Id.* at 1260 (discussing the dilemma where “some nations will find it in their interest to profit from regulatory arbitrage by offering underregulated havens”).

284. See *id.* at 1260, 1268–69.

thus obstructs the international financial community's interest in early detection of misconduct that, although perpetrated on Swiss territory, has the potential to harm markets and institutions worldwide.

Finally, a unilateral, extraterritorial approach may have significant legal, political, and logistical costs for the United States. Politically speaking, as a matter of international comity, extraterritorial regulatory extensions are generally disfavored.²⁸⁵ In the area of financial law especially, several European nations have been vocal in their opposition to U.S. efforts to project its rules and regulations abroad.²⁸⁶ Legally, the United States Supreme Court also has a dim view of extraterritorial financial regulation, as reflected in its 2010 decision in *Morrison v. National Australia Bank*.²⁸⁷ There, the Court held that section 10(b) of the Exchange Act—"the basic antifraud provision of the U.S. securities laws"²⁸⁸—does not apply extraterritorially.²⁸⁹ Lower courts have applied that decision broadly to a wide range of statutes that confer a private right of action for securities law violations,²⁹⁰ and also the antiretaliation provision of the Dodd-Frank whistleblower program.²⁹¹

285. See Wade Estey, Note, *The Five Bases of Extraterritorial Jurisdiction and the Failure of the Presumption Against Extraterritoriality*, 21 HASTINGS INT'L & COMP. L. REV. 177, 178 (1997) (noting that pursuant to the presumption against extraterritoriality, "Congress does not intend for legislation to contravene the basic legal principles of other nations" (citing *Foley Bros. v. Filardo*, 366 U.S. 281, 285 (1949))).

286. Coffee, *supra* note 282, at 1263–64 (observing European nations' "concern[s] that the U.S. approach [with Dodd-Frank] ignored national sovereignty and represented an alleged return to a prior tradition of U.S. imperialism under which the United States assumed that its preferred financial practices could be mandated for the rest of the world").

287. 561 U.S. 247 (2010).

288. *Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 200 (2d Cir. 2014) (citing *Morrison*, 561 U.S. at 267).

289. *Morrison*, 561 U.S. at 265.

290. See, e.g., *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 176 (2d Cir. 2014) (rejecting claims that arise out of foreign-issued securities that are purchased on foreign exchanges even though they are cross-listed on a domestic exchange); *In re UBS Sec. Litig.*, No. 07-11225, 2011 WL 4059356, at *4–6 (S.D.N.Y. Sept. 13, 2011) (same); *In re Société Générale Sec. Litig.*, No. 08-2495, 2010 WL 3910286, at *6–7 (S.D.N.Y. Sept. 29, 2010) (holding that transactions involving American depository receipts ("ADRs") do not qualify as a purchase or sale of a security listed on an American exchange); see also Hannah L. Bauxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities Law*, 75 L. & CONTEMP. PROBS. 161, 167 (2012) (criticizing the holding in *Société Générale* as overreading *Morrison*).

291. *Liu Meng-Lin v. Siemens, AG*, 763 F.3d 175, 183 (2d Cir. 2014); *Ulrich v. Moody's Corp.*, No. 13-CV-00008 VSB, 2014 WL 4977562, at *7 (S.D.N.Y. Sept. 30, 2014); see also Recent Case, *Second Circuit Holds that Antiretaliation Provision of Dodd-Frank Act Does Not Apply Extraterritorially*, 128 HARV. L. REV. 1826, 1829 (2015).

Even if these legal and political cost-generating constraints could be minimized, it would still be unclear whether a unilateral system of whistleblowing—projected globally by the SEC—is sustainable or productive. Imagine a world in which the United States aims to induce information from French and German citizens, which states do not have robust financial whistleblower programs of their own. Though speculative, it seems fair to assume that these foreign citizens will probably be less likely to come forward to U.S. regulatory authorities, discouraged by their unfamiliarity with U.S. law and the simple annoyance of making the effort. Further, even if a foreign national were so inclined, the right incentives may not exist. U.S. regulators can only reward whistleblowers who provide information about violations of U.S. law or that which pertains to U.S. institutions.²⁹² This necessarily means that U.S. regulators could not, for instance, induce insider information about an ongoing financial abuse in a major foreign banking institution if that misconduct did not directly violate U.S. securities law, even if all eight of the U.S. G-SIBs were counterparties to transactions with that institution.

* * *

As this Part has argued, there are many benefits to a strong, broadly scoped financial whistleblowing program. In the first instance, such a whistleblower program helps regulators overcome traditional asymmetries in information, expertise, and resources by leveraging private market actors—*particularly* in new frontiers of financial innovation. There are secondary benefits as well, including efficiency gains, more robust market discipline, and potential improvement in business conduct. At the same time, whistleblower programs have real costs—both economic and social. In an effort to maximize whistleblowing’s benefits, the next Part considers how certain design improvements might be effective in mitigating whistleblower programs’ costs. It also briefly considers some previously made proposals for redesign and suggests why they may be misguided.

III. IMPLICATIONS FOR DESIGN, DISCRETION, AND COORDINATION

Until this point, this Article has highlighted the challenges to securities law enforcement where financial innovation and its

292. 17 C.F.R. § 240.21F-2(a)(1) (2015) (defining whistleblower as an individual that provides information regarding a “possible violation of the *Federal* securities laws (including any rules or regulations thereunder)” (emphasis added)).

byproduct, diffusion, are concerned. It has suggested that, against these regulatory challenges, whistleblower programs can be an effective tool. And indeed, whistleblower programs have expanded as the darling of postcrisis securities law enforcement. Even so, many still debate the programs' merits. To further that debate, the principal aim of Part II was to probe this postcrisis regulatory intervention with a revised and retrospective cost-benefit analysis.

This Part evaluates existing, and offers some original, proposals for whistleblower program design. Section III.A considers additional requirements that could mitigate some of the costs discussed earlier. Section III.B evaluates—with some skepticism—suggestions to move away from a cash incentive scheme as well as the incentives suggested to replace it. Lastly, Section III.C suggests a path toward greater transnational coordination around whistleblowing programs.

A. Reporting Requirements

The benefits of whistleblower programs, as earlier discussed, are significant: not only are whistleblowers effective at detecting misconduct, these programs can also offer gains in efficiency, industry ethic, and market discipline, and provide some participatory or expressive value. This Section argues that several costs of whistleblower programs—such as their ability to tax regulatory resources or interfere with firm compliance—can be managed through revisions in regulatory design.

One straightforward way to mitigate the costs associated with high volumes of low-quality tips is to impose additional requirements regarding the use of counsel. In other words, the SEC could require counsel to act as “gatekeepers” of the whistleblower program.²⁹³ The SEC has, after all, “long sought to enlist professionals as the advance guard of its Enforcement Division.”²⁹⁴ John Coffee has suggested, for example, that the SEC impose a certification duty on securities counsel with respect to corporate disclosures; in particular, Coffee suggests the SEC “mandate that all disclosure documents filed with it

293. See John C. Coffee, Jr., *The Attorney As Gatekeeper: An Agenda for the SEC* 8 (Columbia Law Sch., Working Paper No. 221, 2003), http://www.law.columbia.edu/center_program/law_economics/wp_listing_1/wp_listing?exclusive=filemgr.download&file_id=69110&rtcontentdisposition=filename%3DWP207.pdf [<http://perma.cc/8T7E-D4N3>] (writing that “[t]he term ‘gatekeeper’ has been frequently used to describe independent professionals who serve investors, preparing, verifying, or assessing the disclosures that they receive”).

294. Thomas O. Gorman, *The SEC, Gatekeepers and Saying Something*, LEXISNEXIS LEGAL NEWSROOM (Sept. 10, 2015, 8:31 AM), <http://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2015/09/10/the-sec-gatekeepers-and-saying-something.aspx> [<http://perma.cc/T6PB-ZHN3>].

must be signed by an independent attorney, who would acknowledge his or her responsibility for the preparation or review of the document.²⁹⁵

Here too, with respect to the whistleblower program, the SEC could require whistleblowers to submit tips through counsel. (Counsel would presumably, in most cases, work on a contingency basis, taking a portion of the eventual award.) Counsel would be required to certify, prior to submission, the legitimacy of the tip after engaging in independent due diligence of the whistleblower's information.²⁹⁶ Requiring counsel to play a gatekeeping role could reduce the incidence of low-quality information and, as an added benefit, streamline the SEC's task even further by presenting the Commission with a well-organized and coherent package.

A second design improvement—to reduce compliance-frictional costs—would be requiring insiders to report misconduct internally before turning to the SEC. Although the whistleblower rule currently has no such requirement,²⁹⁷ the SEC considered one in the proposed rule, and various stakeholders in the industry strongly supported it.²⁹⁸ The likely outcome of a reporting requirement would be a far more productive attitude in the industry toward the whistleblower program. It would also be closer in line with the model chosen by our economic partners abroad. Finally, by devoting resources to strengthening the industry's internal whistleblower programs, regulators might play some role in reducing the industry stigma surrounding whistleblowers and altering industry norms and perceptions of financial misconduct.²⁹⁹

B. *Alternative Incentives*

Another common design question is whether bounties are an appropriate and productive incentive. As detractors point out, incentivizing whistleblowers with cash bounties has costs. For one, the

295. JOHN C. COFFEE JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 349 (2006).

296. *Cf. id.* (arguing that attorneys can do “due diligence”).

297. SEC Final Rule Release, *supra* note 87, at 34,301 (“[W]e have determined not to include a requirement that whistleblowers report violations internally . . .”).

298. *See, e.g.*, Robert A. Long, David B.H. Martin & Steven E. Fagell, Covington & Burling LLP, Comment Letter on Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (Feb. 18, 2011), <http://www.sec.gov/comments/s7-33-10/s73310-283.pdf> [<http://perma.cc/2CZR-KA89>].

299. *See supra* Section II.B.5 (discussing the potential for whistleblower programs to improve business ethics in the financial services industry).

prospect of a large cash bounty may incentivize frivolous tips.³⁰⁰ There may also be public policy or social costs that arise from a pay-for-information scheme.³⁰¹ The United Kingdom, for example, has resisted a bounty model for fear that cash rewards would encourage antisocial behavior, such as malicious reporting and entrapment, and would have a negative impact on public perception.³⁰² To mitigate the drawbacks of a purely cash-incentivized scheme, one possible design modification would thus be a statutory amendment to section 21F, which gives the SEC more discretion with respect to the *kind* of incentives it provides.³⁰³

Several proposals along these lines have previously been made. One possibility is to wholly eliminate or substantially reduce cash incentives. There is some research to suggest that whistleblowers, at least generally speaking, are not solely motivated by bounties and that morality and civic duty play a significant role.³⁰⁴ In the financial services industry, however, motivating whistleblowers on morality grounds may be more difficult than in other industries. The problem, as others have suggested, is that financial misconduct is not always viewed as a morally reprehensible act. Professor Rapp argued,

[I]n the context of financial fraud the moral need to blow the whistle is less salient than in other settings, where the decision to remain silent could compromise health and safety of employees or customers. Indeed, there is considerable moral ambiguity surrounding corporate fraud—with white collar crime not widely perceived as serious moral problem.³⁰⁵

300. See *supra* Section II.C.2.

301. See *supra* Sections II.C.1, II.C.3.

302. See BANK OF ENGLAND PRUDENTIAL REGULATION AUTHORITY & FINANCIAL CONDUCT AUTHORITY, *supra* note 112, at ¶¶ 5, 29 (declining to adopt U.S.-style cash awards).

303. Currently, the Dodd-Frank Act provides that the SEC “shall” provide a bounty to whistleblowers who meet the various other eligibility criteria. 15 U.S.C. § 78u-6(b)(1) (2012).

304. 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, 1178, 1202 (2010) (results suggest “that framing reporting as a commodity with a price tag attached may actually suppress internally motivated action” but that may “disappear[] with the introduction of sufficiently high monetary awards”); Gregory Liyanarchchi & Chris Newdick, *The Impact of Moral Reasoning and Retaliation on Whistle-Blowing: New Zealand Evidence*, 89 J. BUS. ETHICS 37, 41 (2009) (“One of the most important factors that affect an individual’s decision on whistle-blowing is his or her moral behavior [I]ndividuals with higher levels of moral reasoning are more likely to blow the whistle than are individuals with lower levels of moral reasoning.”).

305. See Rapp, *supra* note 17, at 122 (citing Pamela H. Bucy, *Moral Messengers: Delegating Prosecutorial Power*, 59 SMU L. REV. 321, 355 (2006)).

Thus the question remains: in the financial services sector, are ethics a realistic alternative to cash incentives and would financial insiders' moral duty alone yield high volumes of quality information? Some, like former Attorney General Eric Holder, fear that for a financial insider whistleblowing may not be worth the risks to one's career, reputation, and social status, without substantial cash rewards.³⁰⁶ It may be, then, that in this context ethical incentives are a much-needed supplement to—but an incomplete replacement for—cash rewards.

Perhaps regulators need to find ways to augment the moral dimension to whistleblowing in finance, with the aim to complement and strengthen the existing incentive effects of cash bounties. They could, for example, focus on the development and design of business school training on whistleblower programs. Regulators could work with business school faculty and administration to develop modules or case studies on whistleblower cases, so that financial professionals develop a sense of whistleblowing as a professional and ethical duty, rather than as a stigmatized activity.³⁰⁷

Also, by further educating investors, regulators could increase market pressure for whistleblowing, which might prompt the industry to develop a sense of ethical professionalism around whistleblowing. Just as financial firms have, in the past several years, taken their responsibility to the community and global society more seriously through movements for corporate social responsibility,³⁰⁸ so too might firms be encouraged to adopt more socially responsible compliance programs that educate and encourage their employees about whistleblowing.

Commentators have also proposed that offering whistleblowers standing to bring claims in federal court would be a meaningful incentive. For example, several scholars have proposed that the

306. See Eric H. Holder, Jr., *Remarks on Financial Fraud Prosecutions at NYU School of Law*, DOJ (Sept. 7, 2014), <http://www.justice.gov/opa/speech/attorney-general-holder-remarks-financial-fraud-prosecutions-nyu-school-law> [<http://perma.cc/R9PH-CQ34>] (suggesting modifications to the \$1.6 million cap for awards under the FIRREA whistleblower program because the amount “wh[ich] would—by any normal standard—be considered a windfall . . . is unlikely to induce an employee to risk his or her lucrative career in the financial sector”); see also Rapp, *supra* note 17, at 113–18 (discussing the economic and social costs for individual whistleblowers).

307. See Gordon & Zaring, *supra* note 203.

308. See, e.g., JPMORGAN CHASE & CO., *CORPORATE RESPONSIBILITY REPORT 2014* (2015), <https://www.jpmorganchase.com/corporate/Corporate-Responsibility/document/jpmc-cr-2014.pdf> [<http://perma.cc/T4AG-9HSM>]; GOLDMAN SACHS, *OUR IMPACT DRIVES GLOBAL PROCESS: SELECTED HIGHLIGHTS FROM THE 2014 ESG REPORT* (2015), <http://www.goldmansachs.com/citizenship/esg-reporting/> [<http://perma.cc/X8ZB-FB2U>].

statute be amended or augmented to include a qui tam–like provision.³⁰⁹ These proponents of a qui tam model argue that giving whistleblowers standing to bring suit would be compelling, by offering whistleblowers “public vindication” and the “chance to tell their stories and . . . restore their reputations.”³¹⁰ And, in their view, it would remove the *disincentive* that the inability to bring a claim creates, by assuring whistleblowers that they would not have to “fight” to get their “fair share” of the award.³¹¹ Again, however, as with morality alone, it is unclear whether financial whistleblowers would be sufficiently motivated by a qui tam provision over the long term. Some would, to be sure, but the bulk of financial insiders more likely prefer to blow the whistle anonymously to avoid the professional and social consequences of doing so.

In sum, while cash bounties may give rise to some costs, the cost of eliminating (or even reducing) them may be greater. In view of the unique circumstances and characteristics of employment in the financial services industry today, dispensing with cash incentives altogether may append the program’s fledgling success. U.S. regulators should, however, be mindful of and open to revisiting the bounty-driven nature of the program. Supplementary incentives could ultimately result in a more socially optimal design and appeal to a broader range of potential whistleblowers.

C. *Transnational Coordination*

As earlier discussed, the Commission’s unilateral, extraterritorial approach has also given rise to additional costs and possibly made the program less effective than it otherwise could be. This Section thus argues that international coordination is more desirable (and less costly) than extraterritorialism. It also suggests a way to accomplish such coordination through international financial regulatory networking institutions.

The United States’ penchant for unilateral extraterritorialism could likely be significantly reduced if the existing international networking institutions were better able to broker coordination among the relevant states. As John Coffee points out, the extraterritorial provisions of the Dodd-Frank Act were in large part

309. See, e.g., Rapp *supra* note 17, at 145 (proposing an “Informers Act” in which whistleblowers would have standing to seek fines that are owed to the government); Garrett, *supra* note 217, at 781, 787 n.96.

310. See Rapp, *supra* note 17, at 78, 140.

311. Garrett, *supra* note 217, at 781–82 (noting that similar disincentives already exist under the IRS’s whistleblower program).

motivated by Congress's concern that "meaningful reform on the international level faced interminable delays before a sufficient international consensus could be reached."³¹² A more efficient and effective international regulatory framework might thus satisfy national regulators who are eager to plug the gaps in securities law as applied to global institutions, counteracting these states' desire to regulate and enforce with an extraterritorial reach.³¹³

This effort could perhaps most productively begin with work at the International Organization of Securities Organizations ("IOSCO"). IOSCO is an international standard-setter in the securities area.³¹⁴ It is comprised of national securities regulators that regulate over ninety-five percent of securities markets worldwide.³¹⁵ The impetus for the development of this organization was, as Chris Brummer describes it, "the rapid internationalization of securities markets" and the reality that "financial globalization enabled greater mobility of fraudsters."³¹⁶ For that reason, "authorities wanted to ensure both robust (and common) approaches to securities regulation and sufficient cooperation to enforce national rules when criminals, evidence, and witnesses were in other countries."³¹⁷ This past year alone, IOSCO focused on converging regulatory policy regarding transparency in the credit default swaps market,³¹⁸ researching the timeliness and frequency of disclosure to investors,³¹⁹ and standardizing a code of conduct for credit rating agencies.³²⁰

IOSCO also focuses on issues of financial misconduct in the global securities markets. In June 2015, it published a report on credible deterrence, identifying "key enforcement factors that may

312. Coffee, *supra* note 282, at 1262.

313. *Id.* at 1263 n.9 (recounting EU efforts at extraterritorialism).

314. See *About IOSCO*, INT'L ORG. SEC. COMMISSIONS, https://www.iosco.org/about/?subsection=about_iosco [http://perma.cc/5A39-AEEM].

315. *Id.*; see INT'L ORG. OF SEC. COMM'NS, FACT SHEET 3 (2015), <https://www.iosco.org/about/pdf/IOSCO-Fact-Sheet.pdf> [http://perma.cc/K39R-DHXT].

316. BRUMMER, *supra* note 166, at 77.

317. *Id.*

318. INT'L ORG. OF SEC. COMM'NS, POST-TRADE TRANSPARENCY IN THE CREDIT DEFAULT SWAPS MARKET 40 (2015), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD499.pdf> [http://perma.cc/3BJ5-PYT8].

319. INT'L ORG. OF SEC. COMM'NS, THEMATIC REVIEW OF THE IMPLEMENTATION ON THE TIMELINESS AND FREQUENCY OF DISCLOSURE TO INVESTORS ACCORDING TO PRINCIPLES 16 AND 26 OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 12-15 (2015), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD498.pdf> [http://perma.cc/TV86-ST96].

320. INT'L ORG. OF SEC. COMM'NS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES 4 (2015), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD482.pdf> [http://perma.cc/X8MZ-9BKU].

deter misconduct in international securities and investment markets.”³²¹ This report did address whistleblowers, though in a rather perfunctory fashion. It noted that “[w]histleblowers are a useful source of information and intelligence” and that “[r]eporting can be enhanced when jurisdictions provide legal protection to whistleblowers to prevent them from being adversely impacted or prejudiced as a result of providing information.”³²² The report did not take a position on whether strong whistleblower programs—those with cash incentives—are more effective and efficient than more passive programs. Rather, it merely presented the two models—the U.S. and European—side by side.³²³

There are likely political economy reasons for the lack of clear recommendation surrounding a strong whistleblower solution. Even so, IOSCO arguably could play more of a leadership role by undertaking a concrete analysis of the costs and benefits of both models and then setting a standard—or best practices—for whistleblower programs to which its member-state regulators would be expected to adhere. Beyond setting a standard for whistleblower programs, IOSCO could also provide standards for international coordination of national whistleblower programs through a Multilateral Memorandum of Understanding (“MMoU”). A whistleblower MMoU could, for example, provide a procedure for enabling citizens of various jurisdictions to share inside information with regulatory authorities both domestically and abroad—even if it did not settle the transatlantic debate over cash incentives.³²⁴

The FSB is another international financial regulatory institution that acts as an “agenda setter.”³²⁵ The FSB—formerly the Financial Stability Forum—was given a heightened mandate after the crisis. Today, the FSB plays a significant role in influencing the domestic

321. Press Release, Int’l Org. of Sec. Comm’ns, IOSCO Publishes Report on Credible Deterrence Approaches in Securities Market Regulation 1 (June 17, 2015), <https://www.iosco.org/news/pdf/IOSCONEWS383.pdf> [<http://perma.cc/5BL3-R2L8>].

322. INT’L ORG. OF SEC. COMM’NS, CREDIBLE DETERRENCE IN THE ENFORCEMENT OF SECURITIES REGULATION 18 (2015), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD490.pdf> [<http://perma.cc/R2EZ-3YF7>].

323. *Id.*

324. Much information sharing is already conducted between enforcement authorities through various Memoranda of Agreement and Assistance Treaties. See Mary Jo White, *The Challenge of Coverage, Accountability and Deterrence in Global Enforcement*, SEC (Oct. 1 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370543090864> [<http://perma.cc/2AUM-A4FL>].

325. See BRUMMER, *supra* note 166, at 72.

regulatory agendas of most major financial economies.³²⁶ In general, the FSB is charged with promoting standards, engendering what it describes as a “race to the top” worldwide in the implementation of best practices.³²⁷ A significant part of this mission is monitoring and evaluating adherence to international standards.³²⁸

Thus, IOSCO and the FSB can be viewed as complementary institutions. Where IOSCO is principally focused on research, analysis, and the development of sector-specific standards, the FSB is focused on financial stability and international cooperation more broadly. In light of their respective institutional capacities, it would be important for the FSB and IOSCO to work together to set standards for and then coordinate a transnational whistleblower policy. As part of the FSB mandate, the FSB could thus complement the standard-setting work of IOSCO by working with individual jurisdictions to transition to a more robust whistleblower paradigm and, subsequently, coordinating information sharing that such regimes might yield on the domestic level.

CONCLUSION

This Article has argued that regulators face new—and ever-changing—challenges in contemporary financial markets, which are increasingly innovative, complex, and diffuse. Old models of securities law enforcement, which are primarily reactive, have quickly become outdated; proactively anticipating misconduct is key to the health of and confidence in the financial markets. Yet regulatory agility in innovative financial spaces can be difficult to achieve; regulatory gaps largely stand in the way. Inherently, regulators operate at a disadvantage in terms of information, resources, and expertise. They thus require assistance from the private market itself.

Whistleblowers have proven a viable solution to these modern-day challenges that financial innovation poses to regulation and enforcement. As a regulatory tool, whistleblowers complement state power by contributing the private market’s resources and knowledge to the task of curbing misconduct. Specifically, in weighing the benefits against the costs, this Article argues that whistleblower solutions are a desirable regulatory choice from the perspective of

326. See *About the FSB*, FIN. STABILITY BOARD, <http://www.financialstabilityboard.org/about/> [http://perma.cc/3A2M-XP2Z].

327. *Id.*

328. See FIN. STABILITY BD., PROMOTING GLOBAL ADHERENCE TO INTERNATIONAL COOPERATION AND INFORMATION EXCHANGE STANDARDS 1 (Mar. 2010), http://www.financialstabilityboard.org/wp-content/uploads/r_100310.pdf [http://perma.cc/975L-F4X7].

stability, efficiency, public welfare, and business ethics. Moreover, this Article urges greater movement toward transnational cooperation or the convergence of whistleblowing programs. As innovation in the industry—along with the complexity and diffusion that it brings—will no doubt continue, internationally coordinated whistleblower programs are an ideal tool for addressing misconduct in global finance. Ultimately, then, this Article not only offers concrete ways to improve whistleblower program design domestically but also suggests a way to effectuate much-needed international coordination around the whistleblower solution through the framework of international financial regulation.