What Should We Expect from the Dodd-Frank Bounty Program?

Diego G. Pardow
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Abstract

Among other changes, the Dodd–Frank bounty program substantially increases the size of the rewards. The supporters argue that the program should encourage more players to step in, whereas the critics claim that it would only increase less reliable whistleblowers. This note describes the economic reasoning behind the dispute, attempting to build a reasonable expectation in light of the available empirical data. Although most of the evidence from previous bounty programs sides with the supporter’s theory, it has to be considered that the quantity and quality of whistleblower reporting are not the only relevant factors. Whistleblowers play a key role diversifying the sources of information that feed the system of enforcement and correcting the monitoring bias that public agencies might develop over time.

Contents

1 Introduction 1

2 Two Alternative Theories 2
   Figure 1: Alternative Theories for Whistleblowing . . . . . . 4

3 Improving on the Extensive Margin 6
   Table 1: Source of Detection on Corporate Frauds . . . . . . . 8

4 Expected Effects on the Quantity of Reporting 9
   Figure 2: Effect of Rewards by Source of Detection . . . . . 10

5 Expected Effects on the Quality of Reporting 12

6 Concluding Remarks 15

References 15

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1 Introduction

Among the many changes introduced as a response to the latest financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) included several amendments to the whistleblower program of the Securities and Exchange Commission (“SEC”). Such provisions are aimed to broaden the scope of the existing bounty program for insider-trading, as well as to substantially increase the size of the bounties. Regarding the former, the scope of the Dodd-Frank bounty program includes every form of securities fraud and not only violations related with insider trading.\footnote{The SEC already had statutory authority to pay bounties to whistleblowers that provide information about insider trading. See, 15 U.S.C. §78u(1)(e) (2006). However, this authority has rarely been used. See, Office of Inspector General (2010) 4–8.} With respect to the size of the bounties, the reform provides a 10 to 30 percent reward for tips that result in a monetary sanction greater than $1,000,000.\footnote{See, Dodd-Frank Act Sec. 922(a) §21F (c)(1)(B). In determining the amount of an award, the SEC shall consider the following reasons: (i) the significance of the information provided by the whistleblower to the success of the enforcement action; (ii) the degree of assistance provided by the whistleblower; (iii) the programmatic interest of the SEC in deterring violations of the securities laws by making awards to whistleblowers; and, (iv) additional relevant factors established by rule or regulation. Such additional factors are addressed in the Proposed Rules for Implementing the Whistleblower Provision of Section 21F, Federal Regulations at 70489–70490.}

As with any other regulation, the Dodd-Frank bounty program has supporters and critics. The supporters argue that this is a low-risk and high-reward policy: a bounty program should encourage more whistleblowers to step in, without inducing substantial costs. Such arguments are grounded on the traditional understanding that people is driven by monetary incentives. On the contrary, the critics claim that a bounty program should only increase less reliable reports, discouraging morally driven whistleblowers and eroding the firms’ compliance programs.\footnote{In addition to monetary rewards, whistleblower laws generally provide anti-retaliation protection for employees and mandatory duties to specific individuals. This note only analyzes the potential effect of monetary rewards, a comprehensive review of the several laws that include whistleblower provisions and the strategy of the regulator adopted on each case can be found in Feldman and Lobel (2010) 1157–1176.}

However, the discussion about the Dodd-Frank bounty program has been rather theoretical. Neither supporters, nor critics, have considered whether their ideas are aligned with the available empirical evidence.\footnote{Particularly, the Dodd-Frank bounty program is built upon the previous experiences of the Internal Revenue Service and the Department of Justice. See, Senate Report No. 111–176, at 110 (2009).} This should be problematic, because their main differences between supporters and critics are located at the premise level. As it is discussed on the following sections, both lines of thought are logically coherent and built on sound economic principles. Therefore, our
What Should We Expect from the Dodd-Frank . . .

Diego G. Pardow

expectations about the Dodd-Frank bounty program should be modeled according with the set of assumptions that seems to be more realistic for the context in which such a policy is meant to be applied.

This note is aimed to provide the analytical framework required for this task. Accordingly, the following section describes the economic reasoning behind the dispute between supporters and critics of the Dodd-Frank bounty program. The next topic is the policy goal behind this reform and the likely composition of the target population. The remaining sections are an attempt to adjudicate between both theories using the available empirical evidence. To this end, I will address in separate sections the potential effect of the bounty program in the quantity and quality of the reports. Finally, the last section offers some concluding remarks.

2 Two Alternative Theories

As it was briefly discussed above, the disagreement between supporters and critics of the Dodd-Frank bounty program can be understood as another round in the larger debate in the Law & Economics literature about the effect of rewards on human behavior: on the one hand, the supporters rely on the traditional underpinnings of the rational choice and relative-price theories; on the other hand, the criticism is drawn upon the relatively novel insights brought by behavioral economists and social psychologists.5 This section presents the dispute between these two alternative lines of thought, with the purpose of unpacking the premises upon which each theory is built.

The main argument raised by the scholarly supporting the Dodd-Frank bounty program is that introducing an economic reward should increase the number of violations effectively reported.6 Such argument is grounded on one of the cornerstones of the Law & Economics literature, known as the relative-price theory.7 This theory, in turn, relies on two sets of premises related with the quantity and the

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5There is a wide range of topics in which there is an ongoing debate between traditional economics and behavioral economics, particularly in the field of crime and punishment. See, Jolls, Sunstein and Thaler (1998); as well as, the reply by Posner (1998), for a concise introduction to this debate. With respect to the enforcement of Corporate Law, the traditional assumption of rational behavior has been recently challenged, for example, by Puchniak and Nakahigashi (2010).


7The theory, which is commonly explained using the celebrated sticks-and-carrots analogy, claims that the legal system produces external stimuli and that such stimuli should be the main factors driving the behavior of the people to whom the legal rule is meant to be applied. See, Becker (1968) 176–179, who is widely regarded as the pioneer in developing the elasticity of the “supply” of offenses with respect to the expected punishment “offered” by the legal system. This two components, along with the expected gains arising from a violation, comprise the relative price of illegal activities.
What Should We Expect from the Dodd-Frank . . .

Diego G. Pardow

quality of whistleblower’s reporting. First, the quantity of violations reported by whistleblowers is positively correlated with the size of the bounties.\(^8\) Implicitly, this assumes that all whistleblower are money-driven, or at least, that implementing a bounty program would not discourage those with a different set of motivations.\(^9\)

Second, the quality of the reports is held constant. In other words, the ability of each report to trigger an enforcement action is not affected by any increases in the number of violations effectively reported. Again, this entails that every source of whistleblowing will provide a similar quality of reporting, or at least, that reports made by money-driven whistleblowers are not significantly worst than those of morally driven whistleblowers.\(^10\)

On the other hand, the criticism to the Dodd-Frank bounty program argues that the willingness to report should not be homogeneous across the different types of whistleblowers. Analytically, a monetary reward should increase outside-the-firm and money-driven reporting, while decreasing inside–the-firm and morally driven reporting.\(^11\) The first idea behind this argument, which is mainly related with the effect of a bounty program on the overall quantity of violations reported, draws upon the motivation crowding theory developed by the behavioral economics literature during the last 20 years.\(^12\) As it is shown in the Figure 1, the best way to understand this critique is by focusing on the endpoints of the linear function proposed by the relative-price theory.

Starting in a world without monetary rewards, denoted by the point B, the motivation crowding theory argues that some amount of whistleblower’s reporting should be observed. Then, it assumes that the regulatory agency can choose, for example, between the following three different levels of reward: low (R), medium (R’), or high (R”).\(^13\) A low-level reward would have a negative effect on the number

\(^8\) Particularly, the willingness to blow the whistle is generally understood as a strictly increasing linear function of the expected payoffs of doing so, Landes and Posner (1975) 3–6.


\(^10\) Although these ideas are not made explicit on the literature, they follow from the assumption that all the “firms” acting as private enforcers are presumed to be equally efficient and that there are no entrepreneurial resources specialized to the industry. See, Landes and Posner (1975) 4.


\(^12\) The motivation crowding theory claims that human behavior is triggered by a combination of internal values and external stimuli. When the legal system introduces a reward, it is indeed signaling what is the price of certain activities. However, the internal value assigned by the individuals subject to the rule could be either higher or lower than the external pricing. If the reward sets the external price below the internal value, it would reduce the motivation to follow the legal rule (“crowding-out effect”). On the contrary, a reward will have positive effects on behavior whenever the external price is set beyond the internal value (“crowding-in effect”). See, Frey and Jegen (2001) 591–595.

\(^13\) The reasoning offered here is aimed to reproduce the experimental evidence gathered by Yubal Feldman and Orly Lobel. They observe that low-level rewards are associated with a crowding-out effect, whereas high-level rewards are associated with a crowding-in effect. In
Number of violations reported shown as a function of the level of the reward. The sketch was drawn using as a reference the figure with which Frey and Jegen (2001) illustrate the crowding-out effect as a discrete jump to the left that reduces whistleblower’s initial motivation. The crowding-in effect is represented here as influencing whistleblower’s behavior in the opposite direction and exactly by the same magnitude. The dashed line denotes the potential outcome of both effects when acting simultaneously.

of reporting \((C<B<A)\), because it undermines the moral value of the legal rule. The opposite effect should be observed with high-level rewards, whereby the moral value of the rule is reinforced and thus the external stimulus acts as a complement of the internal motivation \((A''<C'')\).\(^{14}\) Between those extremes, a medium-level of other to provide a comprehensive picture, a medium-level reward that equates the approaches of both the motivation crowding and relative-price theories, it is also assumed to exist. See, Feldman and Lobel (2010) 193–195.

\(^{14}\)It should be noted that the right-handed boundary of this function has also been subject to criticism. Akerlof and Dickens (1982), argue that cognitive dissonance prevents that individuals rank their preferences linearly, specially within the highest levels of punishment. This idea suggests that, as the monetary reward becomes arbitrarily large, the marginal change on behavior should approach to zero. Hence, whereas the crowding effect introduces discontinuities at the
rewards should produce a number of reports similar to the one that the relative-price theory would have predicted (\(C' = A'\)).

Instead of focusing on individual behavior, it is possible to frame this ideas considering that different types of subjects could have a different set motivations: fully rational whistleblowers should act exactly as it is expected in the relative-price theory, whereas monetary rewards would have insignificant effects among those whistleblowers that are mainly driven by their internal beliefs. Somewhere in between, a group of “median” whistleblowers could be affected by a crowding effect because they share, to some extent, both internal and external motivations.\(^{15}\)

From this perspective, the first argument raised by the critics of the Dodd-Frank reform can be summarized as an empirical skepticism regarding the composition of the population targeted by the bounty program, and particularly, on how should we think about this “median” whistleblower.

In contrast, the second source of criticism is largely grounded on normative arguments. Morally driven whistleblowers are assumed to provide a better quality of reporting than the money-driven ones, whereas reports processed through internal compliance programs are also assumed to ensure a higher level of quality than reports made directly to the SEC.\(^{16}\) Therefore, even if the number of violations reported might increase, decrease or remain the same, the dominant effect of the bounty program is negative, because it will marginally increase the number of low-quality reports and marginally decrease the number of high-quality reports.

Finally, it should be noted that the differences between supporters and critics not only reveal an academic disagreement about the effects of rewards on human behavior. They also highlight a fundamental choice about regulation. The belief behind the relative-price theory is that rewarding private enforcement agents is a cost-sensitive way of reducing the number of violations that are left unpunished.\(^{17}\) On the other hand, the concern about the quality of reporting coming

\(^{15}\)Feldman and Lobel (2010) 1195, found that both types of crowding effects are associated with subjects that evidence a relatively small moral commitment with the values protected by the rules. On the contrary, within the subset of subjects with higher levels of moral commitment, both crowding effects were not statistically significant.

\(^{16}\)The latter preference relies on the premise that the compliance programs implemented inside the firm are an effective mechanism for screening out frivolous reports, Ebersole (2011) 137. If such premise holds, then the administrative burden of the SEC would be reduced, improving the overall cost-efficiency of the system. Regarding the preference in favor of morally driven whistleblowers, the justification comes from the idea that relying on money-driven enforcement agents entails the risk that any regulatory gap will be exploited strategically. See, generally, Shavell (1982) and Kaplow (1986).

\(^{17}\)In the end, the argument rests upon the well-known ideas of the liberalism about political economics. Because decentralized whistleblowers are located closer to the relevant information, in a Hayekian sense they can detect violations incurring in less costs than centralized government
from money-driven whistleblowers, is mainly a concern about the administrative costs of handling an increasing number of frivolous reports. Hence, whereas the supporters of the Dodd-Frank bounty program are focusing on reducing the number of false-negatives that go undetected, critics seem to express a preference for erring on the side of caution and minimize the costs of screening the false-positives that go into the system of enforcement.\textsuperscript{18}

3 Improving on the Extensive Margin

In order to build a reasonable expectation about the Dodd-Frank bounty program, we should start formalizing the policy goal that this reform is supposed to achieve. Analytically, there are two different ways of improving the SEC’s performance on securities fraud cases. Provided that government agencies develop consistent monitoring preferences over time, a bounty program could intensify the enforcement efforts within the same set of preferences or either extend their scope.\textsuperscript{19} On the intensive margin, a whistleblower could provide information about a case that the SEC is already investigating, which would improve its chances of winning the case. On the extensive margin, if the potential whistleblowers have a different set of monitoring preferences than the SEC, they should bring a different type of cases to the table and broaden the range of the system of enforcement.

Against this background, the Dodd-Frank bounty program is better understood as a policy directed to complement public enforcement on the extensive margin. The reasons for this judgement are twofold. First, its regulatory design relies heavily on monetary rewards offered to a broadly defined population, a mechanism that is generally aimed to increase the variety of the sources of information that feed the system of enforcement.\textsuperscript{20} Second, another salient feature of the Dodd-Frank

\textsuperscript{18}A system of enforcement is generally understood as a tradeoff between false-negatives and false-positives, because oftentimes both sources of error are negatively correlated. In our case, the intuition is that a reward might reduce the violations unpunished while increasing the number of frivolous reports. However, under some circumstances, both types of error can be independent or either have a positive correlation. See, Polinsky and Shavell (2000) 60-62.

\textsuperscript{19}The distinction is not trivial. The intensive margin is related with the magnitude of the punishment, whereas the extensive margin is related with its certainty. Optimal deterrence relies on both components, but the tools addressed to improve one of the margins, typically will not work for the other. See, Roe and Jackson (2009) 208–209.

\textsuperscript{20}Kovacic (1996) 1821–1822. In contrast, improvements on the intensive margin will likely require more specialized reporting, because the information not only has to meet some degree of quality, it also needs to be functional to the agency’s monitoring preferences. Hence, the population targeted by the program should have been defined more narrowly, for example, focusing on people with some degree of involvement in the violation. Nevertheless, within this population a procedural reward, such as the ones included in plea agreements, would have been more
reform is that it reduces substantially the SEC’s discretion regarding whether or not award a bounty.\textsuperscript{21} None of these provisions would make sense, unless they are conceived as a way of forcing the SEC to think outside of the box and reach beyond its own monitoring preferences.\textsuperscript{22}

Moreover, a review of the SEC’s performance before the financial crisis confirms that the extensive margin should be the main concern. Using a comprehensive database of all corporate frauds that took place in the US between 1996 and 2004, Luigi Zingales, Alexander Dyck and Adair Morse found that the detection of offenses on the securities market requires a broad web of mechanisms and enforcement agents.\textsuperscript{23} As it is depicted in the Table 1, government agencies are only responsible for roughly 15\% of the frauds detected, whereas the proactive investigations carried by the SEC account for less than one third of those cases. Firm’s internal governance structures and private parties are both key components of the system of enforcement. Within the latter group, financial analysts, auditors, employees and the media are the largest sources of detection, revealing the fraud in more than 40\% of the cases.

The last column on Table 1 further illustrates the complementariness of the system of enforcement. If we look at the average speed with which a fraud is detected, we can think about each of these actors as if they were reacting one after the other, consecutively correcting the errors made in the previous stage. From this perspective, financial analysts and shorts sellers are the first to step in, detecting the fraud within the first 12 months. Frauds that make it through these monitors are then caught by traditional mechanisms of corporate oversight, such as auditors and government agencies. Employees, plaintiff law firms and the media are the last stage of the system, acting over the group of violations that remain undetected.

Finally, public enforcers and private whistleblowers not only act with different timings, they also seems to be looking at different regions of the securities market. There is extensive data supporting that the SEC has consistent monitoring preferences, and particularly, that those preferences reveal a targeting bias toward smaller firms.\textsuperscript{24} Interestingly, other studies have found that private whistleblowers appropriate than a monetary reward. See, Barnard (2010) 410-412.

\textsuperscript{21}Ebersole (2011) 140. Particularly, the conditions under which a bounty shall be granted are extensively regulated, and the SEC has a duty to report annually to the Congress about how is handling the flow of whistleblower’s tips. See, DODD-FRANK ACT Sec. 922(a) §21F (c) & (g)(5).

\textsuperscript{22}If the monitoring preferences are roughly consistent, any administrative discretion should be used to channel the funds of the Bounty Program towards the intensive margin. Hence, by offering monetary rewards to private parties and limiting the SEC’s ability to discretionally choose among these parties, the Dodd-Frank reform makes the public budget flexible enough to permit large swings in the resource allocation. See, Rose-Ackerman (1986) 140.

\textsuperscript{23}Zingales, Dyck and Morse (2007) 11-12.

\textsuperscript{24}Cox, Thomas and Kiku (2004) 908. Their results show that following a major turn-over in the
Table 1: Source of Detection on Corporate Frauds

<table>
<thead>
<tr>
<th>Fraud Detector</th>
<th>Frequency of Cases</th>
<th>Length in Months</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Count (Percent)</td>
<td>Median (OLS)</td>
</tr>
<tr>
<td>Firm’s Internal Mechanisms</td>
<td>74 (32.2%)</td>
<td>–</td>
</tr>
<tr>
<td>Public Enforcement</td>
<td>34 (14.8%)</td>
<td>–</td>
</tr>
<tr>
<td>SEC</td>
<td>9 (3.9%)</td>
<td>21.2 (20.4)</td>
</tr>
<tr>
<td>Non-Financial Regulators</td>
<td>25 (10.9%)</td>
<td>13.3 (14.7)</td>
</tr>
<tr>
<td>Private Enforcement</td>
<td>122 (53.0%)</td>
<td>–</td>
</tr>
<tr>
<td>Analysts</td>
<td>21 (9.1%)</td>
<td>8.4 (10.8)</td>
</tr>
<tr>
<td>Auditors</td>
<td>21 (9.1%)</td>
<td>14.7 (13.9)</td>
</tr>
<tr>
<td>Employees</td>
<td>30 (13.0%)</td>
<td>20.9 (22.9)</td>
</tr>
<tr>
<td>Media</td>
<td>21 (9.1%)</td>
<td>21.0 (20.2)</td>
</tr>
<tr>
<td>Outside Shareholders</td>
<td>5 (2.2%)</td>
<td>15.9 (15.2)</td>
</tr>
<tr>
<td>Plaintiff Law Firms</td>
<td>4 (1.7%)</td>
<td>31.4 (30.8)</td>
</tr>
<tr>
<td>Short Sellers</td>
<td>10 (4.3%)</td>
<td>10.5 (12.3)</td>
</tr>
<tr>
<td>Strategic Players</td>
<td>10 (4.3%)</td>
<td>13.3 (15.5)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>230 (100%)</strong></td>
<td>–</td>
</tr>
</tbody>
</table>

This table identifies the enforcement agent that first brought the fraud to light, using a comprehensive sample of 230 cases that took place between 1996 and 2004. Internal mechanisms include frauds where the detector is the firm (e.g., press release), its company management, or the board of directors. Public enforcement is restricted to proactive investigations by a government agency, including the SEC, industry regulators (e.g., FERC, FAA, FDA) and the State Attorney General’s office. The length of the fraud is based on the corresponding class period defined during the subsequent trial, and the quantities reported here are the sample median and a regression estimate. Source: Zingales, Dyck and Morse (2007) 53–55, Tables 2 and 4.

...tend to concentrate on larger firms, which is exactly the opposite bias. To some extent, these differences might be showing a structural divergence on the SEC’s higher ranks during 2000, the agency shifted its enforcement focus away from challenging frauds at firms in financial distress, to seeking out frauds at companies where investors may have suffered larger losses. However, both before and after the shift, the frequency of smaller firms targeted with enforcement actions was statistically significant.

Bowen, Call and Rajgopal (2010) 1250. This study and the one of Cox and Thomas have roughly the same time-window (1990–2004), use similar variables to measure the firm’s size and rely on a regression analysis to estimate the monitoring preferences. Although the statistical tools they use are not exactly the same – Cox and Thomas use a probit model, whereas Bowen, Call and Rajgopal use a logit model, it is noteworthy that the firm-size coefficient is significant and negative in the case of the SEC, while significant and positive in the case of private whistleblowers.
What Should We Expect from the Dodd-Frank . . .

Diego G. Pardow

underlying incentives of public and private enforcement. Provided that the SEC’s main concern is maximize its ability to win the suit, the preference for smaller firms could be explained as a strategy directed to find weaker opponents. On the other hand, whistleblowers would be choosing larger firms as a way of maximize the size of the bounty. In any case, it is clear that the SEC cannot succeed as a stand-alone mechanism, and that any attempt of improving its performance, has to consider those other mechanisms that would foster whistleblower reporting.

4 Expected Effects on the Quantity of Reporting

The second section of this paper discussed two alternative theories about the potential effects of rewards on whistleblower’s behavior and its third section described the population targeted by the Dodd-Frank bounty program. This section evaluates which of these theories seems to be more plausible considering the target population. A relative-price theorist would have predicted that the Dodd-Frank bounty program will increase the numbers of violations detected, whereas a motivation crowding theorist should have remained skeptical. Overall, the available evidence supports the first of these lines of thought, but more importantly, those findings make sense in light of the likely behavior of the players involved.

Several studies on social psychology highlight that the detrimental effect of rewards is triggered under special circumstances. Particularly, in the experiments on whistleblower’s behavior conducted by Yubal Feldman and Orly Lobel, the crowding-out effect is observed only when the subject’s moral commitment is weak and the reward is perceived as small. As it is depicted in Figure 2, none of the potential fraud detectors included in the target population seems to fit in this description. Let’s start with the easiest case. Public enforcers and corporate auditors are expressly excluded from receiving rewards. Hence, the Dodd-Frank bounty program should have a neutral effect on their behavior.

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27Bowen, Call and Rajgopal (2010) 1250, show that the size of the bounty and the number of corporate frauds reported by whistleblowers are indeed positively correlated. Using a sample of 218 allegations of financial misconduct between 1989 and 2004, the authors found that whistleblower reporting is more frequent among firms in the healthcare and military industries, this is, the industries that are within the scope of the Qui Tam bounty program. On the other hand, to the best of my knowledge, there is no historical data supporting a crowding-out effect in the context of corporate frauds.
29Feldman and Lobel (2010) 1193–1195. Moreover, in their data individuals with a strong moral commitment tend to report the violation with disregard of the size of the reward. In turn, if the bounty is perceived as large then all individuals blow the whistle, with independence of their moral commitment.
30Dodd-Frank Act Sec. 922(a) §21F (c)(2)(A)& (C).
Figure 2: Effect of Rewards by Source of Detection

<table>
<thead>
<tr>
<th>First Stage (0-10 months)</th>
<th>Second Stage (10-20 months)</th>
<th>Third Stage (20-30 months)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Analysts</strong></td>
<td><strong>Government Agencies</strong></td>
<td><strong>Plaintiff Law Firms</strong></td>
</tr>
<tr>
<td><em>Reward-neutral</em></td>
<td><em>Reward-neutral</em></td>
<td><em>Reward-seeking</em></td>
</tr>
<tr>
<td><em>Neutral effect</em></td>
<td><em>Neutral effect</em></td>
<td><em>Positive effect</em></td>
</tr>
<tr>
<td><strong>Corporate Auditors</strong></td>
<td><strong>Employees</strong></td>
<td><strong>Media Journalists</strong></td>
</tr>
<tr>
<td><em>Reward-neutral</em></td>
<td><em>Reward-seeking</em></td>
<td><em>Reward-neutral</em></td>
</tr>
<tr>
<td><em>Neutral effect</em></td>
<td><em>Positive effect</em></td>
<td><em>Neutral effect</em></td>
</tr>
</tbody>
</table>

*Unknown effect*: Short Sellers, Strategic Players, Outside Shareholders

Expected effect of the Dodd-Frank bounty program on its target population. This diagram presents the potential enforcement agents grouped in three consecutive stages, according with the average length of the fraud detection (Supra, Table 1, columns 1 and 3). The solid boxes include the fraud detector, its likely reaction to rewards and the expected effect on its behavior. The dashed box denotes the group of fraud detectors with respect to which the Dodd-Frank bounty program should have a positive effect. Source: The expected behavior of analysts and journalists to blow the whistle is taken from Zingales, Dyck and Morse (2007) 26–30, the likely motivation of employees is taken from Bowen, Call and Rajgopal (2010) 1151–1152.

A more interesting group is the one formed by plaintiff attorneys and the employees of the firms involved in violations. Plaintiff law firms are widely regarded as “professional” and “reward-seeking” whistleblower.\(^{31}\) Therefore, they should behave exactly as predicted by the relative-price theory and increase its whistleblowing activities insofar the expected reward provides enough financial benefits for doing so.\(^{32}\) Similarly, employees seems to be highly-sensitive to monetary rewards, which would support the idea that their moral commitment is weak.\(^{33}\) The

\(^{31}\)Ebersole (2011) 160.

\(^{32}\)See, e.g., Macey and Miller (1991); Coffee (1986).

\(^{33}\)Bowen, Call and Rajgopal (2010) 1151–1152, made a parallel analysis of several samples of cases about financial misconduct. Most of their samples were build using searches in general-purpose databases (e.g. Lexis Nexis, Court filings), whereas one sample in particular was obtained from records of the US government’s Occupational Safety and Health Administration office (OSHA). This is the agency entrusted to handle employees’ claims related with anti-retaliation protection of whistleblowers. In the OSHA database, the frequency of Qui Tam reporting – this is, the cases that generally involve a monetary reward— was consistently higher that in all of
good news, however, is that the size of the bounties awarded by the Dodd-Frank program could hardly be considered as small in this group of whistleblowers.34

In contrast, a bounty of that magnitude could be easily perceived as small for those whistleblowers that are located on the right-hand tail of the income distribution, such as short sellers, outside shareholders and financial analysts. However, although there is no evidence on the behavior of the first two groups, the latter group seems to be following a strong moral commitment. Financial analysts that have blown the whistle are generally senior executives with a consolidated career, they did not received any monetary reward, neither benefit from an improved reputation.35

Likewise, journalists might not be sensitive to the bounties included in the Dodd-Frank reform, either because is their source of information the one entitled to collect the reward, or because receiving a reward would be conflicting with their professional duties. Moreover, the losses in advertisement following a fraud detection could be substantial, creating a hostile environment to publishing scoops on corporate frauds. Again, however, in most of the detections caught by the media, the journalists involved are well-known figures, coming from national newspaper with a broad base of advertisement-clients.36

Therefore, for those whistleblowers that could be regarded as money-driven, the size of the bounties included in the Dodd-Frank program should be large enough to provide an adequate external motivation.37 On the other hand, financial analysts and employees, the effect of monetary rewards was more intense. Zingales, Dyck and Morse (2007) 65, Table 11, reached to a similar conclusion grounded on the fact that employees were responsible for 46% of the frauds detected in healthcare firms, but only accounted for a 16% of the cases on other industries. For a substantive analysis about why the employees decision of blowing the whistle is grounded on strategic decisions, Callahan and Dworkin (1994) 162–166.

34Recall that the minimum bounty in the Dodd-Frank program would be a 10% of any administrative sanction of more than one million dollars. Hence, the minimum bounty would be $100,000, roughly twice the median household income.

35Using a regression analysis, Zingales, Dyck and Morse (2007) 26–28, found that the frequency whistleblowing by financial analysts increases with age and the status of their brokerage house. A 59% of the detections are associated with analysts working in a top-ten investment bank and 14% in brokerage houses ranking from 11th to 40th. Additionally, after detecting the fraud none of the analysts moved to an investment bank located at a higher tier and the likelihood of improving in the peer-review rankings was not significant.

36Id. 62, Table 9. An 84% of the cases reported by newspapers are published on the Wall Street Journal or the New York Times, whereas Business Week and Fortune account for 5 of the 6 cases identified by magazines.

37Additionally, the Dodd-Frank Act requires that whistleblowers retain a counselor in order to qualify for the bounty program. Considering that the group of reward-seeking whistleblowers should be comprised by employees and plaintiff attorneys, such dispositions make sense as mechanism that would increase their ability to work together. See, DODD-FRANK ACT Sec. 922(a) §21F (d).
lysts and media journalists might perceive such rewards as small, either relative to their income or with respect to the expected costs of blowing the whistle. This group of whistleblowers, however, have acted in several cases despite of not having financial reasons for doing so. This could be showing a strong moral commitment, or maybe that they are maximizing something else. In any case, even if the Dodd-Frank bounty program does not offer any additional motivation, neither should discourage them. In short, all the evidence seems to side with the relative-price theory predicting that the number of violations reported should increase, particularly through employees and plaintiff law firms.

5 Expected Effects on the Quality of Reporting

A second source of criticism to the Dodd-Frank bounty program is that any increases in the number of violations reported, should come at the expense of decreasing the efficiency of the system of enforcement. This argument rests on two assumptions. First, a large fraction of the information provided by money-driven whistleblowers would not be reliable. Hence, the marginal costs involved in handling less reliable information would be larger than its marginal benefits. Second, offering monetary rewards for violations reported directly to the SEC could undermine the internal compliance programs. Considering that such programs act as a mechanism to screen the quality of whistleblowing, a policy fostering that the reporting is made outside the firm should further decrease the reliability of the information delivered to the SEC.

The intuition that money-driven whistleblowers provide less reliable information is appealing, because if they are indeed fully rational agents, they should exploit to their own profit any regulatory gap on the Dodd-Frank bounty program. Interestingly, however, the available evidence shows that bounty programs have been rather successful in avoiding this problem. On the one hand, the fraction of frivolous reports delivered by money-driven whistleblowers is substantially smaller than the one delivered by whistleblowers with a different set of motivations. On the other hand, if we measure the reliability of the information according with the response of the market after learning about the news, the performance of money-

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38See, Kovacic (1996) 1831, evaluating this argument with respect to the Qui Tam bounty program.
40Zingales, Dyck and Morse (2007) 33 & 65, Table 11, look at the fraud allegations that were dismissed or settled for less than 3 million, and compare its frequency in the healthcare industry and in other industries. Again, the healthcare industry is used as a proxy of money-driven whistleblowing because that is the general scope of the Qui Tam bounty program. Noticeably, the frequency of frivolous claims in the healthcare industry is 36% while in other industries is 55%.
driven whistleblowers seems to be adequate when compared to other mechanisms of private enforcement.\textsuperscript{41}

As before, those findings highlight something important about the underlying incentives scheme. The success of any mechanism of private enforcement is dependent on its ability to reward the players according with their performance. In derivative and securities class action cases, which are probably the most flawed mechanism of private enforcement, the problems arise when the plaintiff’s attorney takes control over the suit.\textsuperscript{42} Noticeably, the relative performance of private plaintiffs on Qui Tam cases confirm that the main issue is not the motivation behind the whistleblowers’ behavior, nor the costs of handling their reports. The things become problematic only when private plaintiffs have the ability to drive the litigation.\textsuperscript{43}

From this perspective, one of the salient differences between the False Claim Act and the Dodd-Frank Act is that the latter do not grant a private cause of action entitling whistleblowers to pursue the litigation independently.\textsuperscript{44} It has been argued that a similar kind of problems could arise because private plaintiffs are entitled to appeal to the SEC’s decision of not pursuing a case.\textsuperscript{45} At this point, however, the scrutiny to the Dodd-Frank bounty program seems to be largely misplaced. The argument is not about the marginal costs involved in handling less reliable information, its about the level of deference that the courts should grant to the SEC’s decisions.\textsuperscript{46}

\textsuperscript{41}Bowen, Call and Rajgopal (2010) 1253–1254, assess the quality of whistleblowing using event studies. The idea behind this research technique, is that reliable information about a fraud should affect the firm’s market price beyond chance variability. When this measure has been applied to other mechanisms of private enforcement, such as derivative actions or securities class actions, the effect on the firm’s market price has been rather small (Romano, 1991). On the contrary, in the case of whistleblower reporting the effects are large and statistically significant.

\textsuperscript{42}Pardow (2011) 17–20. There are several studies that have found evidence supporting this claim. Romano (1991) 80, shows that in a small group of cases where the plaintiff had a large fraction of shares—and accordingly, had a larger degree of leverage over her attorney, the outcome of the suits was substantially better. Cox and Thomas (2006), found a similar pattern on a larger sample of securities class action cases, concluding that the presence of institutional investors significantly increased the size of the settlement. Finally, Black, Cheffins and Klausner (2006) have used survey work to argue that government agencies and institutional investors are the larger source of liability risk to outside directors.

\textsuperscript{43}Kovacic (1996) 1832 & 1851, note 186. Between 1986 and 1996, the Justice Department achieved recoveries in nearly 100% (149 out of 151) of the Qui Tam cases in which they took the control over the litigation, whereas private plaintiffs realized recoveries in only 6.3% (31 out of 494) of the cases in which the DOJ declined to participate.

\textsuperscript{44}The only private cause of action is related with the anti-retaliation protection of whistleblowers. See, Dodd-Frank Act, Sec. 922(a) §21F (h)(1)(B)(i). With respect to the legal standing of private parties under the False Claim Act, See Kovacic (1996) 1812–1818.

\textsuperscript{45}Ebersole (2011) 143.

\textsuperscript{46}It should be noted that this is not a black or white issue. As it was discussed before, the
Finally, regarding the concern that the Dodd-Frank bounty program would undermine the internal compliance programs, it has to be considered that not all the firms are created equal. Although the compliance programs are well-suited to deal with occasional offenders, they are largely ineffective if the violations are an important source of income for the firm or either when high-rank officers are involved.\textsuperscript{47} Moreover, following the improvements to compliance programs included in the Sarbanes-Oxley Act, there was a substantial decrease in the number of violations reported by employees.\textsuperscript{48} The fact that such decrease was observed across all industries, including those under the scope of the \textit{Qui Tam} bounty program, suggests that employees are responsive to such improvements even if public enforcers are offering monetary rewards for external reporting.\textsuperscript{49}

Against this background, a race to external reporting seems to be unlikely. Furthermore, the rules to implement the Dodd-Frank bounty program proposed by the SEC expressly address this concern. On the one hand, internal reporting is included as one of the factors that will lead to a higher bounty.\textsuperscript{50} On the other hand, whistleblower may maintain eligibility up to 90 days after internal reporting and the SEC has discretion to allow corporate compliance even after external reporting.\textsuperscript{51} Considering that a successful compliance program brings along the benefits of a lenient punishment, beyond these rules a degree of competition between external and internal reporting seems to be healthy.\textsuperscript{52}

\textsuperscript{47}Using survey data about the behavior of employees, Callahan and Dworkin (1994) 173–174, found that, excluding monetary rewards, the more frequent factors triggering an external whistleblowing are the rank of the officers involved and the degree to which the firm’s revenues are dependant on the violation.

\textsuperscript{48}Such findings are consistent with a study of the National Whistleblower Center estimating that over 89% of employees who filed a \textit{Qui Tam} case had initially reported their concerns internally. See, National Whistleblower Center (2010) 4.

\textsuperscript{49}Zingales, Dyck and Morse (2007) 67, Table 13.

\textsuperscript{50}Proposed Rules for Implementing the Whistleblower Provision of Section 21F, Federal Regulations at 70500.

\textsuperscript{51}Id. at 70516 & 70496.

\textsuperscript{52}Indeed, some firms have even introduced internal bounty programs that offer monetary rewards to those employees that blow the whistle. See, Moberly (2006) 1107-1108.
6 Concluding Remarks

A common approach in Corporate Law is that, given the choice between spending a fixed amount of resources on monitoring by public agencies or monitoring by private parties, one should prefer this or the other. That approach, however, is misleading with respect to the Dodd-Frank bounty program. The program is not conceived as an alternative to public enforcement. It is conceived as a complementary mechanism that would improve public enforcement on its extensive margin. In other words, the role of whistleblowers is broadening the sources of information that feed the system of enforcement, forcing the SEC to reach beyond its own monitoring preferences.

Improving the extensive margin makes sense because the SEC is currently relying on a complex web of fraud detectors that includes the media, financial analysts, corporate auditors, employees and plaintiff law firms. Moreover, the evidence from previous bounty programs has shown that the latter two generally have a positive response to the monetary rewards, whereas the remaining members of the target population should not have a negative response. Hence, the number of violations reported would increase, but more importantly, the variety of cases brought before the SEC would also increase. In short, the Dodd-Frank bounty program seems to be a Pareto optimal move.

Another mistake is focusing on the idea that the program will increase the overall administrative costs involved in handling the whistleblowers reports. The relevant issue is whether the marginal benefits of additional reporting will overtake the marginal costs. From this perspective, there is extensive data supporting that money-driven whistleblowers provide reliable information. Particularly, the risk of opportunistic behavior typically arises when the plaintiff is entitled to pursue the litigation independently, which is expressly excluded in the Dodd-Frank Act. In conclusion, the available empirical evidence suggests that neither opportunistic behavior, nor crowding effects should be problematic.

Finally, the Dodd-Frank Act is rather inconsistent with the approach of the Sabarnes-Oxley Act with respect to the role of the internal compliance programs. To some extent, the weakening of such programs seems to be plausible, but such concern has to be properly weighted. On the one hand, the SEC’s implementation rules are aimed to minimize this side effect. On the other hand, firms are well suited to deal internally with occasional offenders, but the compliance programs tend to fail if the violation represents an important source of income or either when involves high-rank officers.
References


