

**BETTER BOUNTY HUNTING:  
HOW THE SEC'S NEW WHISTLEBLOWER  
PROGRAM CHANGES THE SECURITIES FRAUD  
CLASS ACTION DEBATE**

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**ABSTRACT**—The SEC's new whistleblower bounty program has provoked significant controversy. That controversy has centered on the failure of the implementing rules to make internal reporting through corporate compliance departments a prerequisite to recovery. This Article approaches the new program with a broader lens, examining its impact on the longstanding debate over fraud-on-the-market (FOTM) class actions. The Article demonstrates how the bounty program, if successful, will replicate the fraud deterrence benefits of FOTM class actions while simultaneously increasing the costs of such suits—rendering them a pointless yet expensive redundancy. If instead the SEC proves incapable of effectively administering the bounty program, the Article shows how amending it to include a *qui tam* provision for Rule 10b-5 violations would offer several advantages over retaining FOTM class actions. Either way, the bounty program has important and previously unrecognized implications that policymakers should not ignore.

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INTRODUCTION

“Fraud-on-the-market” (FOTM) securities class actions have been under sustained attack.<sup>1</sup> Congress dealt them a major blow by enacting the Private Securities Litigation Reform Act of 1995 (PSLRA),<sup>2</sup> and the courts have been whittling away at them for decades.<sup>3</sup> Last year, four Supreme Court Justices went so far as to suggest it is time to reconsider *Basic v. Levinson*, the case that gave FOTM class actions life,<sup>4</sup> and the Court has since

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<sup>1</sup> 17 C.F.R. § 240.10b-5 (2013). As described more fully in Part I, a fraud-on-the-market class action alleges that corporate misstatements or omissions inflated the price at which dispersed public shareholders purchased stock on the secondary market, and seeks out-of-pocket damages on behalf of the class based on losses sustained when the truth was revealed. The suit may be brought despite the lack of actual reliance on the part of the class members due to judicially recognized presumptions of reliance. *See Basic Inc. v. Levinson*, 485 U.S. 224 (1988); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

<sup>2</sup> Pub. L. No. 104-67, 109 Stat. 737.

<sup>3</sup> *See, e.g., Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

<sup>4</sup> *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring) (“[R]econsideration of the *Basic* presumption may be appropriate.”); *id.* at 1208 n.4 (Thomas, J., joined by Kennedy & Scalia, JJ., dissenting) (“The *Basic* decision itself is questionable.”).

granted certiorari in a case that presents it with such an opportunity.<sup>5</sup> Scholars, for their part, have grown increasingly critical of FOTM class actions.<sup>6</sup> None seriously defend them as a compensatory tool, and many question their deterrence benefits. But professors are cautious types, and academic proposals to eliminate the FOTM class action have tended to be conditional on concurrent changes to the U.S. securities fraud enforcement regime—changes that would compensate for any loss in deterrence that might result from their elimination.

This Article demonstrates that the new Whistleblower Bounty Program (WBP) created by the Dodd–Frank Wall Street Reform and Consumer Protection Act is the proverbial nail in the FOTM class action coffin.<sup>7</sup> The WBP mandates that the Securities and Exchange Commission (SEC) pay significant financial rewards to eligible individuals who voluntarily provide the agency with original information about securities law violations if that information leads to an enforcement action resulting in \$1 million or more in sanctions. The program has prompted a firestorm of controversy, but the discussion thus far has been insular—one focused on the efficacy of the WBP as a stand-alone program. Little attention has been paid to the program’s impact on the desirability of FOTM class actions. But if it works as intended, the WBP promises to supplant the deterrence benefits of FOTM class actions, while simultaneously increasing their costs. Even if the SEC fails to effectively administer the WBP as currently designed, the program has important implications for the FOTM class action debate: coupling the elimination of FOTM class actions with the addition of a qui tam provision to the WBP would be a significant improvement over the status quo.

Understanding the relationship between the WBP and FOTM class actions requires a sophisticated appreciation of the social welfare function FOTM class actions actually play. Part I provides this needed background, explaining why traditional rationales for corporate liability fail to justify the large transfer payments FOTM suits effect between diversified shareholders—the primary victims of fraud-on-the-market. It demonstrates

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<sup>5</sup> On November 15, 2013, the Supreme Court granted certiorari in *Halliburton Co. v. Erica P. John Fund, Inc.* See *Granted & Noted List Cases for Argument in October Term 2013*, U.S. SUPREME COURT (Dec. 16, 2013), <http://www.supremecourt.gov/orders/13grantednotedlist.pdf>. The first question presented is “[w]hether this Court should overrule or substantially modify the holding of *Basic Inc. v. Levinson* . . . to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory.” See Petition for a Writ of Certiorari at 3, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. filed Sept. 9, 2013).

<sup>6</sup> See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 72 (2011) (asserting that the “consensus view among academics” is that the FOTM class action “just doesn’t work”).

<sup>7</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

that if FOTM suits aid in deterrence, it is by virtue of the information they produce about firm governance, not the circular remedies they impose. To the extent they expose frauds, FOTM suits help to trigger severe market-based punishment of not only the officers responsible for the fraud (who will also face a heightened probability of government sanction as a result of the suit), but their overseers as well. The specter of such punishment can improve directors' and officers' ex ante incentives to invest firm resources in fraud deterrence, as well as to avoid committing fraud themselves, thus aligning their interests more closely with those of diversified shareholders. Although FOTM class action settlement payments are not a significant source of this punishment, they are important insofar as they create the pool of funds from which shareholders compensate class action attorneys for their fraud-detection efforts.

The WBP, which is described in detail in Part II, shares the same basic purpose as FOTM class actions: fraud detection. It seeks to accomplish this by increasing the benefits and decreasing the costs of blowing the whistle for two groups of potential SEC tipsters: corporate "insiders" who have independent knowledge of a securities law violation that is not derived from publicly available sources (think Enron employee Sherron Watkins), and corporate "outsiders" whose independent analysis of publicly available data reveals information about a securities law violation that is not generally known to the public (think Harry Markopolos). If such individuals voluntarily present their information to the SEC before the agency learns of it from independent sources, and it leads the SEC to impose \$1 million or more in monetary sanctions, the whistleblower is entitled to between 10% and 30% of the sanctions collected. To further incentivize whistleblowing, the WBP promises tipsters confidential treatment and legal rights against retaliation.<sup>8</sup>

Whether the WBP will succeed in increasing fraud detection, or do so to such an extent as to justify the program's costs, has been the subject of a rigorous debate. That debate is surveyed and evaluated in Part II. Missing from the current conversation, however, is an appreciation of the significant impact the program will have on the desirability of FOTM class actions, should the WBP prove effective. As detailed in Part III, the fraud detection capabilities of FOTM suits are naturally limited. FOTM class action attorneys do not have privileged access to information about internal corporate affairs, nor do they have the sort of legal investigative tools available to the SEC. To the contrary, they are not even entitled to basic discovery until after they file a complaint and survive a motion to dismiss (a significant hurdle in light of heightened pleading standards imposed by

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<sup>8</sup> See 15 U.S.C. § 78u-6(h) (2012).

the PSLRA). If FOTM class action attorneys help to detect fraud then it is because they are able to entice corporate insiders to reveal information to them, or because they have developed some expertise in analyzing publicly available information to discern suspicious activity.

But now, insiders have much stronger incentives to participate in the WBP than to serve as confidential informants in FOTM suits. And to the extent FOTM attorneys have special fraud detection capabilities, they can personally participate in the WBP (as can others with similar skills, which the program can be expected to draw out). The upshot is that FOTM suits are less likely to be responsible for exposing frauds in the wake of the WBP, and more likely to merely parrot information that is already in the public domain. FOTM suits that do not expose frauds produce no social benefits while imposing significant costs on both investors and the judiciary. The effect of the WBP (should it prove successful) will therefore be to tip the cost–benefit scales against the social desirability of FOTM suits, warranting their elimination.

This assumes, of course, that the SEC proves capable of acting on the credible tips it receives. If it does not, the program may not replicate the fraud detection benefits of FOTM suits. In this scenario, the WBP would not justify the outright elimination of private enforcement of fraud-on-the-market. The WBP would still, however, lay the groundwork for its transformation. Part IV explains why adding a Rule 10b-5 qui tam provision to a dysfunctional WBP would be a superior alternative to retaining FOTM suits, and sketches what such a provision might look like. Adding a qui tam provision to the WBP would ensure that tips not actively being pursued by the SEC, or affirmatively judged thereby to be insubstantial, could be pursued in private litigation. A qui tam provision would thus help to sustain the WBP, even if the SEC proved incapable of responding to the influx of whistleblower tips. As with FOTM suits, qui tam litigation under the WBP would largely result in circular corporate payments (shareholder-funded settlements or judgments, paid back to shareholders through a Fair Funds distribution<sup>9</sup>), with a cut going to the private enforcers to reward them for their fraud detection efforts. But unlike with FOTM suits, such rewards would be paid only in cases that actually produced an informational benefit. And numerous inefficiencies that result from the possibility of dual-track SEC and class action enforcement would be eliminated. Qui tam litigation would also ensure that any disciplining influence private Rule 10b-5 enforcement has exerted on

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<sup>9</sup> Section 308(c) of the Sarbanes–Oxley Act authorizes monetary penalties collected by the SEC to be distributed to investors in a so-called “Fair Funds” distribution, along with disgorgement. *See* 15 U.S.C. § 7246; 17 C.F.R. §§ 201.1100–.1106 (2013).

the SEC in the past is not lost. Finally, the proposal offers important political advantages that make its adoption more feasible than prior reform efforts.

The remainder of this Article proceeds as follows. Part I traces the history of the controversial FOTM class action and explains its modern day theoretical justifications. Part II provides a primer on the new WBP, surveys its track record to date, and evaluates the debate that has raged over its likely success. Part III broadens that debate to consider the impact of the WBP on the case for FOTM class actions, explaining why the WBP's success would justify the elimination of FOTM suits. Part IV presents the idea of appending a Rule 10b-5 qui tam provision to the WBP, and demonstrates why this would be a more attractive alternative to retaining FOTM suits in the event the WBP proves unsuccessful in its current design. The Article then briefly concludes.

## I. FRAUD-ON-THE-MARKET CLASS ACTIONS

### A. *What Are They and Where Do They Come from?*

The Rule 10b-5 “fraud on the market” class action has been described as a “judicial oak” that grew “from little more than a legislative acorn.”<sup>10</sup> That legislative acorn was planted in 1942,<sup>11</sup> when the SEC promulgated Rule 10b-5 under authority conferred on it in Section 10(b) of the Securities Exchange Act of 1934.<sup>12</sup> Rule 10b-5 makes it illegal to make any false statement of material fact, or to omit to state facts necessary to make statements not misleading, in connection with the purchase or sale of securities.<sup>13</sup> At the time of its adoption, the rule was intended to close a loophole in the SEC’s enforcement authority and “had no relation in the [SEC’s] contemplation to private proceedings.”<sup>14</sup> But only a few years later, the federal courts found an implied private right to sue for damages under Section 10(b) and Rule 10b-5. They did so by invoking the doctrine that violating the command of a federal statute “is a wrongful act and a tort” entitling the injured party to compensation.<sup>15</sup> Although the Supreme Court has since held that no private cause of action shall be recognized

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<sup>10</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

<sup>11</sup> Press Release, Sec. & Exch. Comm’n, Securities Exchange Act of 1934 Release No. 3230 (May 21, 1942) (available at [http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1942\\_0521\\_SEC\\_PR\\_RuleX\\_10b5.pdf](http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1942_0521_SEC_PR_RuleX_10b5.pdf)).

<sup>12</sup> 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5 (2013).

<sup>13</sup> 17 C.F.R. § 240.10b-5(b).

<sup>14</sup> *Milton V. Freeman, Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967).

<sup>15</sup> *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

under federal law absent clear congressional intent,<sup>16</sup> private enforcement of Rule 10b-5 remains.<sup>17</sup>

In its early years, the Rule 10b-5 private right of action did in fact operate much like a tort claim, with the federal courts requiring plaintiffs to plead and prove essentially the elements of common law fraud.<sup>18</sup> The main advantage of suing under Rule 10b-5 as opposed to state law was the more generous service of process provisions conferred on plaintiffs by the federal securities laws.<sup>19</sup> But over time, the Rule 10b-5 private right began to lose its moorings in the common law. For example, the requirement that a plaintiff stand in contractual privity with the defendant was abandoned, exposing firms to suit by secondary market purchasers of their securities.<sup>20</sup> The most dramatic break with the common law tradition came in the Supreme Court's seminal 1988 decision *Basic Inc. v. Levinson*.<sup>21</sup> Relying on finance theory, the Court observed that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations" about the value of the shares.<sup>22</sup> It therefore held that "where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed."<sup>23</sup> *Basic* thus allows plaintiffs who did not actually read misleading corporate disclosures to sue under Rule 10b-5, even though they would not be able to do so in a traditional common law fraud case. It also eliminates individualized issues of proof regarding reliance that tend to preclude class certification of common law fraud

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<sup>16</sup> See *Alexander v. Sandoval*, 532 U.S. 275, 286–88 (2001) (discussing the change in the Court's approach to implied private rights of action in federal statutes).

<sup>17</sup> See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 992–94 (1994) (describing implied private right of action under section 10(b) and Rule 10b-5 as having been "grandfathered" by the Court).

<sup>18</sup> *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241, 1245 (5th Cir. 1971) (observing that "many of the principles applicable to common law suits apply by analogy to" Rule 10b-5 suits).

<sup>19</sup> Indeed, this was the advantage sought in *Kardon*. See 69 F. Supp. at 513–14.

<sup>20</sup> See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974); see also Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 643 (1996) (noting "how controversial it was at common law to move beyond privity in fraud cases").

<sup>21</sup> 485 U.S. 224 (1988). For a good discussion of the import of *Basic*, and the history leading up to it, see Jill E. Fisch, *The Trouble with Basic: Price Distortion After Halliburton*, 90 WASH. U. L. REV. 895 (2013).

<sup>22</sup> *Basic*, 485 U.S. at 246.

<sup>23</sup> *Id.* at 247.

claims.<sup>24</sup> This is of critical importance, because the shareholders who rely on the integrity of market prices rather than researching their stock picks (and thus need *Basic*'s presumption of reliance to state a claim) tend to be diversified, owning only small stakes in specific companies; for them, bringing suit individually under Rule 10b-5 would rarely be cost-justified. The *Basic* decision, along with the Supreme Court's earlier recognition of a presumption of reliance in omission cases,<sup>25</sup> paved the way for the modern Rule 10b-5 class action, which I refer to herein as a "fraud-on-the-market" or "FOTM" suit. In a FOTM suit, an entrepreneurial lawyer seeks redress on behalf of dispersed public shareholders who are alleged to have purchased a firm's shares in the secondary market at a price artificially inflated due to fraudulent misstatements or omissions, and to have suffered a loss when the truth was revealed. The individuals responsible for the alleged misrepresentations or omissions (usually the firm's officers) are typically named in the suit, as is the firm itself. Although the firm usually does not sell securities during the period of the alleged fraud and, thus, does not directly benefit,<sup>26</sup> it faces strict liability for the frauds of its employees under common law principles of respondeat superior liability.<sup>27</sup> The plaintiff class typically consists of thousands of shareholders, and the potential damage awards are therefore staggering.<sup>28</sup> Perhaps as a result of this expansive liability exposure, and the expense and distraction of prolonged litigation, FOTM suits almost always settle if they survive a motion to dismiss.<sup>29</sup> And the settlements are almost always paid for by the

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<sup>24</sup> *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1193 (2013) ("Absent the fraud-on-the-market theory [adopted in *Basic*], the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class.").

<sup>25</sup> *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972).

<sup>26</sup> Sections 11 and 12(a)(2) of the Securities Act of 1933 contain express private causes of action for fraud in connection with an issuer's primary offering of securities. *See* 15 U.S.C. §§ 77k, 77l(a)(2) (2012).

<sup>27</sup> Strict corporate liability is imposed in Rule 10b-5 cases notwithstanding the fact that the Securities Exchange Act of 1934 contains an express control person provision that allows for a good faith defense. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 695–700.

<sup>28</sup> Indeed, they can amount to a substantial percentage of a corporation's total capitalization. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928 (1999).

<sup>29</sup> *See, e.g.,* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1064 (2006) (finding "only thirty-seven securities law cases seeking damages that were tried to judgment against public companies, their officers and directors, or both" in the period spanning 1980–2005, when thousands of such cases were filed); Michael Klausner et al., *When Are Securities Class Actions Dismissed, When Do They Settle, and for How Much? An Update*, 26 PROF. LIAB. UNDERWRITING SOC'Y J., Apr. 2013, at 1, 2 (finding that "virtually all" securities class actions filed in the 2006–2010 timeframe that survived a motion to dismiss "were ultimately settled rather than tried"). The inability of

firm and (most typically) its insurer, without contribution from the individual defendants.<sup>30</sup>

The failure of firms to require individual defendants to contribute to settlement payments in FOTM suits could be caused by several factors. When, as is often the case, settlements are fully covered by insurance, there is no need for contribution by either the firm or the individual defendants.<sup>31</sup> When the settlement exceeds policy limits, agency costs may explain a board's decision to forego seeking contribution from the individual defendants.<sup>32</sup> Alternatively, boards may decide in good faith that imposing liability on the defendant officers would do more harm to the firm than good.<sup>33</sup> Whatever the cause, the lack of individual monetary exposure appears to be an intractable feature of FOTM suits.<sup>34</sup>

### B. What Purpose Do They Serve?

1. *Compensation.*—What justifies FOTM class actions? The traditional response, consistent with the federal courts' original basis for recognizing an implied private right to sue under Rule 10b-5, is victim compensation. But few today defend FOTM suits on compensatory

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officers and directors to claim indemnification if they lose at trial is another commonly cited factor that may push companies to settle. *See, e.g.,* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1570 (2006). Plaintiffs' lawyers also have good reasons to favor settlement over trial. *See, e.g.,* Bratton & Wachter, *supra* note 6, at 102 (discussing plaintiff's-side litigation incentives).

<sup>30</sup> A recent empirical study of securities class actions filed between 2006 and 2010 found that the insurer paid the full settlement in 58% of settled cases and partially funded the settlement in another 28%; outside directors contributed in none of the settled cases, and officers contributed in only 2%. Michael Klausner et al., *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PROF. LIAB. UNDERWRITING SOC'Y J., May 2013, at 1, 4. For an excellent introduction to the role insurance plays in securities class actions, see TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT* (2010).

<sup>31</sup> See Klausner et al., *supra* note 30; see also Ellen M. Ryan & Laura E. Simmons, *Securities Class Action Settlements: 2012 Review and Analysis*, CORNERSTONE RESEARCH, [http://www.cornerstone.com/files/upload/Cornerstone\\_Research\\_2012\\_Settlements.pdf](http://www.cornerstone.com/files/upload/Cornerstone_Research_2012_Settlements.pdf) (last visited July 6, 2014) (reporting that almost 80% of securities class action settlements were fully funded by insurance in 2011, whereas approximately 65% were in 2012 (possibly due to higher settlement amounts in 2012)).

<sup>32</sup> See, e.g., Arlen & Carney, *supra* note 27, at 711 (advancing this hypothesis); Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1285–87 (2011) (same).

<sup>33</sup> For example, if the fraud allegations are of dubious merit, the board may rightly worry that requiring individual contributions would provoke undesirable disclosure practices by managers in the future. *See, e.g.,* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 864–66 (1984) (describing the efficiency gains that can flow from shifting legal risk from managers to shareholders).

<sup>34</sup> Reforms that would cause FOTM suits to result in greater managerial liability have been proposed but have not gained momentum. *See, e.g.,* Coffee, *supra* note 29, at 1572–85.

grounds.<sup>35</sup> This is due to a well-recognized “circularity problem.” As explained above, corporations and the insurance policies they purchase almost always fund the settlements in FOTM suits. As a result, the shareholders ultimately pay for the compensation provided in this type of litigation. FOTM suits therefore result in a transfer of funds from one group of innocent shareholders to another. Over time well-diversified shareholders will find themselves on both sides of the “v.” in roughly equal measure, meaning to them FOTM suits are an exercise in pocket shifting or, worse, a negative proposition once attorneys’ fees and other litigation costs are taken into account.<sup>36</sup>

The argument that diversified shareholders are not compensated in any meaningful sense by FOTM suits is often coupled with the argument that these investors do not really *need* compensation anyway, because over time they are likely to win as often as they lose from secondary market fraud—sometimes winning when they sell at an artificially inflated price, sometimes losing when they buy at an artificially inflated price.<sup>37</sup> Thus, the argument goes, the promise of out-of-pocket damages is not needed in order to discourage diversified investors from undertaking inefficient self-protection measures,<sup>38</sup> and it does not serve a sensible insurance function.<sup>39</sup>

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<sup>35</sup> See, e.g., BAKER & GRIFFITH, *supra* note 30, at 6 (“[A]n emerging consensus among most corporate and securities law scholars rejects compensation as a justification for shareholder litigation.”); Langevoort, *supra* note 20, at 651 (“[T]he compensatory system has relatively few informed, non-self-serving defenders.”).

<sup>36</sup> See, e.g., Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996) (“[P]ayments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up.”). Diversified shareholders make up an increasing percentage of the market. See INV. CO. INST., 2013 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE U.S. INVESTMENT COMPANY INDUSTRY 37 (53d ed. 2013) (detailing the net inflow of capital into index funds since 1998); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 884–86 (discussing the “[t]riumph of [p]ortfolio [t]heory”).

<sup>37</sup> This argument originated in Frank H. Easterbrook and Daniel R. Fischel’s seminal article *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985), and the “idea of compensation for securities fraud losses has been under attack in the legal academy virtually ever since.” Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 225–26 (2007) (challenging the idea that diversified investors will not suffer net losses as a result of fraud-on-the-market, but acknowledging that the FOTM class action is a poor vehicle for providing compensation).

<sup>38</sup> See, e.g., Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 635–41 (1992) (arguing that uninformed investors will not invest in precautions regardless of the liability rule because they can cheaply diversify and thus avoid losses from secondary market fraud). To be sure, informed traders are differently positioned, but the FOTM suit is a poor vehicle for providing compensation to this subset of investors. See *id.* (demonstrating that the presumption of reliance available in FOTM suits perversely incentivizes informed traders to invest more in precautions than they would under an actual reliance rule); see also Bratton & Wachter, *supra* note 6, at 97–99 (advancing the argument that compensating underdiversified information traders makes

Finally, given that innocent shareholders indirectly fund the settlements in FOTM suits, the compensation they provide cannot be justified as serving corrective justice or retributive ends.<sup>40</sup>

2. *Deterrence.*—In light of its perceived failings as a compensatory tool, modern defenders of the FOTM suit herald it instead as an important supplement to the securities fraud deterrence efforts of the federal government and, in particular, the SEC.<sup>41</sup> To understand this justification requires an understanding of both the deterrence goal and the precise way in which FOTM suits may assist in achieving it.

a. *The goal.*—An optimal securities fraud deterrence regime would not deter all fraud at any cost; rather, it would minimize the sum of the social costs of securities fraud (which I'll refer to as "underdeterrence costs") and enforcement. As explained above, the distributional

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sense in theory but not in actuality); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 345–49 (arguing that informed traders warrant compensation because they engage in reliance-based trading, but observing that because FOTM suits compensate investors without regard to their reliance they dilute returns to informed investors).

<sup>39</sup> See, e.g., Arlen & Carney, *supra* note 27, at 718–19 (rejecting the loss spreading argument in the FOTM context because diversified shareholders are risk-neutral and such suits do not effectively spread losses to a larger group); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 304–09 (explaining why risk-reallocation arguments for FOTM suits are unpersuasive); see also Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little?*, 158 U. PA. L. REV. 2043, 2067 (2010) (rejecting the insurance function of all small claims class actions "because individuals are not risk averse with respect to small losses"); cf. James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 340–344 (2009) (defending loss spreading as a justification for investor compensation).

<sup>40</sup> See, e.g., Arlen & Carney, *supra* note 27, at 719 (rejecting justice-based argument in favor of FOTM suits because such suits "simply replace[] one group of innocent victims with another" and can serve to "injure innocent people in addition to shareholders," such as employees). Further undermining the compensatory rationale is the fact that FOTM suits recover only a very small percentage of investor losses. See Coffee, *supra* note 29, at 1545–46 (surveying statistics on recovered losses in FOTM suits). Indeed, an empirical study by Professors James Cox and Randall Thomas estimated that less than 30% of institutional investors with provable losses bothered to file claims in settled FOTM cases. James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 413 (2005).

<sup>41</sup> See Langevoort, *supra* note 20, at 652 (describing the need for private enforcement to supplement the SEC's deterrence efforts as "the conventional view"); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1314 (2008) ("As the original compensatory justification for private Rule 10b-5 enforcement grew less persuasive, a deterrence-based justification took on increased prominence."); see also Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 103–04 (2005) ("Many scholars have concluded that deterrence, rather than the need for private redress, has been the Court's primary rationale for recognizing private causes of action under the securities and investor protection laws; private plaintiffs in these cases are seen by courts not so much as 'victims' in need of compensation but rather as private attorneys general.").

consequences of secondary market fraud may be of little concern to the extent public shareholders are diversified.<sup>42</sup> But secondary market fraud also imposes deadweight losses on society. For example, it impedes shareholders' ability to monitor corporate managers, increasing agency costs. It also causes bid-ask spreads to rise, reducing liquidity and making portfolio adjustments more expensive.<sup>43</sup>

Enforcing a liability regime creates its own costs, of course. These include not just the substantial funds required to investigate and prosecute claims—funds which might be put to more productive use elsewhere—but also so-called overdeterrence costs. Overdeterrence is a risk to the extent that corporate agents fear inaccurate prosecution and legal error; such fear may cause them to disclose less useful information to the marketplace, to overinvest firm resources in the disclosure process, or even to avoid the U.S. public capital markets altogether. Vicarious corporate liability can have similar effects if firms fear wrongheaded prosecutions or if the sanctions for failing to prevent a renegade agent from committing fraud are too severe. To the extent that third parties like auditing firms and investment banks face erroneous or oversized liability for aiding and abetting securities fraud, they may increase the price they charge for their services, or simply avoid servicing companies that pose too great a liability risk.<sup>44</sup>

The deterrence argument in favor of FOTM suits is premised on the idea that the SEC needs assistance in order to achieve the optimal level of fraud deterrence, or stated slightly differently, that in the absence of FOTM suits, underdeterrence costs would be too high. Why is the SEC presumed to need help from the class action bar to deter fraud at optimal levels? Two arguments are typically made. The first charges that the SEC has skewed incentives that lead it to systematically underdeter—either because it is captured by managerial interests that favor light enforcement, or because its personnel are lazy, inept, or suffer from behavioral biases that lead them to

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<sup>42</sup> See INV. CO. INST., *supra* note 36 (detailing the net inflow of capital into index funds since 1998); Gilson & Gordon, *supra* note 36 (discussing the “triumph of portfolio theory”).

<sup>43</sup> The ultimate effect is a higher cost of capital, which slows economic growth. For in-depth discussions of the social costs of fraud-on-the-market and, conversely, the social benefits of accurate disclosure, see Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252–68 (2009); Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 1005–42 (1992); Pritchard, *supra* note 28, at 937–45; and Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1895 (2013).

<sup>44</sup> For an in-depth discussion of how a liability regime can produce these costs, see Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2183–99 (2010).

pull their punches (or to direct those punches at the wrong defendants).<sup>45</sup> The second argument questions not the SEC's motives, but rather its capacity to pursue investigations and enforcement actions at optimal levels in light of resource constraints.<sup>46</sup>

Between the two, the resource-based argument likely has more adherents, but it requires further discussion because it stands in apparent tension with the theory of optimal sanctions. That theory posits that to efficiently deter misconduct, a sanction should be set equal to the externalized social costs of the misconduct multiplied by the inverse of the probability the sanction will be imposed (assuming risk-neutrality).<sup>47</sup> Thus, if misconduct causes \$200 in harm and there is a 50% chance of being sanctioned, the fine should be set at \$400 (or its nonmonetary equivalent) so that, on an expected value basis, a would-be violator fully internalizes the costs of the contemplated misbehavior. If a government agency lacks resources to pursue the misbehavior at levels that would lead to a 50% enforcement rate, it could increase the fine and obtain the same level of deterrence (for example, at a 10% enforcement rate the fine should be set at \$2000, or its nonmonetary equivalent).

This logic suggests that, if the SEC is underdetering because it is resource constrained, the solution is to increase the severity of the sanctions it imposes for securities fraud, not to invite private enforcement, which, as explained below, comes with significant costs. Indeed, expected utility theory predicts that risk-averse persons will be more deterred by a compensated increase in the severity of the sanction than an equivalent

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<sup>45</sup> See, e.g., Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 99 (2008) (observing that "securities class actions . . . guard against selective enforcement and inaction by the SEC" and "overcome[] lackluster governmental incentives"); James J. Park, *Rules, Principles and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 121 (2012) (noting that advocates of decentralized enforcement argue "that competition among enforcers can prevent a captured regulator from underenforcing the securities laws"); see also Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 24 (2003) (cataloguing behavioral biases that may affect SEC personnel).

<sup>46</sup> See, e.g., Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 126–27 (2005) ("Because the SEC lacks adequate resources to effectively police the national securities market, supplemental enforcement is essential to achieve an appropriate level of deterrence."); Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 374–75 (2010) (detailing the resource constraints faced by the SEC and asserting that private enforcement is needed to fill the gap); Langevoort, *supra* note 20, at 652 (accepting "the conventional view that private litigation is a necessary supplement to SEC enforcement" because of federal resource constraints, while suggesting that Rule 10b-5 class actions could be eliminated entirely "in a world with an optimally staffed SEC").

<sup>47</sup> Steven Shavell, *Foundations of Economic Analysis of Law* 483 (2004).

compensated increase in the probability of detection.<sup>48</sup> One compelling answer to this objection to the resource-based argument in favor of private enforcement is that people do not always behave as expected utility theory would predict: in practice, “the probability of sanctions (or, as it is frequently expressed, the certainty of sanctions) matters more than their magnitude.”<sup>49</sup> Increasing detection levels may be preferable to upping the severity of sanctions for additional reasons as well. For example, increasing monetary sanctions will increase the number of potential defendants who are judgment proof, and increasing nonmonetary sanctions (e.g., lengthening prison terms) can be expensive and can raise marginal deterrence and fairness concerns.<sup>50</sup>

The shift in rationale for FOTM suits from a private law/compensatory justification to one grounded in public law notions of deterrence is significant. As I have explained elsewhere, “There are few instances, at least since our Republic developed a mature public law enforcement capability, in which Congress has expressly granted private parties the right to sue to enforce public law norms absent a traditional tort-like injury that can be meaningfully redressed through litigation”; and those rare cases in which it has done so, such as the *qui tam* action under the False Claims Act, have proven highly controversial.<sup>51</sup> There are good reasons for this.

One reason is that profit-driven private enforcement complicates the task of setting optimal sanctions. When enforcers are profit-driven, the magnitude of the sanction and the amount spent on enforcement cannot be set independently. This is because “the level of the defendant’s liability determines the extent of enforcement (whether a suit will be brought and how much will be spent by the parties on litigation)”;<sup>52</sup> thus, the higher the sanction, “the higher the payoff from suit; the higher the payoff, the more people will spend investigating and bringing suits.”<sup>53</sup> This can drive

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<sup>48</sup> Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 178 (1968).

<sup>49</sup> SHAVELL, *supra* note 47, at 481. “In expected utility theory, the utilities of outcomes are weighted by their probabilities. . . . [But a series of choice problems demonstrates that] people overweight outcomes that are considered certain, relative to outcomes which are merely probable—a phenomenon [that has been labeled] the *certainty effect*.” Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 265 (1979). This learning “suggests that the probability of detection is far more likely to have an impact on agents than will increasing the sanction when there is a very low probability of detection.” James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 9 (1997).

<sup>50</sup> See, e.g., Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 695 n.21 (1997).

<sup>51</sup> Rose, *supra* note 41, at 1325–26.

<sup>52</sup> A. Mitchell Polinsky, *An Introduction to Law and Economics* 146 (4th ed. 2011).

<sup>53</sup> Easterbrook & Fischel, *supra* note 37, at 621.

expected sanctions above their optimal level if actual sanctions are set higher than social cost to account for a less than 100% probability of enforcement.<sup>54</sup> This, in turn, can lead to overdeterrence. Of course, some misconduct (including securities fraud) has no social value, and society would therefore wish to deter it unconditionally; with respect to such misconduct, the outsized sanctions private enforcement may produce would not at first blush appear problematic. But outsized sanctions would remain a concern if liability extended beyond the individual wrongdoers to their employers (as it does in the case of securities fraud). This is because vicarious liability is not designed to deter unconditionally but rather to encourage firms to invest only socially optimal amounts in deterrence efforts.

Even if sanctions could be perfectly calibrated, overdeterrence would also remain a concern—with respect to both individuals and vicariously liable firms—if inaccurate prosecution and legal error were feared, and this is more likely to be the case in a regime of private as opposed to public enforcement.<sup>55</sup> The risk of inaccurate prosecution and legal error is greatest when a law is overbroad or vague, or key issues of proof lend themselves to subjective interpretation. This is the case with securities fraud.<sup>56</sup> In such situations, a public enforcer can mitigate overdeterrence by engaging in “discretionary nonenforcement”—declining to prosecute borderline cases that could be won, but that risk producing undesirable behavior.<sup>57</sup> “Discretionary nonenforcement allows society to avoid the costs of crafting more precisely tailored rules, and the loopholes such rules inevitably create. It also allows for ready adjustment by a public enforcer if beliefs change as to the type of conduct that warrants sanction.”<sup>58</sup> But in a private enforcement regime, “discretionary nonenforcement is a non sequitur”—if bringing suit appears profitable, the suit will be brought.<sup>59</sup>

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<sup>54</sup> One solution to this problem is to decouple the bounty payment from the sanction, but this is difficult to do effectively and can create opportunities for collusive settlements. See Rose, *supra* note 41, at 1327–28 (discussing the limits of decoupling).

<sup>55</sup> Rose, *supra* note 44, at 2190.

<sup>56</sup> See *id.* at 2185–86 (discussing how hindsight can bias judicial determinations relating to scienter, particularly in cases involving forward-looking statements or omissions); see also *infra* note 66.

<sup>57</sup> William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 38 (1975).

<sup>58</sup> Rose, *supra* note 41, at 1329.

<sup>59</sup> *Id.*; see also William E. Kovacic, Private Monitoring and Antitrust Enforcement: Paying Informants to Reveal Cartels, 69 GEO. WASH. L. REV. 766, 781 (2001) (“Robust private participation, especially independent rights of action that eliminate a public prosecutorial monopoly, reduce or eliminate the ability of government enforcement officials to use prosecutorial discretion as a nonlegislative tool for altering the law.”); Landes & Posner, *supra* note 57, at 39 (“The existence of a public monopoly of enforcement in a particular area of the law is a necessary . . . condition of discretionary nonenforcement.”).

Additional complications can arise from private enforcement if it operates concurrently with public enforcement. For example, the specter of private liability can frustrate efforts by public enforcers to reach cooperative solutions with regulated parties.<sup>60</sup>

That private Rule 10b-5 enforcement imposes these types of costs has not gone unnoticed. To the contrary, concerns about frivolous FOTM suits, and the overdeterrence they produce, have prompted a series of judicial and congressional reforms. These include the adoption of stricter pleading requirements in Rule 10b-5 class actions,<sup>61</sup> a statutory safe harbor for forward-looking statements,<sup>62</sup> a discovery stay pending decision on a motion to dismiss,<sup>63</sup> and the elimination of private aiding and abetting liability.<sup>64</sup>

Although these reforms have gone a long way to discourage marginal litigation,<sup>65</sup> concerns about the costs of FOTM suits remain. The scope of the private right of action under Rule 10b-5 still has fuzzy borders.<sup>66</sup> Strict vicarious liability remains a feature of the regime, and it is frequently observed that the out-of-pocket measure of damages used in FOTM suits likely grossly exceeds the social harm actually caused by the fraud.<sup>67</sup>

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<sup>60</sup> See David Freeman Engstrom, *Agencies as Litigation Gatekeepers*, 123 YALE L.J. 616, 634 (2013) (noting the critique that “profit-motivated private enforcement will deprive regulatory regimes of needed ‘coherence’ by, among other things, disrupting the subtle cooperative relationships that arise between regulators and regulatory targets”); Stephenson, *supra* note 41, at 117–18 (discussing the ways in which private enforcement can interfere with public enforcement efforts).

<sup>61</sup> See generally Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ‘33 and ‘34 Act Claims*, 76 WASH. U. L.Q. 537 (1998) (discussing the PSLRA’s heightened pleading requirements).

<sup>62</sup> See generally Ann Morales Olazábal, *Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995: What’s Safe and What’s Not?*, 105 DICK. L. REV. 1 (2000) (discussing the PSLRA’s safe harbor for forward-looking statements).

<sup>63</sup> 15 U.S.C. § 78u-4(b)(3)(B) (2012).

<sup>64</sup> See Rose, *supra* note 44, at 2198 n.62.

<sup>65</sup> For empirical studies on the effectiveness of the PSLRA in weeding out frivolous claims, see Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598 (2006); Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627 (2006); and Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913.

<sup>66</sup> See, e.g., Alexander, *supra* note 36, at 1494 (“It is not easy to state a clear standard [of materiality] whose factual application can be readily understood, particularly when applied to omissions.”); Langevoort, *supra* note 20, at 644 (footnotes omitted) (observing that “scienter has a good bit of indeterminacy to it, especially when we think of it in terms of awareness of the truth rather than motive to deceive and even more when we consider its recklessness component,” and that “[m]atters of materiality and duty are often difficult to work through confidently”).

<sup>67</sup> See, e.g., Alexander, *supra* note 36, at 1497 (“It seems likely that the true social costs of any particular violation are significantly less than the tens or hundreds of millions of dollars represented by potential class-based damages.”); Langevoort, *supra* note 20, at 646 (arguing that “full out-of-pocket compensation in open-market cases is systematically excessive and dysfunctional”).

Another critique is that the specter of vicarious liability in FOTM suits may dissuade companies from self-reporting fraud to, or otherwise cooperating with, the SEC.<sup>68</sup> The widely condemned practice of SEC “no admission” settlements, for example, is largely explained by firms’ refusal to admit to allegations that can be used against them in a follow-on FOTM suit.<sup>69</sup> Finally, the burden FOTM suits impose on the federal judiciary is significant.<sup>70</sup>

From an optimal deterrence perspective, the costs FOTM suits produce are tolerable only if such suits produce an even greater savings in underdeterrence costs. After all, if FOTM litigation increases enforcement costs more than it decreases the social costs of securities fraud, it would move the system farther from, rather than closer to, the ideal. At this point, the debate tends to stall. Measuring under- and overdeterrence costs is incredibly difficult, and significant empirical uncertainty therefore exists regarding the relative costs and benefits of FOTM suits.<sup>71</sup> A growing cohort of scholars doubts that the deterrence benefits of FOTM class actions exceed their costs.<sup>72</sup>

But even the most vocal critics of FOTM class actions have remained hesitant to recommend their abolition without compensating adjustments to the U.S. securities fraud deterrence regime.<sup>73</sup> Professors William Bratton and Michael Wachter, for example, recently proposed a tradeoff: “[T]he SEC should ask for more money and refocus its enforcement operation on

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<sup>68</sup> See Arlen & Kraakman, *supra* note 50, at 707 (“[T]raditional strict liability generates what we term ‘perverse effects’: that is, strict liability only encourages policing measures insofar as they reduce the incidence of misconduct, but it perversely discourages them insofar as they increase the firm’s expected liability for undeterred misconduct.”). *But see* Cox, *supra* note 49, at 11–19 (challenging the argument that strict corporate liability produces perverse effects). See generally Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994) (demonstrating how strict corporate liability can cause firms to spend less on efforts to detect employee misconduct).

<sup>69</sup> Samuel W. Buell, *Liability and Admission of Wrongdoing in Public Enforcement of Law*, 82 U. CIN. L. REV. 505, 518 (2013) (explaining the SEC’s belief that, were it to require admissions, “[f]irms would refuse to deal, primarily because the collateral consequences of factual admissions in public enforcement actions can cripple firms, particularly in class action litigation”).

<sup>70</sup> See Coffee, *supra* note 29, at 1539–42 (surveying statistics showing how securities class actions tax the judiciary).

<sup>71</sup> See James D. Cox & Randall S. Thomas, Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law, 6 EUR. COMPANY & FIN. L. REV. 164, 183 (2009) (discussing these difficulties).

<sup>72</sup> See Bratton & Wachter, *supra* note 6, at 72 n.1 (discussing the growing academic consensus that securities class actions are likely inefficient).

<sup>73</sup> Some early critics of the FOTM class action were more resolute in their recommendations. See Mahoney, *supra* note 38, at 626 (concluding that “FOTM should be rejected and that Rule 10b-5 plaintiffs should be required to prove reliance”); Arlen & Carney, *supra* note 27, at 734 (recommending that respondeat superior liability be eliminated in FOTM suits).

individual defendants and, in return, propose a rule that eliminates the FOTM presumption [of reliance] in private litigation.”<sup>74</sup> Professor Merritt Fox also recommends the elimination of FOTM suits, but as part of a fundamental restructuring of the civil liability system governing mandatory disclosure.<sup>75</sup> I have likewise argued for the elimination of FOTM class actions, but only if simultaneous reforms are enacted to better align the SEC’s interest with the national interest in achieving optimal securities fraud deterrence.<sup>76</sup> I have alternatively suggested that the SEC be given authority to prescreen, and potentially veto or usurp, FOTM class actions.<sup>77</sup> As far as politicians go, the empirical uncertainty over the desirability of FOTM suits favors the status quo—especially in light of powerful vested interests and the almost certain public backlash that would result should a financial scandal emerge after Congress was perceived as cutting back on fraud deterrence.

The thesis of this Article is that the SEC’s new Whistleblower Bounty Program (WBP) pushes the debate concerning FOTM suits forward in important ways that are not currently being discussed. Specifically, the WBP promises to greatly reduce the deterrence benefits that FOTM suits may have produced in the past, while at the same time increasing their costs. Thus, it should change minds regarding the desirability of FOTM class actions. But before turning to the WBP and why it may have these effects, it is important to understand precisely *how* FOTM class actions may have assisted in fraud deterrence prior to the new program’s adoption—notwithstanding that the incidence of liability in such suits falls not on the culpable officers, but on the corporation and ultimately its innocent shareholders.

*b. How fraud-on-the-market class actions may help.*—It is often asserted that FOTM suits aid in deterrence, without much elaboration. But as explained below, the standard deterrence justification for civil litigation against firms does not make sense in the FOTM context. This is not to say that such suits lack all deterrence potential, but rather that the mechanism through which they may promote deterrence is different than is commonly

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<sup>74</sup> Bratton & Wachter, *supra* note 6, at 82.

<sup>75</sup> Fox, *supra* note 43.

<sup>76</sup> Rose, *supra* note 44, at 2228–29.

<sup>77</sup> Rose, *supra* note 41, at 1354–58. A variety of other reform proposals directed at FOTM suits have been advanced. *See, e.g.*, Alexander, *supra* note 36 (suggesting damages in FOTM suits be replaced with civil penalties); Coffee, *supra* note 29 (suggesting ways to cause culpable insiders to shoulder more of the liability in FOTM suits); Grundfest, *supra* note 17 (urging the SEC to consider eliminating private Rule 10b-5 enforcement); Langevoort, *supra* note 20 (suggesting a cap on compensatory damages in FOTM cases); Pritchard, *supra* note 28 (suggesting FOTM suits be replaced with stock exchange enforcement).

understood. FOTM suits may aid in deterrence not by virtue of the settlements they impose on firms, but rather by virtue of the *information* they convey to the marketplace. They may also have the salutary effect of causing the SEC to perform its deterrence job more effectively.

(1) *Fraud detection*.—The fact that corporations, and ultimately their shareholders, foot the bill in FOTM suits does not necessarily negate their deterrent value. Respondeat superior liability has long been defended on deterrence grounds. The traditional argument is that it forces a firm’s owners to fully internalize the social costs of employee misconduct, thus providing them with an otherwise missing incentive to invest firm resources in deterrence efforts.<sup>78</sup> Firms have a variety of deterrence tools at their disposal. For example, they can screen applicants for their propensity to act lawfully, set up and maintain internal control systems to monitor employees on the job, modify production processes to reduce the likelihood of misconduct, use pay and promotions to reward good behavior, and take steps internally to detect and punish misconduct.<sup>79</sup> Without the threat of respondeat superior liability, the argument goes, a firm’s owners would lack incentives to invest in such socially desirable deterrence efforts.<sup>80</sup>

Encouraging firms to invest in deterrence is thought important because the threat of personal liability may fail to adequately deter. For example, if sanctions are monetary, judgment-proof employees may ignore them. Professors Jennifer Arlen and William Carney have argued that this is a problem in the fraud-on-the-market context. Although the public company CEOs and other high level officers who commit fraud-on-the-market tend to be persons of means, Arlen and Carney hypothesize that most will find fraud worthwhile only in “last period” situations when lying can buy them time to turn around an ailing firm but being forthright will cost them their jobs and much of their wealth; thus, they may expect to be judgment proof in the event the fraud proves unsuccessful.<sup>81</sup> Employees might also systematically underestimate the risk that their conduct may result in certain harms (or in liability) due to behavioral biases, in which case

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<sup>78</sup> See, e.g., Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345, 1362–63 (1982).

<sup>79</sup> For discussions of these methods, see Arlen & Kraakman, *supra* note 50, at 702–03, 706; Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 569–70 (1988).

<sup>80</sup> Indeed, the employer might even promote the misconduct. See, e.g., Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1241–42 (1984).

<sup>81</sup> See Arlen & Carney, *supra* note 27, at 702–03.

personal liability alone may lead to suboptimal deterrence.<sup>82</sup> Professor Donald Langevoort has offered such a behavioral account for why officers commit fraud-on-the-market. He posits that information-flow problems in large organizations combine with “corporate cultural biases” (particularly overoptimism and confirmation biases) to skew the information that reaches officers; this in turn causes them to release false information to the marketplace—first innocently and later intentionally—in what he describes as an “optimism-commitment whipsaw effect.”<sup>83</sup> To be sure, nonmonetary sanctions can fix the judgment-proof problem and, if salient enough, perhaps the behavioral one, too. But respondeat superior liability may be a less expensive deterrence fix. It might also be preferable if one does not trust the government to impose nonmonetary sanctions at levels necessary to produce optimal deterrence.

The traditional deterrence justification for respondeat superior liability has its weaknesses, however—both in general and in the case of fraud-on-the-market in particular. Professor Arlen, for example, has criticized the fact that respondeat superior liability is strictly imposed. Forcing firms to bear all the costs caused by their agents’ employment—even those that firms cannot prevent with due care—is often defended as a way to force firms to take the full social costs of their operations into account when setting activity levels.<sup>84</sup> But Professor Arlen has observed that this can have a perverse effect on a firm’s incentive to engage in policing efforts because those efforts may increase the likelihood that employee misconduct will come to light and the firm, in turn, will be sanctioned.<sup>85</sup> She thus favors a vicarious liability regime that is either duty-based or that mitigates the sanction imposed on firms if they can demonstrate reasonable policing

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<sup>82</sup> See Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705, 1733–37 (1996) (explaining how respondeat superior liability can incentivize employers to “provide stimuli that promote reasonable behavior by complex individuals who acting alone, undisciplined, would otherwise (even under the threat of tort liability) act reasonably less often”); Kornhauser, *supra* note 78, at 1373 (observing that “[o]nly enterprise liability will lead to an appropriate level” of care “[i]f agents misperceive the costs of accidents and enterprises do not,” but noting that such misperceptions should dissipate over time as agents learn the costs of accidents). This justification for respondeat superior liability assumes, of course, that employers would be unable to fully and costlessly shift the expected liability back to employees.

<sup>83</sup> Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 167 (1997).

<sup>84</sup> See, e.g., Sykes, *supra* note 79, at 567 (“[When] the employer’s business does not bear the full cost of the compensable wrongs attendant upon its operation (either directly through liability payments or indirectly through wages paid to employees who make liability payments), its profitability is inflated relative to what it would be if the employee could pay judgments in full. In a competitive market, the employer is then likely to expand production beyond the socially optimal level because his private marginal costs of production are lower than the social marginal costs of production.”).

<sup>85</sup> See *supra* note 68.

efforts as a way to encourage such behavior.<sup>86</sup> Although government enforcers often reward firms for their internal compliance efforts by mitigating fines,<sup>87</sup> the specter of crushing respondeat superior liability in private litigation may stymie governmental efforts to influence firm behavior.

When it comes to FOTM suits in particular, the traditional deterrence argument in favor of respondeat superior liability loses force completely. This is because the social costs of fraud-on-the-market are borne most directly by diversified shareholders.<sup>88</sup> The threat of liability is therefore unnecessary to encourage them to invest firm resources in fraud deterrence efforts, or to adjust activity levels appropriately. As its primary victims, diversified shareholders have natural incentives to take cost-justified steps to prevent fraud-on-the-market—just as they have natural incentives to take cost-justified steps to prevent other sorts of agency costs.<sup>89</sup> And because these shareholders stand on both sides of the “v.” in FOTM suits, the possibility of settlement payments will not change their behavior in any event. The “circularity problem” thus undermines not just the compensatory rationale for FOTM suits, but also the deterrence rationale.<sup>90</sup>

The fact that the traditional justification for respondeat superior liability is not persuasive in FOTM suits does not mean such suits lack any deterrence potential, however. Even if FOTM suits are not necessary to correct shareholder incentives regarding fraud deterrence, they could help shareholders *act* on those incentives.<sup>91</sup> To understand this argument requires, first, an understanding of why boards’ incentives to invest in fraud

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<sup>86</sup> See *supra* note 68.

<sup>87</sup> See, e.g., Press Release, Sec. & Exch. Comm’n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006) (*available at* <http://www.sec.gov/news/press/2006-4.htm>) (“The [SEC’s] decisions in particular cases are intended to encourage the management of corporations accused of securities law violations to do everything within their power to take remedial steps, from the first moment that the violation is brought to their attention. Exemplary conduct by management in this respect weighs against the use of a corporate penalty; failure of management to take remedial steps is a factor supporting the imposition of a corporate penalty.”).

<sup>88</sup> See *supra* note 43 and accompanying text.

<sup>89</sup> As Professor Velikonja has pointed out, others, such as employees, can suffer from securities fraud as well; as a result, “no single . . . class of private parties[] has optimal incentives” to prevent it. Velikonja, *supra* note 43, at 1945. Still, most recognize that shareholders bear the brunt of the social costs of fraud-on-the-market, meaning that their incentives, although not perfect from a social welfare standpoint, come very close.

<sup>90</sup> Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1688 (2011); see also Arlen & Carney, *supra* note 27, at 701 (describing FOTM as “an aspect of agency costs”); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003) (recognizing that securities fraud class actions relate to corporate governance failures).

<sup>91</sup> Rose & Squire, *supra* note 90, at 1698.

deterrence may diverge from those of diversified shareholders, and, second, how FOTM suits can help to align them.

Although diversified shareholders would naturally want the firms in their portfolio to take reasonable steps to deter fraud-on-the-market, it is the board of directors that actually controls a corporation's operations. And directors may not share the natural incentives of diversified shareholders. Whereas diversified shareholders are likely to lose as often as they win from secondary market fraud, and thus do not stand to profit from its distributional consequences, directors—and the officers to whom they may feel beholden—are positioned differently. They have considerable wealth tied up in the particular firms they serve, including stock, expected salary, and reputational capital. If left unpunished, fraud-on-the-market could help to enhance that wealth. In the absence of any threat of sanction, directors might therefore invest fewer firm resources in fraud deterrence than shareholders (and society) would prefer. A salient threat of sanction may also be necessary to overcome behavioral biases that lead directors to underestimate the likelihood that their CEO or other top officers would engage in fraud. Shareholders have a variety of familiar weapons they can use to sanction directors who fail to advance their interests: they can vote them out of office, sue them for breach of fiduciary duty, or (most promising) take the so-called Wall Street Walk.<sup>92</sup> But these threats are credible only if shareholders are likely to learn of the managerial malfeasance. And monitoring directors' efforts at fraud deterrence is very difficult, and an anathema to the diversification strategy.<sup>93</sup>

FOTM suits might be conceptualized as a way for shareholders to outsource this monitoring function to the class action bar. When fraud is exposed, it captures shareholders' limited attention, prompting them (and the market more broadly) to impart whatever punishment is deemed warranted on the board. This typically includes a share sell-off, leading to a large drop in the firm's stock price,<sup>94</sup> which in turn hits management in the pocketbook and increases the likelihood of a takeover. It also potentially

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<sup>92</sup> The "Wall Street Walk" refers to the practice of "voting with [one's] feet"—that is, exiting the investment by selling one's shares. Such action may, inter alia, depress the firm's share price and expose management to the threat of a takeover. See Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645, 2646 (2009).

<sup>93</sup> For a variety of reasons, the intermediary institutions that manage diversified investor funds cannot be counted on to engage in active corporate monitoring on diversified shareholders' behalf. See Gilson & Gordon, *supra* note 36, at 888–95.

<sup>94</sup> See, e.g., Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582 (2008) (finding in an empirical study that "[o]n average firms lose 38% of their market values when news of their misconduct is reported").

includes loss of position,<sup>95</sup> as well as reputational damage.<sup>96</sup> The threat of such punishment may, in turn, improve directors' ex ante incentives to invest in fraud deterrence.<sup>97</sup> Of course, FOTM suits can also produce large settlement payments, and to the extent these are not covered by insurance, they, too, may impart punishment on the board through their impact on the value of directors' shareholdings.<sup>98</sup> But studies show that the bulk of the decline in a firm's stock price upon the revelation of fraud is attributable to reputational loss rather than anticipated legal penalties.<sup>99</sup> Thus, the deterrence value of FOTM suits lies more in the information they produce about the underlying fraud than in the legal remedies they impose.<sup>100</sup>

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<sup>95</sup> This is certainly the case for those implicated in the fraud. *See generally* Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193 (2008) (finding in an empirical study that individual perpetrators of financial misconduct face significant disciplinary action, with the vast majority getting fired).

<sup>96</sup> *See generally* Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J.L. & ECON. 365 (2006) (empirical study finding that directors of companies sued in securities class actions suffer a reputational penalty measured by a decrease in net board positions if their case settles in the top quartile of settlement amounts or is accompanied by a parallel SEC enforcement action).

<sup>97</sup> Professor Urska Velikonja questions whether there is much that directors can do to guard against fraud by top-level officers. *See Velikonja, supra* note 32, at 1304–05. Professors Arlen and Carney have expressed similar doubts. *See Arlen & Carney, supra* note 27, at 715–16. If these scholars are correct, the benefit side of the FOTM suit ledger was small to nonexistent even before the WBP. This is, indeed, my own intuition. *See Rose & Squire, supra* note 90, at 1698–1703. But proving that empirical point is not my objective in this Article; rather, my aim is to set forth the strongest theoretical case for FOTM suits and to demonstrate how it is affected by the WBP.

<sup>98</sup> Professors Baker and Griffith have shown that insurers that issue Directors & Officers policies attempt to price governance risk in setting premium amounts, but they conclude that the price differentials are likely much too small to create incentives for worse-governed firms to improve. *See BAKER & GRIFFITH, supra* note 30, at 97–104. Their research also shows that insurance companies themselves “neither monitor nor provide loss-prevention programs to the corporations they insure.” *Id.* at 105.

<sup>99</sup> *See Karpoff et al., supra* note 94, at 582 (reporting that 24.5% of the decline in a firm's stock price upon the revelation of financial misconduct reflects the market adjusting to the true value of the firm if managers had not “cooked the firm's books,” 8.8% reflects expected legal penalties, and 66.6% reflects lost reputation; thus, reputation loss “exceeds the legal penalty by over 7.5 times, and it exceeds the amount by which firm value was artificially inflated by more than 2.5 times”).

<sup>100</sup> The argument advanced here is in this way different from the one Professor Squire and I made in *Intraportfolio Litigation, supra* note 90. *Intraportfolio Litigation* focused primarily on intercorporate legal disputes between publicly held firms. It observed that those suits suffer from the same “circularity problem” as FOTM class actions, undermining traditional compensatory and deterrence-based rationales for corporate liability. But we argued that corporate liability might still serve a useful social function in those suits, emphasizing that the damages imposed could assist diversified shareholders in portfolio governance by causing “financial data about each portfolio firm to better reflect the contribution of that firm's managers to overall portfolio wealth.” *Id.* at 1697. Most intercorporate disputes (for example, those involving contract breaches or patent violations) do not directly speak to the quality of management in the way that securities fraud does, and thus, the impact of the damage award or settlement payment on a company's stock price is likely to be a more significant informational signal. *Cf.* Bruce Haslem et al., *How Much Do Corporate Defendants Really Lose?* (May 21, 2013)

The information FOTM suits produce could also help to deter would-be fraudsters in a more direct fashion. Even though FOTM suits do not result in the imposition of monetary sanctions on culpable officers, to the extent they help detect frauds, they increase the likelihood that culpable officers will be sanctioned by both the government (perhaps even criminally) and by the firm itself.<sup>101</sup>

If FOTM suits help to reduce agency costs in the ways imagined above, they may be worth the cost to shareholders notwithstanding their apparent circularity.<sup>102</sup> Their worth will turn, of course, on how *much* new (and accurate) information they produce—that is, how much fraud they are actually responsible for exposing. One should not overestimate their contribution.<sup>103</sup> Many FOTM suits produce no new information because they come after the fraud has been exposed by other sources and do not otherwise enrich the public's understanding of what occurred. One study concluded that private litigation uncovered only 3% of the incidents of financial fraud exposed between 1996 and 2004 in companies with more than \$750 million in assets.<sup>104</sup> The SEC fared better in that study, but only slightly.<sup>105</sup> Employees were responsible for exposing the largest percentage of the frauds.<sup>106</sup>

These results are hardly surprising. Class action lawyers are corporate outsiders and thus have no inherent advantage in detecting corporate misconduct by virtue of their position. The SEC is also a corporate outsider, of course, but it has powerful investigative tools. FOTM plaintiffs, by contrast, must survive a motion to dismiss before being entitled to even basic discovery.<sup>107</sup> What the class action bar brings to the detection table, then, necessarily comes from its members' learned expertise in analyzing publicly available information to identify suspicious

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(unpublished manuscript) (*available at* [http://papers.ssrn.com/abstract\\_id=2290821](http://papers.ssrn.com/abstract_id=2290821)) (empirical study finding that firms involved in litigation other than securities litigation do not exhibit reliable signs of reputational damage across various measures).

<sup>101</sup> See *supra* note 95.

<sup>102</sup> One way to gauge this would be to allow shareholders to opt their firms out of the FOTM class action regime, as some scholars have advocated. See, e.g., Bratton & Wachter, *supra* note 6, at 128–32; A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta: *The Political Economy of Securities Class Action Reform*, 2007–08 CATO SUP. CT. REV. 217, 247–55.

<sup>103</sup> See Rose & Squire, *supra* note 90, at 1703 (opining that “the marginal amount of new information generated by a private [FOTM] lawsuit against the corporation is likely to be extremely small, especially as compared to the lawsuit’s costs”).

<sup>104</sup> See Alexander Dyck et al., Who Blows the Whistle on Corporate Fraud?, 65 J. FIN. 2213, 2230 (2010).

<sup>105</sup> *Id.* at 2214 (reporting that the SEC was responsible for exposing 7%).

<sup>106</sup> *Id.* at 2226 (reporting that employees were responsible for exposing 17%).

<sup>107</sup> 15 U.S.C. § 78u-4(b)(3)(B) (2012).

disclosure practices, as well as its skills in eliciting current or former company insiders to divulge incriminating facts as confidential informants.<sup>108</sup>

(2) *SEC performance.*—In addition to any work they do on the detection front, it has also been argued that FOTM suits may aid in fraud deterrence by positively affecting the SEC’s own efforts to detect and punish securities fraud.<sup>109</sup> Without the FOTM class action bar looking over its shoulder and threatening to pick up its slack, the SEC might be less aggressive in its own enforcement activities.<sup>110</sup> This could be due to a fear of embarrassment or congressional reprimand should the class action bar expose frauds the SEC failed to detect, or it could simply be a product of the competitive spirit. Whatever the cause, the idea is that FOTM litigation can improve the SEC’s poor enforcement incentives, in addition to making up for them through direct fraud detection.

One might imagine that the SEC also benefits from FOTM suits because they allow the agency to outsource the litigation function, freeing up SEC resources for other uses. But as explained above, the revelation of fraud (and the market penalty it prompts) is far more important to deterrence than are the corporate sanctions FOTM suits impose (which are mostly covered by insurance<sup>111</sup>). If fraud were exposed by other sources, then there would be little reason for allowing a FOTM suit to proceed, unless the pursuit of the case would likely result in revelation of details not previously known to the public. But FOTM suits do not usually result in a public airing of facts unearthed in discovery, if discovery takes place at all.<sup>112</sup> Nor does a judicial

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<sup>108</sup> The class action bar has been forced to hone the latter skill in the wake of the PSLRA because confidential informants are often necessary in order to meet the statute’s heightened pleading requirements. See Michael J. Kaufman & John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation*, 19 CORNELL J.L. & PUB. POL’Y 637, 666–67 (2010).

<sup>109</sup> See *supra* note 45; see also Amanda M. Rose, *State Enforcement of National Policy: A Contextual Approach (with Evidence from the Securities Realm)*, 97 MINN. L. REV. 1343, 1357 (2013) (observing that “when multiple enforcers are tasked with regulating the same misconduct, competitive instincts may kick in,” thus “overcoming incentives to take the easier path”).

<sup>110</sup> For an examination of the forces that may lead government agencies to deviate from socially optimal enforcement practices, see Rose, *supra* note 44, at 2210–19.

<sup>111</sup> See *supra* note 98.

<sup>112</sup> Such a public airing might occur in the briefing filed in connection with a motion for summary judgment. Michael Klausner, Jason Hegland, and Matthew Goforth conducted an empirical study of 533 securities class actions filed between 2006 and 2010. See Klausner et al., *supra* note 29, at 1. In response to my inquiry, Professor Klausner reported that a motion for summary judgment was filed in only 5.4% of all resolved cases in their sample (29 out of 533). E-mail from Michael Klausner, Professor, Stanford Law School, to author (May 30, 2013, 7:33 PM) (on file with author). Professor Klausner and Jason Hegland conducted a similar study of securities class actions filed between 2000 and 2003. See Michael Klausner & Jason Hegland, *When Are Securities Class Actions Dismissed, When*

decision on a motion to dismiss appear to convey important information to the market.<sup>113</sup> (To the extent FOTM suits are themselves responsible for exposing frauds, they do relieve SEC budgetary pressure, and allowing them to proceed to settlement is necessary in order to produce a fund from which to compensate the lawyers for their efforts—but this merely restates the justification for FOTM class actions discussed in the previous Subsection.)

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To summarize, if FOTM suits help to deter securities fraud, it is because they assist in fraud detection, motivate the SEC to be more aggressive in its enforcement efforts, or both. If FOTM suits are socially worthwhile, it is because the underdeterrence costs they thereby save exceed the additional enforcement costs they produce. Prior to the creation of the WBP, many doubted whether this was the case. As detailed in Part III, the WBP now dramatically tips the scales against the desirability of FOTM suits. But before exploring the program's impact on the FOTM class action debate, it is necessary to understand how the WBP operates, as well as the controversy that has surrounded its implementation. The next Part provides this needed background.

## II. THE SEC'S NEW WHISTLEBLOWER BOUNTY PROGRAM

The Whistleblower Bounty Program (WBP) is a creation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).<sup>114</sup> Section 922 of Dodd-Frank amended the Securities Exchange Act of 1934 to create a new section 21F titled "Securities whistleblower incentives and protection."<sup>115</sup> While the basic contours of the WBP are laid out in the statute, many details were left to the SEC to flesh out in rulemaking.<sup>116</sup> On August 12, 2011, final SEC rules regarding the WBP

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*Do They Settle, and for How Much?—Part II*, 23 PROF. LIAB. UNDERWRITING SOC'Y J., Mar. 2010, at 1. Professor Klausner informed me that a motion for summary judgment was filed in 10.6% of all resolved cases in this sample (73 out of 692). E-mail from Michael Klausner, Professor, Stanford Law School, to author (May 30, 2013, 7:33 PM) (on file with author).

<sup>113</sup> See Stephen P. Ferris & A.C. Pritchard, *Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act* (John M. Olin Ctr. for Law & Econ., Paper No. 01-009, 2001) (available at <http://papers.ssrn.com/abstracts=288216>) (empirical study of securities fraud class actions finding no statistically significant stock price reaction to decisions to dismiss).

<sup>114</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>115</sup> 15 U.S.C. § 78u-6 (2012).

<sup>116</sup> See *id.* §§ 78u-6(j), 78u-7(a).

became effective.<sup>117</sup> Part II.A provides a basic overview of the WBP and briefly discusses new protections it affords whistleblowers against retaliation (those who are already familiar with the program’s details may wish to skip over this section). Part II.B reports on the WBP’s track record to date. Finally, Part II.C evaluates the debate that has raged over its design and likely efficacy.

#### A. *A Primer*

The WBP entitles “whistleblowers”—defined as individuals (not corporations or other entities) who provide the SEC with information about possible securities law violations pursuant to specified procedures<sup>118</sup>—to a bounty award if they meet several criteria. First, a whistleblower must have provided information to the SEC “voluntarily.”<sup>119</sup> Second, that information must have been “original.”<sup>120</sup> Third, the information must have “led to” a successful SEC enforcement action resulting in more than \$1 million in monetary sanctions (a so-called covered action).<sup>121</sup> Finally, the whistleblower must not otherwise be ineligible for an award.<sup>122</sup> If these criteria are met, the whistleblower is entitled to share in a bounty award of between 10% and 30% of the sanctions collected in the covered action and in certain “related actions,” if procedural requirements for claiming an award are followed.<sup>123</sup>

*1. Voluntariness.*—The voluntariness requirement encourages whistleblowers to come forward with information early. To be considered “voluntary,” a whistleblower’s submission must be made before the SEC requests information related to the subject matter of the submission directly from the whistleblower or the whistleblower’s representative.<sup>124</sup> It must also be made before any similar request by the Public Company Accounting Oversight Board (PCAOB), any self-regulatory organization (SRO), another authority of the federal government, or a state Attorney General or securities regulator.<sup>125</sup> The mere fact that a whistleblower’s employer received a request from one of these authorities related to the

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<sup>117</sup> See Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300, 34,300 (June 13, 2011) (to be codified at 17 C.F.R. pts. 240, 249) [hereinafter WBP Release].

<sup>118</sup> 17 C.F.R. § 240.21F-2(a)(1) (2013).

<sup>119</sup> See *infra* Part II.A.1.

<sup>120</sup> See *infra* Part II.A.2.

<sup>121</sup> See *infra* Part II.A.3.

<sup>122</sup> See *infra* Part II.A.4.

<sup>123</sup> See *infra* Part II.A.5.

<sup>124</sup> 17 C.F.R. § 240.21F-4(a)(1)–(2) (2013).

<sup>125</sup> *Id.*

whistleblower's subsequent submission does not, however, render the submission involuntary,<sup>126</sup> nor does a whistleblower's receipt of a request for information from his or her employer in connection with an internal investigation.<sup>127</sup> To be disqualifying, the request must come from one of these authorities, and must be made to the whistleblower or his or her representative (such as an attorney), *directly*.<sup>128</sup>

The voluntariness requirement also serves to direct whistleblower awards to individuals who, in the absence of the WBP, might not come forward at all. Under the rules, submissions are deemed involuntary if the whistleblower was already required to report the information to the SEC as a result of (1) a preexisting legal duty, (2) a duty arising out of a judicial or administrative order, or (3) a contractual duty owed to the SEC, PCAOB, any SRO, another authority of the federal government, or a state Attorney General or securities regulator.<sup>129</sup> If a contractual duty to report to the SEC is merely owed to the whistleblower's employer, it will not render the submission involuntary; the SEC is of the view that "employers should not be able to preclude their employees from whistleblower eligibility by generally requiring all employees to enter into agreements that they will report evidence of securities violations" to the SEC.<sup>130</sup>

2. *Originality*.—For whistleblowers to be entitled to a bounty, the information they voluntarily provide must be "original."<sup>131</sup> Section 21F defines "original information" as information that is derived from a whistleblower's "independent knowledge or analysis" and "is not known to the [SEC] from any other source, unless the whistleblower is the original source of the information."<sup>132</sup> Further, the information cannot be "exclusively derived from an allegation made in a judicial or administrative

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<sup>126</sup> "For example, an examination request directed to a broker-dealer or an investment adviser would not automatically foreclose whistleblower submissions related to the subject matter of the exam from all employees of the entity." WBP Release, *supra* note 117, at 34,307.

<sup>127</sup> *Id.* at 34,308.

<sup>128</sup> In determining whether a whistleblower's submission "significantly contributed to" a covered action, however, the SEC will "evaluate whether a previous request to the whistleblower's employer obtained substantially the same information, or would have obtained the information but for any action of the whistleblower in not providing the information to his or her employer. In such circumstances, [it] ordinarily would not expect to treat the whistleblower's submission as having 'significantly contributed' to [the covered action]." *Id.* at 34,309; *see infra* Part II.A.3 (discussing the "led to" requirement).

<sup>129</sup> 17 C.F.R. § 240.21F-4(a)(3).

<sup>130</sup> WBP Release, *supra* note 117, at 34,309.

<sup>131</sup> 17 C.F.R. § 240.21F-3(a).

<sup>132</sup> 15 U.S.C. § 78u-6(a)(3) (2012).

hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.”<sup>133</sup>

“Independent knowledge” is defined by SEC rule as factual information in a whistleblower’s possession that is not derived from “publicly available sources.”<sup>134</sup> It is not limited to direct, first-hand knowledge of law violations, but includes knowledge gained through a whistleblower’s “experiences, communications and observations in . . . business or social interactions.”<sup>135</sup> The term “independent analysis” is defined to mean a whistleblower’s “examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public . . . whether done alone or in combination with others.”<sup>136</sup> “[T]here are circumstances,” the SEC has explained, in which “individuals can review publicly available information, and, through their additional evaluation and analysis, provide vital assistance to the [SEC] staff in understanding complex schemes and identifying securities violations.”<sup>137</sup>

In addition to being derived from independent knowledge or analysis, to be “original” the information must not already be known to the SEC from any other source, “unless the whistleblower is the original source of the information.”<sup>138</sup> A whistleblower will be deemed the “original source” of information the SEC first obtained from another source if the other source obtained the information from the whistleblower or the whistleblower’s representative.<sup>139</sup> To be considered the original source of information the SEC first obtains from another governmental authority or SRO, the whistleblower must have “voluntarily” provided the information to such authorities as that term is defined above.<sup>140</sup>

The following hypothetical may help to illustrate how the originality requirement operates. Assume that Sally tells her coworker Frank about possible securities law violations she discovered taking place at their employer, Alpha Corporation. The suspected violations are not publicly known, and the SEC is unaware of them. Frank in turn reports the information he learned from Sally to the SEC. After receiving Frank’s tip, the SEC commences an investigation. On these facts, Frank’s submission

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<sup>133</sup> Id.

<sup>134</sup> 17 C.F.R. § 240.21F-4(b)(2).

<sup>135</sup> Id.

<sup>136</sup> Id. § 240.21F-4(b)(3).

<sup>137</sup> WBP Release, *supra* note 117, at 34,312.

<sup>138</sup> 15 U.S.C. § 78u-6(a)(3).

<sup>139</sup> 17 C.F.R. § 240.21F-4(b)(5).

<sup>140</sup> Id.

counts as “original information” because it is based on his “independent knowledge” (a concept that, as noted above, includes second-hand information received from non-public sources) and was not previously known by the SEC. If Sally reports the same information to the SEC after Frank, her submission will also count as “original information” because it is likewise based on “independent knowledge” and, although Frank already made the SEC aware of the information, Sally is the “original source” of Frank’s submission. Thus, both Frank and Sally will potentially be entitled to share in a bounty award if an enforcement action is brought against Alpha Corporation resulting in more than \$1 million in monetary sanctions. This is not to say, however, that Frank and Sally will be treated identically. Frank and Sally will be treated differently by virtue of the *timing* of their respective submissions. By reporting first, Frank will have an easier time than Sally in establishing that his tip “led to” a covered action, a concept discussed below. And if Frank’s tip prompted the SEC to question Sally before she made her submission, Sally will be unable to meet the voluntariness requirement discussed above. Assuming both Frank and Sally succeed in establishing their eligibility, the timing of their submissions may also impact the size of their respective awards.<sup>141</sup>

3. *Leading to Success.*—A whistleblower’s submission must “lead[] to” a successful SEC judicial or administrative action that results in monetary sanctions (including penalties, disgorgement, and interest<sup>142</sup>) of more than \$1 million—a so-called covered action.<sup>143</sup> In determining whether a covered action exists, the SEC may aggregate the monetary sanctions in two or more separately captioned SEC actions, if the proceedings arise from the “same nucleus of operative facts.”<sup>144</sup> Whether a whistleblower’s submission of original information “led to” a successful covered action depends on if the original information submitted concerned conduct already actively under investigation, by either the SEC or certain other authorities. If an investigation was already underway, the whistleblower’s submission must have “significantly contributed to the success” of the covered action.<sup>145</sup> If no investigation had begun, the

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<sup>141</sup> See *infra* Part II.A.5.

<sup>142</sup> 15 U.S.C. § 78u-6(a)(4).

<sup>143</sup> *Id.* § 78u-6(a)(1); 17 C.F.R. § 240.21F-3(a)(3)–(4).

<sup>144</sup> 17 C.F.R. § 240.21F-4(d)(1).

<sup>145</sup> *Id.* § 240.21F-4(c)(2). The SEC has indicated that in applying this standard, it will look at factors “such as whether the information allowed [it] to bring: (1) [a] successful action in significantly less time or with significantly fewer resources; (2) additional successful claims; or (3) successful claims against additional individuals or entities.” WBP Release, *supra* note 117, at 34,325. The SEC has also noted that, absent extraordinary circumstances, it will not consider information to have “significantly contributed” to the success of a covered action if “(i) [the SEC] or some other law enforcement agency

original information submitted need only have been “sufficiently specific, credible, and timely” to cause the SEC to commence an examination, open (or reopen) an investigation, or “to inquire concerning different conduct as part of a current examination or investigation,” and the SEC must have brought a covered action “based in whole or in part on conduct that was the subject of [the] original information.”<sup>146</sup> Thus, in the hypothetical posed above, the SEC would judge Frank’s submission under the easier “sufficiently specific, credible, and timely” test because it was received before an investigation concerning the alleged misconduct was underway. Sally’s tip, by contrast, would have to meet the tougher “significant contribution” test.

This would not be the case, however, if Frank were part of Alpha Corporation’s internal compliance department, and Sally reported the same information to the SEC within 120 days of reporting it to Frank. SEC rules provide that if a whistleblower provides information through “an entity’s internal whistleblower, legal, or compliance procedures,” or to PCAOB, any SRO, another authority of the federal government, or a state Attorney General or securities regulator, and within 120 days the whistleblower submits the same information to the SEC, the SEC will treat the whistleblower as having submitted the information to the SEC “as of the date of [the] original disclosure, report or submission to one of these other authorities or persons.”<sup>147</sup> In this revised hypothetical, Sally would therefore have an easier time establishing that her tip “led to” a covered action because it would be treated as having been made prior to the commencement of the SEC’s investigation, thus subject to evaluation under the easier “sufficiently specific, credible, and timely” test. Frank, as a compliance officer, would likely be rendered ineligible for an award, as discussed *infra* in Part II.A.4.

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has issued a subpoena or other document request, inquiry or demand to an entity or an individual other than the whistleblower; (ii) there is evidence that the whistleblower was aware of the investigative request, inquiry or demand; and (iii) the whistleblower withheld or delayed providing responsive documents prior to making the related submission to the Commission.” *Id.*

<sup>146</sup> 17 C.F.R. § 240.21F-4(c)(1). The SEC has indicated that its inquiry will “focus on whether the submission identifies persons, entities, places, times and/or conduct that correspond to those alleged” by the SEC in the covered action, and that it may consider “whether, and the extent to which, the information included: (1) Allegations that formed the basis for any of the [SEC’s] claims in the covered action; (2) provisions of the securities laws that the [SEC] alleged as having been violated in the [covered] action; (3) culpable persons or entities (as well as offices, divisions, subsidiaries or other subparts of entities) that the [SEC] named as defendants, respondents or uncharged wrongdoers in the [covered] action; or (4) investors or a defined group of investors that the [SEC] named as victims or injured parties in the [covered] action.” WBP Release, *supra* note 117, at 34,324.

<sup>147</sup> 17 C.F.R. § 240.21F-4(b)(7).

This special rule is meant to mitigate the possibility that the WBP will discourage employees from reporting internally before going to the SEC for fear of losing their entitlement to a bounty and thus undermine the effectiveness of internal compliance programs.<sup>148</sup> The SEC also sought to encourage internal reporting by adopting a rule that, in certain situations, credits a whistleblower with information uncovered by an internal probe. Specifically, a whistleblower who reports information internally at the same time or up to 120 days before the whistleblower reports the same information to the SEC will be credited with any information the entity later submits to the SEC that was discovered in the course of an internal audit or investigation initiated as a result of the whistleblower's report.<sup>149</sup> In the revised hypothetical, for example, it could be that the information that Sally provided to Frank, and later to the SEC, was not itself sufficiently "specific" and "credible" to cause the SEC to open an investigation. But if her disclosure to Frank prompted an internal investigation that uncovered additional information about securities law violations, and Alpha Corporation reported that information to the SEC, Sally might nevertheless be able to claim a bounty. She would be given credit by the SEC for all of the information submitted by Alpha Corporation and in this way potentially satisfy the "leading to success" requirement.

4. *Ineligible Whistleblowers.*—A variety of whistleblowers are ineligible for a bounty award even if they satisfy these criteria. Ineligible whistleblowers include employees of certain governmental agencies and self-regulatory organizations,<sup>150</sup> persons who fail to submit their information in the form and manner specified by the SEC, and those who fail to comply with SEC requests related to their submission.<sup>151</sup> Whistleblowers are also ineligible if they knowingly provide false or misleading information to the SEC with intent to hinder or mislead,<sup>152</sup> or obtain their information "by a means or in a manner that is determined by a United States court to violate applicable Federal or state criminal law."<sup>153</sup> A whistleblower's culpability for the misconduct at issue in the SEC action or related action for which an award is sought does not result in ineligibility

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<sup>148</sup> WBP Release, *supra* note 117, at 34,322–23.

<sup>149</sup> 17 C.F.R. § 240.21F-4(c)(3).

<sup>150</sup> *Id.* § 240.21F-8(c)(1)–(2). Spouses, parents, children, siblings, and household members of SEC employees are also excluded from eligibility. *Id.* § 240.21F-8(c)(5).

<sup>151</sup> *Id.* § 240.21F-8(a)–(c).

<sup>152</sup> *Id.* § 240.21F-8(c)(7).

<sup>153</sup> *Id.* § 240.21F-4(b)(4)(iv). Technically, information obtained in this manner is excluded from the definition of "original information."

unless the whistleblower is convicted of a related criminal violation.<sup>154</sup> But when considering a culpable whistleblower's application for a bounty, any monetary sanctions he or she has been ordered to pay, or which an entity whose liability is based substantially on his or her conduct is ordered to pay, will be excluded in the SEC's determination of whether the \$1 million threshold for a "covered action" has been met, and such sums "will not be included within the calculation of the amounts collected for purposes of making [bounty] payments."<sup>155</sup> Further, as discussed in Part II.A.5, culpability is a factor that may cause the SEC to decrease the percentage of collected sanctions awarded to a whistleblower.

Whistleblowers are also excluded from eligibility if they obtained their information "through a communication that was subject to the attorney-client privilege" or "in connection with the legal representation of a client on whose behalf [the whistleblower or his or her] employer or firm are providing services."<sup>156</sup> There is an exception, however, if disclosure of the information would otherwise be permitted by 17 C.F.R. § 205.3(d)(2) or the applicable state attorney conduct rules.<sup>157</sup> This exclusion is designed to prevent the WBP from interfering with the attorney-client relationship by encouraging attorneys to breach confidences for personal financial reward, except in those situations where the law already countenances disclosure.

The WBP also seeks to avoid "creating incentives for independent public accountants to [personally] benefit by 'front running' the firm's proper handling of information obtained through engagements required under the Federal securities laws."<sup>158</sup> Thus, whistleblowers who obtained their information in connection with an audit of a company's financial statements are ineligible if disclosing the information to the SEC was contrary to requirements of Section 10A of the Securities Exchange Act of

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<sup>154</sup> Id. § 240.21F-8(c)(3).

<sup>155</sup> Id. § 240.21F-16.

<sup>156</sup> Id. § 240.21F-4(b)(4)(i)-(ii). Technically, information obtained in this manner is excluded from the definition of "original information." See also WBP Release, *supra* note 117, at 34,314-15.

<sup>157</sup> WBP Release, *supra* note 117, at 34,314. Section 205.3(d)(2) allows an attorney appearing and practicing before the SEC in the representation of an issuer to reveal client confidences without the issuer's consent if necessary "[t]o prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors," to prevent the issuer from committing perjury in an SEC investigation or otherwise perpetrating a fraud on the SEC, and to "rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used." 17 C.F.R. § 205.3(d)(2). See generally Barry R. Temkin & Ben Moskovits, *Lawyers as Whistleblowers Under the Dodd-Frank Wall Street Reform Act: Ethical Conflicts Under the Rules of Professional Conduct and SEC Rules*, 84 N.Y. ST. B.A. J., July-Aug. 2012, at 10.

<sup>158</sup> WBP Release, *supra* note 117, at 34,318.

1934.<sup>159</sup> Whistleblowers are also ineligible if they are associated with a public accounting firm and obtained their information through the performance of an engagement (other than an audit) required of an independent public accountant under the federal securities laws, and the information relates to a violation by the engagement client or the client's directors, officers, or other employees.<sup>160</sup>

The exclusion for whistleblowers who obtained their information in the course of an accounting engagement required under the federal securities laws is subject to an important exception. Such a whistleblower *may* claim a bounty if he or she has "a reasonable basis to believe that disclosure of the information to the [SEC] is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors," has "a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct," or "[a]t least 120 days have elapsed since [the whistleblower] provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or [the whistleblower's] supervisor."<sup>161</sup>

Subject to the same important exception, whistleblowers are ineligible if they obtain their information because: (1) they serve as an "officer, director, trustee, or partner of an entity and another person informed [them] of allegations of misconduct, or [they] learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law";<sup>162</sup> (2) they are an "employee whose

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<sup>159</sup> 15 U.S.C. § 78u-6(c)(2)(C) (2012); 17 C.F.R. § 240.21F-8(c)(4). Section 10A details the steps that a registered public accounting firm must take if, in the course of an audit of an issuer, it becomes aware of information indicating that an illegal act may have occurred at the issuer. *See* 15 U.S.C. § 78j-1(b). These steps begin with internal reporting through the client's corporate hierarchy, and end with disclosure to the SEC only if the issuer has not responded appropriately. *See id.* Whistleblowers who acquire information from a person who would be ineligible for this reason are likewise ineligible unless they are providing the SEC "with information about possible violations involving that person." 17 C.F.R. § 240.21F-8(c)(6)(i).

<sup>160</sup> Technically, information obtained in this manner is excluded from the definition of "original information." 17 C.F.R. § 240.21F-4(b)(4)(iii)(D). The SEC has made clear that "[p]ersons working on other engagements, to the extent that they are not covered by Section 10A or are not required under the Federal securities laws, will not be deemed ineligible simply because the engagement is with an audit client of the firm." WBP Release, *supra* note 117, at 34,336. Moreover, tips about violations of Section 10A are not contrary to the requirements of Section 10A; thus, an employee of a public accountancy firm who reports on his or her employer's failure to comply with Section 10A would be "eligible for an award based on a covered action against the public accountant or the issuer." *Id.* at 34,336 n.315.

<sup>161</sup> 17 C.F.R. § 240.21F-4(b)(4)(v). If the whistleblower received the information under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's supervisor was already aware of the information, 120 days must have elapsed from the date the whistleblower received the information. *Id.*

<sup>162</sup> *Id.* § 240.21F-4(b)(4)(iii)(A).

principal duties involve compliance or internal audit responsibilities, or [they] were employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity”;<sup>163</sup> or (3) they are employed “by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law.”<sup>164</sup> These exclusions are designed to ensure “that the persons most responsible for an entity’s conduct and compliance with law are not incentivized to promote their own self-interest at the possible expense of the entity’s ability to detect, address, and self-report violations.”<sup>165</sup>

5. *Criteria for Determining the Bounty Award.*—If one or more whistleblowers meet the above criteria and follow the required procedures for making a claim (discussed below), the SEC must award them, in the aggregate, at least 10% but not more than 30% of the monetary sanctions collected in the covered action.<sup>166</sup> Within this range, the amount awarded is in the sole discretion of the SEC.<sup>167</sup> The SEC must also pay eligible whistleblowers amounts equal to 10%–30% of the monetary sanctions collected in certain “related actions”<sup>168</sup> if specified claims procedures are followed.<sup>169</sup> An action is “related” if it is based upon the same original information that led to the covered action, and is brought by the Attorney General of the United States, an “appropriate regulatory agency,”<sup>170</sup> an SRO, or a state Attorney General in a criminal case.<sup>171</sup> To give an award based on a related action, the SEC must determine that the original information the whistleblower gave to the SEC “also led to the successful enforcement of the related action under the same criteria” used to evaluate awards for covered actions.<sup>172</sup>

In exercising its discretion to determine the appropriate award, and, if there are multiple eligible claimants, their respective portions, the SEC will

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<sup>163</sup> *Id.* § 240.21F-4(b)(4)(iii)(B).

<sup>164</sup> *Id.* § 240.21F-4(b)(4)(iii)(C). Technically, information obtained in any of these three manners is excluded from the definition of “original information.”

<sup>165</sup> WBP Release, *supra* note 117, at 34,314.

<sup>166</sup> 15 U.S.C. § 78u-6(b)(1) (2012).

<sup>167</sup> *Id.* § 78u-6(c)(1)(A); 17 C.F.R. § 240.21F-5(a).

<sup>168</sup> See 15 U.S.C. § 78u-6(b)(1); 17 C.F.R. § 240.21F-3(b).

<sup>169</sup> See 17 C.F.R. § 240.21F-11 (detailing these procedures).

<sup>170</sup> “Appropriate regulatory agency means the [SEC], the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and any other agencies that may be defined as appropriate regulatory agencies under Section 3(a)(34) of the Exchange Act (15 U.S.C. § 78c(a)(34)).” 17 C.F.R. § 240.21F-4(f).

<sup>171</sup> 15 U.S.C. § 78u-6(a)(5); 17 C.F.R. § 240.21F-3(b)(1).

<sup>172</sup> 17 C.F.R. § 240.21F-3(b)(2).

consider several factors.<sup>173</sup> In deciding whether to increase the amount of a whistleblower's award, the SEC will consider (1) the significance of the information provided to the success of the covered action or related action,<sup>174</sup> (2) "the degree of assistance provided by the whistleblower,"<sup>175</sup> (3) the SEC's "programmatic interest . . . in deterring violations of the securities laws,"<sup>176</sup> and (4) the extent to which the whistleblower participated in internal compliance systems.<sup>177</sup> In deciding whether to decrease the amount of a whistleblower's award, the SEC will consider (1) the "culpability or involvement of the whistleblower in matters associated" with the covered action or related action;<sup>178</sup> (2) whether the whistleblower unreasonably delayed in reporting the suspected securities violations;<sup>179</sup> and (3) "in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system."<sup>180</sup> These factors are merely guidelines, not a rigid formula—"the determination of the appropriate percentage of a whistleblower award will involve a highly individualized review of the facts and circumstances surrounding each award."<sup>181</sup>

6. *Claims Process.*—Dodd–Frank mandated the creation of a new "Office of the Whistleblower" (OWB) within the SEC's Division of Enforcement, and charged it with administering the WBP.<sup>182</sup> According to the SEC's fiscal year 2013 annual report on the WBP program, OWB is currently staffed by a chief, deputy chief, nine attorneys, and three paralegals.<sup>183</sup> Among other things, the OWB maintains a website that provides information about the WBP as well as links to the forms required to submit a tip (Form TCR) and apply for a bounty payment (Form WB-APP). The OWB ensures that any Form TCR it receives by mail or fax is inputted into the SEC's "Tips, Complaints, and Referrals System" (the

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<sup>173</sup> If the SEC makes awards to multiple claimants, it "will determine an individual percentage award for each whistleblower, but in no event will the total amount awarded to all whistleblowers in the aggregate be less than 10 percent or greater than 30 percent of the amount" collected. 17 C.F.R. § 240.21F-5(c).

<sup>174</sup> 15 U.S.C. § 78u-6(c)(1)(B)(i)(I); *see also* 17 C.F.R. § 240.21F-6(a)(1).

<sup>175</sup> 15 U.S.C. § 78u-6(c)(1)(B)(i)(II); *see also* 17 C.F.R. § 240.21F-6(a)(2).

<sup>176</sup> 15 U.S.C. § 78u-6(c)(1)(B)(i)(III); *see also* 17 C.F.R. § 240.21F-6(a)(3).

<sup>177</sup> 17 C.F.R. § 240.21F-6(a)(4).

<sup>178</sup> *Id.* § 240.21F-6(b)(1).

<sup>179</sup> *Id.* § 240.21F-6(b)(2).

<sup>180</sup> *Id.* § 240.21F-6(b)(3).

<sup>181</sup> WBP Release, *supra* note 117, at 34,331.

<sup>182</sup> See 15 U.S.C. § 78u-7(d) (2012).

<sup>183</sup> SEC 2013 Annual Report to Congress on the Dodd–Frank Whistleblower Program 5 [hereinafter WBP 2013 Report].

TCR System), a new centralized database for the “prioritization, assignment, and tracking of TCRs received from the public.”<sup>184</sup> Whistleblowers also have the option to input their tip directly into the TCR System via an online version of Form TCR.

Once in the TCR system, a whistleblower’s tip is “triaged” by the Enforcement Division’s Office of Market Intelligence (OMI), a newly created office staffed with “a team of more than [forty] former traders, exchange experts, accountants and securities lawyers,” as well as an agent on loan from the FBI.<sup>185</sup> OMI evaluates each tip and assigns those identified as “sufficiently specific, timely, and credible to warrant the further allocation of [SEC] resources” to appropriate enforcement staff.<sup>186</sup> As the SEC’s investigation proceeds, the OWB serves as a liaison between the whistleblower (or his or her lawyer) and enforcement staff; it also works with enforcement staff to track enforcement cases involving whistleblowers “to assist in the documentation of the whistleblower’s information and cooperation in anticipation of an eventual claim for award.”<sup>187</sup>

After a final judgment is entered in a covered action, the OWB posts on its website a “Notice of Covered Action.”<sup>188</sup> Whistleblowers then have ninety days to file a claim for an award based on that covered action.<sup>189</sup> After the time for filing an appeal of the covered action has expired, or, if an appeal has been filed, after the appeal has been concluded, the SEC will evaluate any whistleblower claims that have been timely filed in connection with the action.<sup>190</sup> It will determine whether any of the claimants meet the criteria for a bounty and, if so, the appropriate percentage of collected sanctions to

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<sup>184</sup> SEC Annual Report on the Dodd–Frank Whistleblower Program Fiscal Year 2012, at 4 [hereinafter WBP 2012 Report]. For more information on the TCR System and OMI, see Bruce Carton, *Details Emerge on SEC Office of Market Intelligence*, Securities Docket (Feb. 9, 2010, 7:24 PM) <http://www.securitiesdocket.com/2010/02/09/details-emerge-on-sec-office-of-market-intelligence/>; Sarah N. Lynch & Matthew Goldstein, *Exclusive: SEC Builds New Tips Machine to Catch the Next Madoff*, Reuters, July 27, 2011, <http://www.reuters.com/article/2011/07/27/us-sec-investigations-idUSTRE76Q2NY20110727>; and Ben Protess & Azem Ahmed, *With New Firepower, SEC Tracks Bigger Game*, N.Y. Times DealBook (May 21, 2012, 9:17 PM), <http://dealbook.nytimes.com/2012/05/21/with-new-firepower-s-e-c-tracks-bigger-game>.

<sup>185</sup> Protess & Ahmed, *supra* note 184.

<sup>186</sup> WBP 2012 Report, *supra* note 184, at 5. “When appropriate, tips that fall within the jurisdiction of another federal or state agency are forwarded to the [SEC] contact at that agency.” *Id.*

<sup>187</sup> *Id.* at 3.

<sup>188</sup> 17 C.F.R. § 240.21F-10(a) (2013).

<sup>189</sup> *Id.*

<sup>190</sup> *Id.* § 240.21F-10(d).

award them as a bounty.<sup>191</sup> A whistleblower can appeal the SEC's final decision denying his or her entitlement to an award, but an SEC decision regarding the amount of an award (including the allocation of an award between multiple whistleblowers) is not appealable as long as the award falls within the required 10%–30% range.<sup>192</sup>

7. *Protection Against Retaliation.*—Even the lure of a substantial bounty payment may not be enough to compel individuals to become whistleblowers if they fear retaliation at work. Congress thus sought to encourage participation in the WBP by prohibiting employers from discriminating against whistleblowers in the terms and conditions of employment because they have provided information to the SEC or have assisted the SEC in an investigation or prosecution related to that information.<sup>193</sup> This provision is enforceable in an action or proceeding brought by the SEC.<sup>194</sup> Moreover, a whistleblower who believes his or her employer has violated this provision may sue for reinstatement, double back pay owed, and fees and costs.<sup>195</sup> Unlike Sarbanes–Oxley's antiretaliation provision, which requires claims be brought through the Department of Labor,<sup>196</sup> the WBP's antiretaliation provision allows whistleblowers to sue directly in federal court.<sup>197</sup> It also affords plaintiffs a more generous statute of limitations.<sup>198</sup> To be entitled to this protection, whistleblowers need not qualify for a bounty award; it is sufficient that they possessed a “reasonable belief” that the information they provided to the SEC related to a “possible” securities law violation.<sup>199</sup>

The WBP also seeks to protect whistleblowers by requiring the SEC to keep a whistleblower's identity confidential until it must be disclosed to a

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<sup>191</sup> This involves multiple layers of review. See WBP 2012 Report, *supra* note 184, at 7; SEC OFFICE OF THE INSPECTOR GEN., EVALUATION OF THE SEC'S WHISTLEBLOWER PROGRAM, REP. NO. 511, at 5 (2013) [hereinafter OIG Report].

<sup>192</sup> 17 C.F.R. § 240.21F-13(a).

<sup>193</sup> The retaliation provision also protects individuals who have made disclosures that are required or protected under Sarbanes–Oxley or a variety of other laws. See 15 U.S.C. § 78u-6(h)(1)(A) (2012).

<sup>194</sup> 17 C.F.R. § 240.21F-2(b)(2).

<sup>195</sup> 15 U.S.C. § 78u-6(h)(1)(C).

<sup>196</sup> See OSHA Fact Sheet: Filing Whistleblower Complaints Under the Sarbanes–Oxley Act, U.S. DEPARTMENT OF LABOR OCCUPATIONAL SAFETY AND HEALTH ADMINISTRATION (Dec. 2011), <http://www.osha.gov/Publications/osha-factsheet-sox-act.pdf>.

<sup>197</sup> 15 U.S.C. § 78u-6(h)(1)(B)(i).

<sup>198</sup> *Id.* § 78u-6(h)(1)(B)(iii). For a discussion of the problems with Sarbanes–Oxley's antiretaliation provision, see Terry Morehead Dworkin, *SOX and Whistleblowing*, 105 MICH. L. REV. 1757, 1764–67 (2007). For a discussion of how the WBP's antiretaliation provision seeks to avoid these problems, see Rachel Beller, *Whistleblower Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance? A Study of the Successes and Failures of the Whistleblower Protection Legislation in the US and China*, 7 N.Y.U. J.L. & BUS. 873, 914–15 (2011).

<sup>199</sup> 17 C.F.R. § 240.21F-2(b).

defendant in a public proceeding, or until the SEC deems it necessary to share it with certain other authorities (in which case those authorities must keep it confidential).<sup>200</sup> A whistleblower also has the option of remaining anonymous up to the point of receiving a bounty, at which time the whistleblower's identity must be disclosed to the SEC.<sup>201</sup> Anonymous Form TCRs must be submitted through an attorney, however, and the whistleblower must provide that attorney with a declaration under penalty of perjury that the information on the form is true and correct.<sup>202</sup> (Nonanonymous whistleblowers must make such a declaration directly on their Form TCRs.<sup>203</sup>) Finally, the WBP makes it unlawful to take actions to impede an individual from becoming a whistleblower, including by threatening to enforce a confidentiality agreement (except agreements related to legal representation).<sup>204</sup>

### *B. Track Record to Date*

While the WBP remains in its infancy, some preliminary data shed light on its operations thus far. The SEC is required to file an annual report with Congress reporting on the WBP and the current state of the Investor Protection Fund (IPF), the account from which bounties are paid.<sup>205</sup> In addition, the OWB must report annually to Congress “on its activities, whistleblower complaints, and the response of the [SEC] to such complaints.”<sup>206</sup> In November 2013, the SEC filed a consolidated report covering the second full fiscal year of the WBP and OWB's operations.<sup>207</sup>

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<sup>200</sup> 15 U.S.C. § 78u-6(h)(2); 17 C.F.R. § 240.21F-7.

<sup>201</sup> See 17 C.F.R. §§ 240.21F-7(b), .21F-9(c), .21F-10(c).

<sup>202</sup> See 15 U.S.C. § 78u-6(d)(2); 17 C.F.R. §§ 240.21F-7(b)(1), .21F-9(c).

<sup>203</sup> 17 C.F.R. § 240.21F-9(b).

<sup>204</sup> *Id.* § 240.21F-17(a).

<sup>205</sup> See 15 U.S.C. § 78u-6(g)(5). Dodd–Frank mandates that bounty payments be made out of the newly created IPF, which is also to be used for funding the SEC Inspector General's suggestion program. *Id.* § 78u-6(g)(2); WBP 2012 Report, *supra* note 184, at 9 n.17. The IPF has three funding sources. First, any monetary sanctions collected by the SEC that are not paid into a fund for victims under section 308 of the Sarbanes–Oxley Act or otherwise distributed to victims must be deposited into the IPF, unless the IPF's balance exceeds \$300 million at the time the sanction is collected. 15 U.S.C. § 78u-6(g)(3)(A)(i). Second, any money in a section 308 fund that is not distributed to victims must be transferred to the IPF unless the IPF's balance exceeds \$200 million. *Id.* § 78u-6(g)(3)(A)(ii). Third, if there is not enough money in the IPF to pay a bounty award, the monetary sanction collected in the covered action on which the award is based shall be deposited into the IPF to cover the shortfall. *Id.* § 78u-6(g)(3)(B). The IPF may also keep any income from investments made with its funds. *Id.* § 78u-6(g)(3)(A)(iii); see also *id.* § 78u-6(g)(4) (detailing the investments that may be made with IPF funds).

<sup>206</sup> 15 U.S.C. § 78u-7(d).

<sup>207</sup> See WBP 2013 Report, *supra* note 183.

According to that report, the IPF is fully funded, with a balance of over \$439 million as of the close of the 2013 fiscal year.<sup>208</sup> The report also indicates that over the course of the 2013 fiscal year, the OWB returned over 2810 phone calls to its whistleblower hotline,<sup>209</sup> received 3238 whistleblower tips (as compared to 3001 in fiscal year 2012),<sup>210</sup> posted 118 Notices of Covered Action,<sup>211</sup> and oversaw the award of four whistleblower bounties—including one for over \$14 million.<sup>212</sup> The number of bounties awarded in fiscal year 2013 is double the number awarded in fiscal year 2012<sup>213</sup> and is likely to grow further in fiscal year 2014, as more cases complete what can be a long progression from initial receipt of a TCR to an actual award determination. “The most common complaint categories reported by whistleblowers . . . were Corporate Disclosures and Financials (17[.2%]), Offering Fraud (17[.1%]), and Manipulation (16[.2%]).”<sup>214</sup> The tips came from individuals located in all fifty states and many foreign countries.<sup>215</sup> Officials have indicated that two to three of the daily tips coming to OMI through the WBP tend to be “high quality,” often coming from “competitors or high-level industry executives or managers that are knowledgeable about how securities markets work.”<sup>216</sup> According to the OWB’s chief, tips have also come in from employees, former employees, spouses, ex-spouses, in-house attorneys, compliance officers, and one former CEO, among others.<sup>217</sup>

Other recent data on the WBP comes from the SEC’s Office of the Inspector General (OIG), in a report the OIG submitted to Congress in January 2013.<sup>218</sup> That report discusses the results of the OIG’s congressionally mandated performance audit of the WBP.<sup>219</sup> As part of that audit, the OIG conducted a statistical sampling of whistleblower TCRs

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<sup>208</sup> *Id.* at 16.

<sup>209</sup> *Id.* at 5.

<sup>210</sup> *Id.* at 8.

<sup>211</sup> *Id.* at 13. According to the report, OWB has posted 431 notices of covered action since the program’s inception. *Id.*

<sup>212</sup> *Id.* at 14–15. Few details were provided about the cases which resulted in bounty awards, in an effort to preserve the anonymity of the whistleblower involved.

<sup>213</sup> *Id.* at 14.

<sup>214</sup> *Id.* at 8.

<sup>215</sup> *Id.* at 9–10.

<sup>216</sup> Tom Steinert-Threlkeld, *SEC Whistleblower Tip Rate: 7 A Day*, ON WALL STREET (May 23, 2012), <http://www.onwallstreet.com/news/sec-whistleblower-sporkin-2679022-1.html>.

<sup>217</sup> *SEC Actively Tracking Corporate Conduct that Might Constitute Informant Retaliation*, [2012] Sec. L. Daily (BNA) 12, at 13 (Oct. 11, 2012).

<sup>218</sup> See OIG Report, *supra* note 191.

<sup>219</sup> See Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1848–49 (2010).

submitted between April 12, 2011 and September 30, 2012.<sup>220</sup> Based on that sampling, it found: on average, OMI conducted initial TCR reviews within one day of receipt; 69% of TCRs received were deemed to require “no further action”;<sup>221</sup> and TCRs that were deemed to require further action were assigned to relevant enforcement personnel within ten days of receipt, on average.<sup>222</sup> The OIG concluded that the “SEC generally is prompt in responding to information that is provided by whistleblowers, applications for whistleblower awards, and in communicating with interested parties,” but recommended that its internal controls be strengthened through the adoption of performance metrics.<sup>223</sup> The OIG also found that the WBP is “clearly defined and user-friendly for users that have basic securities laws, rules, and regulations knowledge,” and has been well publicized by the OWB.<sup>224</sup>

### *C. Evaluating the Program’s Promise: Insular View*

The WBP marks an important sea change in the SEC’s relationship with private informants. Prior to its creation, the only experience the SEC had paying for tips was a little-used, and totally discretionary, insider trading bounty program.<sup>225</sup> With change comes controversy, and the WBP certainly has had its share of detractors. This Section attempts to structure the current debate over the potential efficacy of the WBP. While that debate has ignored the WBP’s impact on the desirability of FOTM class actions—the main focus of this Article—it is an important predicate to my larger argument.

An evaluation of the potential effectiveness of the WBP must begin with a definition of its purpose. One possible definition is “to increase the number of high quality tips” related to securities fraud.<sup>226</sup> But that definition is too narrow, for enhancing the number of high-quality tips is not an end in itself. It is a means to better detect and, in turn, deter securities fraud. And as explained earlier, deterring securities fraud is desirable only insofar as it

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<sup>220</sup> OIG Report, *supra* note 191, at 14.

<sup>221</sup> *Id.* at 16. A TCR may be designated as not requiring further action because it is of low quality, because it relates to a matter already under active investigation by the SEC, or because it is more suitably investigated by another law enforcement agency. *Id.* at 16 n.23.

<sup>222</sup> *Id.* at 16.

<sup>223</sup> *Id.* at v. The SEC has since adopted such metrics. *See* WBP 2013 Report, *supra* note 183, at 17–18.

<sup>224</sup> OIG Report, *supra* note 191, at v.

<sup>225</sup> *See* Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78u (2012).

<sup>226</sup> The WBP technically extends to tips related to any securities law violation, but most of the commentary surrounding the program has focused on its potential to detect fraud, and that is the focus of this Article as well.

operates to enhance overall social welfare—that is, only to the extent that the benefits of increased deterrence exceed the costs of the legal regime.<sup>227</sup> The potential effectiveness of the WBP is discussed below with this broader social cost–benefit calculation in mind.

*1. Social Benefits.*—The WBP will have the laudable effect of deterring securities fraud if it makes it more likely that fraudsters will be caught. A rational corporate manager contemplating fraud would weigh the benefits to him of committing fraud against the expected costs of being caught, discounted by the likelihood of being caught. Thus, if the likelihood of being caught goes up while the expected costs of being caught remain the same, rational corporate officers will find fewer frauds worthwhile. Increasing the likelihood of detection may also galvanize directors and officers to take greater steps to prevent fraud by others within the firm.<sup>228</sup> The WBP will increase the probability of detection if it prompts the submission of tips regarding frauds that would not otherwise have been exposed. Even with respect to frauds that would have come to light absent the WBP, the lure of a bounty might prompt earlier reporting; if so, the program may serve to limit the damage caused by fraud by facilitating quicker intervention to stop it.

It may seem obvious that the WBP would have the effects of encouraging more tips and prompting quicker intervention to stop ongoing frauds, but neither proposition has gone unchallenged. It has been argued, for example, that the WBP may actually discourage reporting—perversely leading to a *lower* probability of fraud detection—by “crowding out” internal motivations to blow the whistle.<sup>229</sup> The assumption underlying the WBP is that the lure of financial reward, as well as the promise of confidentiality and strong retaliation protection, will alter the internal cost-benefit calculation a potential whistleblower engages in when deciding whether to report wrongdoing or remain silent. The costs of blowing the whistle can be significant and include possible workplace retaliation and industry blacklisting; the benefits of reporting include any psychic gratification that may come from exposing the wrongdoing as well as possible avoidance of complicity in that wrongdoing and resultant liability exposure.<sup>230</sup> By

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<sup>227</sup> See *supra* Part I.B.2.a.

<sup>228</sup> See *supra* notes 94–96 and accompanying text.

<sup>229</sup> See, e.g., Dave Ebersole, *Blowing the Whistle on the Dodd–Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 123, 130 n.68 (2011); cf. Diego G. Pardow, *What Should We Expect from the Dodd–Frank Bounty Program?* (July 23, 2012) (unpublished manuscript) (available at <http://ssrn.com/abstract=2115964>) (critically evaluating this claim).

<sup>230</sup> In one whistleblowing study on corporate fraud, 82% of the nonanonymous whistleblowers included in the sample alleged that they were “fired, quit under duress, or had significantly altered responsibilities” as a result of bringing the fraud to light. Dyck et al., *supra* note 104, at 2240. For a

entitling whistleblowers to a sizeable financial reward, protecting their confidentiality, and providing heightened protection against retaliation, the WBP increases the benefits of reporting and decreases the costs—hopefully tipping the scales in favor of reporting.<sup>231</sup> But if the promise of financial reward decreases the psychic benefits of reporting, it is possible that the WBP could have the opposite effect.

While theoretically possible, there is no evidence that the WBP has created such a crowding-out effect or that it will in the future. Financial bounties have successfully increased detection in other regulatory areas,<sup>232</sup> and the uptick in the number of high-quality tips the SEC has received in the wake of the WBP indicates they are working in the securities context as well.<sup>233</sup> Although a recent experimental survey by Professors Yuval Feldman and Orly Lobel supports a limited crowding-out effect attributable to financial rewards for whistleblowing, their results suggest the effect takes hold only in situations where the misconduct being reported does not evoke a high

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comprehensive survey of studies done on whistleblower retaliation, see MARCIA P. MICELI ET AL., WHISTLE-BLOWING IN ORGANIZATIONS 101–30 (2008). See also Marsha J. Ferziger & Daniel G. Currell, *Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs*, 1999 U. ILL. L. REV. 1141, 1172–75 (discussing various losses whistleblowers may suffer through retaliation); 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, 109–18 (considering what factors motivate individuals to either blow the whistle or not come forward, including retaliation).

<sup>231</sup> It has been asserted that “[i]nformants tip only when the discounted gains from doing so exceed the discounted losses,” and a “discounted gain is not the amount an informant could receive in return for his information” but rather “the amount an informant legitimately expects to receive, discounted by the likelihood that the amount will be reduced or not awarded at all.” Ferziger & Currell, *supra* note 231, at 1171 (emphasis omitted). Prior bounty programs that made the payment of bounties entirely discretionary on the part of the administering agency (such as the SEC’s former insider trading bounty program and the pre-1996 version of the IRS’s bounty program) have been widely judged as unsuccessful, perhaps because potential whistleblowers applied a deep discount to such uncertain rewards. Learning from these earlier failures, Congress deliberately chose to make WBP bounties nondiscretionary, and required that they total no less than 10% of collected sanctions in a covered action. Of course, a potential whistleblower in the WBP continues to face uncertainty with respect to: (1) whether a covered action will result from her tip; (2) whether the SEC will deem her to have satisfied the eligibility criteria; (3) the amount of any award within the 10%–30% range; and (4) whether she will have to share that award with other whistleblowers.

<sup>232</sup> See Dyck et al., *supra* note 104, at 2246 (finding that employees revealed fraud in 41% of the cases in the sample from the healthcare industry—a setting where qui tam suits under the False Claims Act are available—but in only 14% of cases in the sample from industries where qui tam suits are not available).

<sup>233</sup> See Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Opening Statement at SEC Open Meeting: Item 2—Whistleblower Program (May 25, 2011) (available at [www.sec.gov/news/speech/2011/spch052511mls-item2.htm](http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm)) (“[T]he quality of the tips we have received has been better since Section 922 became law.”).

level of moral outrage and the promised bounties are small.<sup>234</sup> The bounties promised by the WBP are large, by contrast, and securities fraud—a scienter-based offense—should evoke significant moral outrage. In any event, experimental surveys may not reliably predict how individuals would respond to incentives in real world situations.<sup>235</sup> Intuition and experience tells us that large financial rewards work.

A more serious concern, voiced by many, is that the WBP will have the effect of allowing frauds to persist longer than they otherwise would, thus perversely increasing the social costs of fraud. This will occur, the argument goes, because the WBP creates an incentive for whistleblowers to bypass their companies' internal compliance departments in favor of direct reporting to the SEC.<sup>236</sup> Although the final rules sought to preserve the attractiveness of internal reporting in a variety of ways discussed in Part II.A, they do not include a requirement that a whistleblower first report internally in order to be eligible for a bounty award. The Chamber of Commerce and Institute for Legal Reform criticized this choice as a decision to “put trial lawyer profits ahead of effective compliance and corporate governance.”<sup>237</sup> These organizations issued a joint statement warning that the absence of an internal reporting requirement:

will make it harder and slower to detect and stop corporate fraud – by undermining the strong compliance systems set up under Sarbanes Oxley to ensure companies take whistleblowers seriously. Armed with trial lawyers and new large financial incentives to bypass these programs, whistleblowers will go straight to the SEC with allegations of wrongdoing and keep companies in the dark. This leaves expensive, robust compliance programs collecting dust, while violations continue to fester, eroding shareholder value.<sup>238</sup>

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<sup>234</sup> 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, 1202 (2010).

<sup>235</sup> See MICELI ET AL., *supra* note 230, at 26–32 (discussing the serious limitations for various approaches to studying the predictors of whistleblowing, including experimental surveys).

<sup>236</sup> See, e.g., Lisa M. Noller, *A Modest Practitioner Proposal: Striking a Balance in Whistleblower Lawsuits*, 2012 U. CHI. LEGAL F. 129, 143–46 (raising this objection); Vishal Baloria et al., *A Lobbying Approach to Evaluating the Whistleblower Provisions of the Dodd–Frank Reform Act of 2010*, at 11 (May 2013) (unpublished manuscript) (available at <http://ssrn.com/abstract=1923310>) (observing that the issue most frequently addressed in comment letters related to the WBP was the lack of a requirement of internal reporting).

<sup>237</sup> Press Release, U.S. Chamber of Commerce, *U.S. Chamber Warns New SEC Whistleblower Rule Will Undermine Corporate Compliance Programs* (May 25, 2011) (available at <https://www.uschamber.com/press-release/us-chamber-warns-new-sec-whistleblower-rule-will-undermine-corporate-compliance>).

<sup>238</sup> *Id.* For a good discussion of the effect of Sarbanes–Oxley on internal compliance programs, see Richard E. Moberly, *Sarbanes–Oxley’s Structural Model to Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107. For contrary views regarding the impact of the WBP on such programs, see

Concerns about undermining internal compliance programs led SEC Commissioners Troy Paredes and Kathleen Casey to vote against the adoption of the final rules.<sup>239</sup>

Early results indicate that, like the “crowding-out” concern, this fear may be overblown. The OWB’s chief has stated that a “significant majority” of the whistleblowers who have come forward since the program began reported that they used internal channels first.<sup>240</sup> And the Quarterly Corporate Fraud Index<sup>241</sup> indicates that internal fraud reporting has actually increased in the wake of the WBP.<sup>242</sup> This may be because, in response to concerns about the WBP’s potential impact on internal reporting, many firms proactively “shored up their anti-retaliation policies and tried to communicate more effectively to employees the organization’s renewed commitment to internal reporting processes.”<sup>243</sup> Moreover, even when a

Justin Blount & Spencer Markel, *The End of the Internal Compliance World as We Know It, or an Enhancement of the Effectiveness of Securities Law Enforcement?: Bounty Hunting Under the Dodd–Frank Act’s Whistleblower Provisions*, 17 *FORDHAM J. CORP. & FIN. L.* 1023, 1061 (2012); Geoffrey Christopher Rapp, Legislative Proposals to Address the Negative Consequences of the Dodd–Frank Whistleblower Provisions: Written Testimony Submitted to the U.S. House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises (unpublished manuscript) (available at <http://ssrn.com/abstract=1844586>).

<sup>239</sup> See Kathleen L. Casey, Comm’r U.S. Sec. & Exch. Comm’n, Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), available at <http://www.sec.gov/news/speech/2011/spch052511klcitem2.htm>; Troy A. Paredes, Comm’r, U.S. Sec. & Exch. Comm’n, Statement at Open Meeting to Adopt Final Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (May 25, 2011), available at <http://www.sec.gov/news/speech/2011/spch052511tapitem2.htm>.

<sup>240</sup> Jaime Guerrero, *Most SEC Whistleblowers Tell Company First*, *INSIDECOUNSEL* (March 28, 2012), <http://www.insidecounsel.com/2012/03/28/regulatory-most-sec-whistleblowers-tell-company-fi>. This is consistent with documented whistleblower behavior in other regulatory contexts. See MICELI ET AL., *supra* note 230, at 9 (“Many studies have shown that nearly all [whistleblowers] who use external channels do so after first using internal channels.”).

<sup>241</sup> The index is compiled from actual incidents reported by clients of The Network, a company that describes itself as “the leader in providing integrated governance, risk and compliance . . . solutions that help organizations mitigate risk, achieve compliance and ultimately, create better, more ethical workplaces”; among other products, The Network offers clients a confidential hotline for employees to report suspected law violations. See *About The Network, Inc.*, THE NETWORK, <http://www.tnwinc.com/about> (last visited Jan. 13, 2014).

<sup>242</sup> “Fraud-related incidents reflected in the Fraud Index include reports on corruption, theft, accounting and audit irregularities, misuse of assets, conflicts of interest, and violations of [the Foreign Corrupt Practices Act], UK anti-bribery and SEC legislation.” Press Release, The Network, The Network & BDO Consulting Release 2nd Quarter 2012 Findings: Quarterly Corporate Fraud Index (Sept. 25, 2012) (available at <http://www.tnwinc.com/1553/corporate-fraud-index/>).

<sup>243</sup> Yin Wilczek, *Employees’ Internal Fraud Reports Rise Even in Wake of SEC Whistleblower Program*, 7 *BNA WHITE COLLAR CRIME REPORT* 330, 331 (2012) (quoting Luis Ramos, CEO of The Network); see also Shannon Kay Quigley, Comment, *Whistleblower Tug-of-War: Corporate Attempts to Secure Internal Reporting Procedures in the Face of External Monetary Incentives Provided by the*

whistleblower does bypass internal channels, nothing prevents the SEC from informing the whistleblower's employer that a suspected law violation has been reported to allow for swift internal investigation (so long as the SEC does not reveal the whistleblower's identity). Indeed, the SEC has indicated that "in most cases, upon receiving a whistleblower tip, its staff would contact a corporation and describe the allegations, giving the firm the chance to investigate the matter itself."<sup>244</sup>

Some also contend that the WBP creates incentives for whistleblowers to delay reporting fraud until it grows severe enough to warrant at least \$1 million in sanctions—the minimum amount needed for a "covered action."<sup>245</sup> Delay may indeed be a logical choice if it is clear that no covered action will result if the fraud is reported immediately. But the point at which a fraud will result in a covered action is likely hard for a potential whistleblower to predict, and delay carries with it considerable risks, making it a dangerous strategy. As explained in Part II.A, if the SEC learns of information from another person before the whistleblower reports it to the SEC, to certain other governmental authorities, or through his employer's internal compliance procedures, the whistleblower will fail the originality requirement (unless he is the "original source" of the other person's tip), and thus be rendered ineligible for a bounty.<sup>246</sup> A whistleblower will also fail the "voluntariness" requirement if, before he makes his report, the SEC or certain other authorities request related information from him.<sup>247</sup> And even if he can meet the originality and voluntariness requirements, if the SEC has already opened an investigation into the misconduct by the time a whistleblower submits his information, the whistleblower will face the more stringent "significant contribution" test for determining whether his tip "led to" a covered action.<sup>248</sup> Finally, unreasonable delay in reporting may adversely affect the size of the bounty

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*Dodd-Frank Act*, 52 SANTA CLARA L. REV. 255 (2012) (suggesting modifications to compliance programs to encourage internal reporting in response to the WBP).

<sup>244</sup> Rapp, *supra* note 238. A recent empirical study shows that firms that lobbied against the adoption of the WBP had significantly weaker internal compliance programs relative to a sample of nonlobbying firms, a finding the study's authors view as inconsistent with the claim that the WBP will undermine internal compliance programs. See Baloria et al., *supra* note 236, at 20, 23–24.

<sup>245</sup> See, e.g., John Ashcroft et al., Whistleblowers Cash In, Unwary Corporations Pay, 40 HOFSTRA L. REV. 367, 371 (2011); Rapp, *supra* note 230, at 93–94.

<sup>246</sup> See *supra* Part II.A.2.

<sup>247</sup> See *supra* Part II.A.1.

<sup>248</sup> See *supra* Part II.A.3.

awarded by the SEC, within the 10%–30% range.<sup>249</sup> Thus, the WBP creates fairly strong incentives for whistleblowers to report promptly.

Apart from its impact on the probability and timing of detection, the WBP might also increase deterrence by raising the expected costs a fraudster faces if detected. As the Harry Markopolos–Bernie Madoff saga painfully illustrates, a meritorious tip to the SEC does not always result in investigation and punishment.<sup>250</sup> The WBP now gives tipsters (and their contingency-fee lawyers) a strong financial stake in monitoring and encouraging SEC follow-through. The WBP is also subject to ongoing congressional oversight, with the OWB obligated to report to Congress annually on its response to whistleblower complaints.<sup>251</sup> Of course, poorer SEC follow-through is also a possible result of the WBP, if it prompts a deluge of tips that overwhelm the SEC’s processing capabilities. But with the creation of OMI and the revamped TCR System, the SEC appears well equipped to handle the influx of information, and the recent OIG performance audit suggests it is doing a fairly good job processing tips so far.<sup>252</sup> The SEC can also lean on whistleblowers and their counsel as well as special committees at implicated corporations for assistance in investigations. Thus, the WBP may work to increase not only the likelihood that fraudsters will be detected, but also the likelihood that they will be punished if detected.

It is important to emphasize that the long-term success of the WBP in eliciting tips will depend on how often the SEC is perceived to pay out bounties. Bounties are available only in “covered actions”—i.e., actions involving financial penalties in excess of \$1 million—and pay out only as a percentage of sanctions actually collected. Some contend that “SEC enforcement trends for financial statement misrepresentation are unlikely to provide adequate incentives for whistleblowers to come forward with evidence of financial statement fraud.”<sup>253</sup> This is debatable. In a working paper, Professors Maria Correia and Michael Klausner study a sample of 297 resolved SEC enforcement actions filed between 2000 and 2011

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<sup>249</sup> See *supra* Part II.A.5. Negative consequences also follow from any attempt on the part of a whistleblower to hinder an internal or external probe that may expose the wrongdoing. See *supra* notes 128, 180.

<sup>250</sup> Luke Roosevelt Hornblower, *Outsourcing Fraud Detection: The Analyst as Dodd–Frank Whistleblower*, 6 J. BUS. & TECH. L. 287, 312–18 (2011) (telling the story of Harry Markopolos’s unsuccessful efforts to get the SEC to pursue the Madoff Ponzi scheme).

<sup>251</sup> See *supra* note 206 and accompanying text.

<sup>252</sup> The OIG Report suggests that the SEC is processing tips in a timely manner—it does not speak to the quality of the screening being done. See *supra* Part II.B.

<sup>253</sup> See Tristan Favro, *Financial Statement Misrepresentation & the SEC Whistleblower Program: Rethinking Whistleblower Incentives Without Qui Tam Actions* 27 (Feb. 26, 2013) (unpublished manuscript) (on file with author); see also Rapp, *supra* note 230, at 93–95 (raising similar concerns).

involving firms listed on the NYSE, AMEX, or NASDAQ.<sup>254</sup> They find that the SEC imposed a mean monetary penalty of \$87.2 million (median \$12 million) on corporate defendants in 23% of the total cases (68 out of 297) and a mean monetary penalty of \$29.7 million (median \$265,000) on individual defendants in 69% of the total cases (205 out of 297).<sup>255</sup> It is unclear whether this level of sanctioning will be high enough to elicit tips, but if the confidentiality and antiretaliation provisions of the WBP succeed in keeping the costs of whistleblowing low, it may prove sufficient. If it does not, however, the SEC could always adjust by ratcheting up the sanctions it imposes on culpable individuals and, if necessary, on corporate defendants.<sup>256</sup> Increasing corporate penalties could, however, introduce new costs—a possibility I address in the next subsection.

To be sure, to believe that the WBP will succeed in increasing fraud detection, one must at the very least trust that the SEC will not intentionally sabotage the program by targeting sanctions below the \$1 million mark, or by foregoing enforcement altogether. This is an easy leap to make, in my view. As mentioned above, the WBP will be subject to ongoing congressional oversight. It will also be closely scrutinized by the media, whistleblowers, and the whistleblower bar. Thus, even if the SEC wanted to thwart the program's success by altering (or failing to adjust) its sanctioning or enforcement practices—something that is contradicted by the SEC's enthusiastic embrace of the program—it is unlikely to do so.<sup>257</sup>

2. *Social Costs.*—All told, it seems likely that the WBP will help to reduce the social harm caused by securities fraud through enhanced deterrence. The question remains, however: At what cost? Administering the WBP will undoubtedly consume considerable government resources, as will the additional investigations it prompts. Potentially more onerous, however, are a variety of more indirect costs the program might produce.

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<sup>254</sup> Maria Correia & Michael Klausner, *Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis* (May 15, 2012) (unpublished working paper) (available at [http://recanati-bs.tau.ac.il/Eng\\_Uploads/dbsAttachedFiles/Correia.pdf](http://recanati-bs.tau.ac.il/Eng_Uploads/dbsAttachedFiles/Correia.pdf)).

<sup>255</sup> *Id.* at tbl.5. Additional amounts were paid in disgorgement, and these amounts would also count toward bounties under the WBP. See 15 U.S.C. § 78u-6(a)(4) (2012); 17 C.F.R. § 240.21F-4(e) (2013).

<sup>256</sup> If the problem proved intractable, reforms might be considered to make whistleblowing more lucrative. For example, the SEC could be instructed to assign a monetary value to nonmonetary sanctions (such as director and officer bars) when determining whether a covered action exists and calculating bounty awards. Tristan Favro has recommended several additional possibilities, including counting clawback payments, lowering the \$1 million threshold for what counts as a covered action, or raising the percentage of sanctions that may be awarded to a whistleblower above the current 30% cap. See Favro, *supra* note 233, at 36–40.

<sup>257</sup> See *infra* note 285 and accompanying text.

For example, some fear that the program will elicit a high number of nonmeritorious tips.<sup>258</sup> While it is unlikely that the WBP will produce many tips that are outright fabrications (the requirement that whistleblowers submit their tips under penalty of perjury, as well as the requirement that the SEC bring a covered action based on the tip before a bounty may be awarded, seems a sufficient guard against this), the lure of a large bounty could motivate individuals to view honest conduct as suspicious.<sup>259</sup> Because a whistleblower's identity will be kept confidential if the tip does not pan out, and retaliation protection kicks in so long as the whistleblower had a "reasonable belief" that their tip related to a "possible" securities law violation,<sup>260</sup> reporting is a sensible strategy even when there is only a small chance observed conduct is unlawful.<sup>261</sup>

If mistaken tips become commonplace—something the recent OIG report suggests may be happening<sup>262</sup>—the ultimate damage they cause will depend on how efficient personnel at OMI (and, if the tips are made internally, in corporate compliance departments) become at screening for them. If such personnel become adept at doing so, disposing of mistaken tips early and privately, the costs of the problem may be fairly contained. This is not to say that such costs will necessarily be trivial—the specter of trigger-happy whistleblowers may foster a general atmosphere of distrust and suspicion amongst coworkers, which can negatively affect a firm's productivity.<sup>263</sup> But if mistaken tips frequently lead to serious investigations, the costs will be much more substantial. These costs could include considerable legal fees, unwarranted reputational damage to firms

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<sup>258</sup> See, e.g., Blount & Markel, *supra* note 238, at 1041–42; Lucienne M. Hartmann, *Whistle While You Work: The Fairytale-Like Whistleblower Provisions of the Dodd–Frank Act and the Emergence of "Greedy," the Eighth Dwarf*, 62 *MERCER L. REV.* 1279, 1306–08 (2011); Holger Fleischer & Klaus Ulrich Schmolke, *Financial Incentives for Whistleblowers in European Capital Markets Law? Legal Policy Considerations on the Reform of the Market Abuse Regime* 9 (*Eur. Corporate Governance Inst., Working Paper No. 189, 2012*) (available at <http://ssrn.com/abstract=2124678>).

<sup>259</sup> This is a particular risk when the boundaries of the legal prohibition are vague or uncertain, as is the case with securities fraud. See *supra* note 66. It is even more of a risk with violations of the Foreign Corrupt Practices Act. See Heidi L. Hansberry, *In Spite of Its Good Intentions, the Dodd–Frank Act Has Created an FCPA Monster*, 102 *J. CRIM. L. & CRIMINOLOGY* 195 (2012).

<sup>260</sup> See *supra* note 199.

<sup>261</sup> See Anthony J. Casey & Anthony Niblett, *Noise Reduction: The Screening Value of Qui Tam*, *WASH. U. L. REV.* (forthcoming) (manuscript at 40–43) (available at [http://papers.ssrn.com/abstract\\_id=2237658](http://papers.ssrn.com/abstract_id=2237658)) (exploring how reducing the cost of blowing the whistle can encourage weak tips, to the detriment of deterrence).

<sup>262</sup> See OIG Report, *supra* note 191, at 16 (reporting that 69% of sampled tips were designated by the SEC as not warranting further action).

<sup>263</sup> See Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 *COLUM. BUS. L. REV.* 71, 99 (observing that "high heat" monitoring poses some inchoate risk to morale and productivity that is extraordinarily difficult to measure but potentially quite large").

and individuals, as well as undesirable *ex ante* effects on corporate behavior. For example, companies might choose to avoid profit-maximizing transactions that are legal but thought likely to arouse whistleblower suspicion. Firm managers might also become hesitant to share information outside a small cohort of trusted colleagues, to the detriment of the firm's operations, or may spend resources that could be put to more valuable use assuring employees of the legality of the firm's behavior.

Some may worry that even meritorious tips could lead to unintended consequences if the WBP encourages the SEC to rely more heavily on corporate sanctions than it otherwise would. As mentioned above, the long-term success of the WBP in eliciting tips will depend on how often the SEC is perceived to pay out bounties. And bounties can be paid out only in actions involving financial penalties in excess of \$1 million, and only to the extent they are actually collected. If culpable individuals cannot pay sufficiently high fines to sustain attractive bounty payments, the SEC may be tempted to impose sanctions on their more deep-pocketed corporate employers. As discussed in Part I.B.2.b., there exists a traditional deterrence justification for vicarious corporate liability premised on the notion that a firm's owners should be forced to fully internalize the costs of employee delicts. But that argument loses force in cases involving fraud-on-the-market by publicly traded companies. This is because the diversified shareholders who own the bulk of such companies naturally internalize the social costs of secondary market fraud; moreover, when public companies pay in FOTM suits, most of the money is returned to those same investors. As I explained, FOTM suits may nevertheless serve a useful function if the attorneys' fees they generate induce the class action bar to assist in fraud detection. If the SEC imposes corporate fines on public companies for fraud-on-the-market as a way to sustain the WBP, a similar logic applies: most of the fines will be paid back to shareholders through a fair funds distribution,<sup>264</sup> and the amount siphoned off to pay the bounties may be worth the increased fraud detection the WBP produces. So what, then, is the problem? The answer is that corporate sanctions can also produce undesirable results if they push firms into financial distress, or if they cause boards to overinvest in fraud prevention measures or to reduce their self-policing efforts. Unlike FOTM plaintiffs, the SEC often forbids defendant firms from using insurance to fund settlements, so both threats may loom larger in this context.

There are several answers to these concerns. First, the SEC may in fact be able to collect sufficiently high sanctions from individual defendants to

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<sup>264</sup> See *supra* note 9.

make the WBP work without resorting to corporate fines.<sup>265</sup> Second, the level of corporate fines that might be required to make the program work would likely be far too small to have a noticeable impact on the operations of most public companies,<sup>266</sup> and would be dwarfed in any event by the market penalties the firm would face.<sup>267</sup> Professor Arlen has argued that because the market penalty firms incur for securities fraud is so severe it may dissuade corporate agents from self-policing for fraud in the same way she has argued the risk of respondeat superior liability may do so.<sup>268</sup> The solution, she posits, is for the government to threaten firms that fail to engage in reasonable policing efforts with sufficiently high fines so that policing is attractive, notwithstanding the heightened risk of detection, while absolving firms that demonstrate reasonable policing efforts from corporate liability entirely.<sup>269</sup> The high fines imposed on nonpolicing firms would impact the value of their corporate managers' firm-specific investments and potentially prompt other forms of shareholder discipline by signaling to the market that the "managers failed either to report suspected wrongdoing or to cooperate fully with the government's investigation";<sup>270</sup> a positive signal would presumably be sent regarding the managers of those firms that escaped sanction, lessening the market penalty. The government's sanctioning policy would therefore help to align managerial incentives with those of diversified shareholders. This type of high-fine–no-fine strategy might work well to entice whistleblowing, especially if a lottery mentality takes hold in the whistleblower community. But if more frequent corporate penalties are needed to maintain whistleblower incentives than would be called for under Professor Arlen's preferred policy, a solution would be for the SEC to impose relatively modest (albeit bounty-generating) corporate fines in cases against firms that engaged in reasonable policing efforts, and to allow those fines to be

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<sup>265</sup> See *supra* notes 253–56 and accompanying text.

<sup>266</sup> Indeed, corporate fines far smaller than those imposed by the SEC in the decade preceding the WBP would likely suffice. See Correia & Klausner, *supra* note 255. For example, a fine of \$3.33 million would produce a bounty of between \$333,000 and \$1 million. Of course, rational whistleblowers would discount this figure by the probability their tip would not produce an enforcement action, that the SEC would choose not to impose the penalty, that they would fail to meet the criteria for an award, and that they may have to share their award with others. But the lure of a big payout may be more likely to produce a lottery mentality than such reasoned calculations, at least if the WBP succeeds in keeping the costs of whistleblowing low.

<sup>267</sup> See *supra* notes 94–100 and accompanying text.

<sup>268</sup> See Jennifer Arlen, *Public Versus Private Enforcement of Securities Fraud* (2007) (unpublished manuscript) (*available at* <http://weblaw.usc.edu/assets/docs/Arlen.pdf>); see also *supra* note 68.

<sup>269</sup> Arlen, *supra* note 268, at 36–39.

<sup>270</sup> *Id.* at 38.

paid for with insurance, while pursuing a high-fine–no-insurance approach against non-policing firms.

Others have also warned that the WBP will have a deleterious effect on auditor–client and attorney–client relationships, eroding trust and in turn inhibiting the candor that is necessary to make those relationships work effectively.<sup>271</sup> As explained in Part II.A, auditors and attorneys are generally ineligible to claim bounty awards for providing tips that implicate clients.<sup>272</sup> But their ineligibility is subject to large exceptions.<sup>273</sup> Finally, some also warn that the WBP’s antiretaliation provision will create a human relations nightmare as firms find themselves hamstrung to fire underperforming, but whistleblowing, employees.<sup>274</sup>

3. *Striking the Right Balance.*—Do the potential benefits of the WBP exceed its potential costs? At the risk of disappointment, I do not claim to know. Whether, on net, the WBP will increase social welfare is a question no one can answer with certainty. The benefits and costs discussed above, while potentially very real, are also notoriously difficult to observe and measure. Individuals with different intuitions as to the level of undetected securities fraud plaguing the U.S. capital markets may view the balance differently. What I can say with some degree of confidence is that the program is likely to increase fraud detection, and that the SEC has done a reasonable job in trying to ensure that its costs do not dwarf its benefits.

Whether the SEC has optimized the program is far more debatable. A variety of different choices could have been made in calibrating the final rules. The SEC could have precluded attorneys and auditors from recovering bounties for providing tips relating to their clients without exception. It could have made the standard for invoking retaliation protection more demanding than a “reasonable belief” of a “possible” securities law violation. It could have required internal reporting as a prerequisite to recovery, absent strong evidence of a corrupt corporate compliance department. Similarly, Congress could have made different choices in the statute about, for example, whistleblower confidentiality, the determination of what counts as a “covered action,” or the range of permitted bounty payments. I could go on. Time and close monitoring will shed better light on the choices Congress and the SEC did make and perhaps provide grounds for future revisions to the program. We must wait and see.

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<sup>271</sup> See, e.g., Temkin & Moskovits, *supra* note 157, at 12.

<sup>272</sup> See *supra* Part II.A.4.

<sup>273</sup> See *supra* Part II.A.4.

<sup>274</sup> See, e.g., Blount & Markel, *supra* note 238, at 1042.

A far more tractable question concerns the impact of the WBP, now that we have it, on other aspects of the United States' securities fraud deterrence regime—and in particular on the controversial FOTM class action. The next Part turns to this broader question, which has been neglected in the debate over the WBP, and suggests a stark answer.

### III. HOW THE BOUNTY PROGRAM UNDERMINES THE CASE FOR FRAUD-ON-THE-MARKET CLASS ACTIONS

As discussed in Part I, FOTM suits stood on a weak foundation even before the WBP. The shareholder-funded settlements FOTM suits produce do not advance compensatory goals. Nor do these payments advance deterrence goals, at least not in the way respondeat superior liability is traditionally thought to. If the FOTM class action can be justified, it is as a sort of mandatory corporate governance device: rather than shareholders monitoring the fraud deterrence efforts of management and the SEC directly, FOTM suits allow them to outsource these functions to the class action bar. Prior to the adoption of the WBP, the efficiency of this device was far from clear given the small percentage of FOTM suits that actually revealed original information about securities fraud. In the wake of the WBP, the case for FOTM suits is substantially weaker and, likely, unsustainable. This is because the WBP can be expected to decrease the already limited informational benefits of FOTM suits, while at the same time increasing their costs—assuming, that is, that the program works to enhance fraud detection. But even if it does not, the WBP still undermines the case for FOTM suits. As discussed in the next Part, adding a *qui tam* feature to a dysfunctional WBP would be preferable to retaining FOTM suits.

#### A. *Reduced Benefits*

As explained in Part I.B.2.b.1., the primary way that FOTM suits may aid in deterrence is by assisting in fraud detection. And given that plaintiffs' lawyers are outsiders to the corporation with no access to legal tools of discovery until after their FOTM complaints survive a motion to dismiss, their skills in fraud detection must stem from one of two sources: (1) their ability to get current or former insiders to talk; or (2) their learned ability to analyze publicly available information to discern potential frauds.<sup>275</sup> The WBP is now poised to cover much of the same detection terrain.

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<sup>275</sup> Between the two, the former source is likely more significant. As Professor Gideon Mark has explained, under the PSLRA, plaintiffs

must plead their cases with particularity, but they are generally barred from obtaining discovery to bolster their allegations until after all motions to dismiss have been decided. The result has been

First, it is highly likely that yesterday's FOTM-suit confidential informant will become today's WBP tipster; if this happens, it means that the already small percentage of corporate frauds exposed through private litigation<sup>276</sup> will get even smaller. Current and former corporate insiders with information about potential securities law violations have much more to gain, and much less to lose, by submitting a tip to the SEC than by providing information to a FOTM class action attorney. Submitting a tip leads to the possibility of earning a substantial bounty. By contrast, FOTM class action attorneys cannot pay confidential informants for their information without compromising their integrity as potential witnesses and deponents,<sup>277</sup> and their pro rata share of any settlement payment will likely be much smaller than their expected bounty payment under the WBP (assuming they are even class members).<sup>278</sup> Moreover, subject to limited exceptions, the SEC is legally obligated to keep a tipster's identity confidential until the point of a trial (which will likely never occur), and tipsters also enjoy strong legal protection against retaliation, including the right to sue for reinstatement and double back pay.<sup>279</sup> Providing information to a FOTM class action attorney, by contrast, comes with no comparable safeguards. It is therefore logical to assume that insiders with credible information about securities fraud who might heretofore have assisted a FOTM attorney by serving as a confidential informant (and many others who would not have) will now choose to participate in the WBP.

The second way that FOTM lawyers may assist in fraud detection is by utilizing their own developed expertise to identify frauds based on publicly available information. It is likely that this form of fraud detection will also migrate to the WBP. Under the WBP, corporate "outsiders" whose tips are based on an "independent analysis" of publicly available information may be treated as having provided the SEC with "original information" and thus

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almost universal reliance by plaintiffs in class action securities complaints on information provided by confidential witnesses. Allegations based on such information often are the *only* specific allegations in a complaint supporting a claim of securities fraud.

Gideon Mark, *Confidential Witnesses in Securities Litigation*, 36 J. CORP. L. 551, 554 (2011) (emphasis added) (citations omitted).

<sup>276</sup> See Dyck et al., *supra* note 104.

<sup>277</sup> See Mark, *supra* note 275, at 571 ("The absence of remuneration significantly enhances the credibility of confidential witnesses in class action securities litigation.")

<sup>278</sup> See Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 60 (2002) (citation omitted) (observing that whistleblowers "are not eligible to participate in a class action unless they happen to gain class status by owning stock in the security at issue" and that a "class member who incurred the professional and personal risks to reveal inside information regarding the wrongdoing alleged by the class would receive nothing for incurring these risks; all this whistleblower would get is a pro rata share, based upon the amount of stock held").

<sup>279</sup> See *supra* Part II.A.7.

may be eligible for bounties.<sup>280</sup> A class action lawyer (or group of lawyers) with this sort of fraud detection ability could therefore profit from it through personal participation in the WBP. The WBP's expansive notion of original information creates incentives for other market actors with similar expertise to participate, and for new entrants to develop such expertise in the hopes of profiting from the program.<sup>281</sup> In any of these eventualities, the potential for FOTM class actions to expose otherwise undetected frauds will be reduced.<sup>282</sup>

As explained in Part I.B.2.b.2, beyond detection, FOTM suits may assist in fraud deterrence through their disciplining influence on the SEC. The WBP also reduces the need for FOTM suits to serve this purpose. The WBP creates a new set of SEC watchdogs with incentives to monitor the agency in a more direct fashion than FOTM lawyers—namely, whistleblowers and their counsel. These parties have strong financial motives to ensure that the SEC responds to the specific information brought to its attention about securities law violations, and that the SEC is aggressive in its enforcement and sanctioning activity. They can be expected to complain to the media or Congress if the SEC fails on either front. Dodd–Frank also requires ongoing congressional scrutiny of the SEC's administration of the WBP, including the commission of an annual report in which the SEC must describe how it has responded to whistleblower tips.<sup>283</sup>

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<sup>280</sup> See *supra* Part II.A.2.

<sup>281</sup> For example, it might prompt some to develop more sophisticated techniques for detecting accounting fraud based on publicly available financial data. See Patricia M. Dechow et al., *Predicting Material Accounting Misstatements*, 28 CONTEMP. ACCT. RES. 17 (2011) (developing a model that produces a scaled probability (F-Score) of earnings management based on financial statement variables).

<sup>282</sup> One may object that lawyers will have weaker financial incentives to participate as whistleblowers in the WBP than to file FOTM suits. This is not at all obvious. A recent report from Cornerstone Research shows that the mean settlement amount in securities class actions from 1996–2011 was \$55.2 million (median \$8.3 million). Ryan & Simmons, *supra* note 31, at 3. This compares to the mean \$87.2 million (median \$12 million) in sanctions imposed on public companies in SEC actions filed from 2000–2011, as reported by Correia and Klausner. See *supra* notes 254–55 and accompanying text. To be sure, securities class actions result in settlement at higher rates than SEC investigations result in the imposition of corporate sanctions, but providing a tip to the SEC through the WBP is dramatically less expensive and risky than is litigating a class action lawsuit. In any case, the appropriate question is not whether participation in the WBP will be as profitable as bringing FOTM suits, but whether it will be sufficiently profitable to make participation worthwhile. There is little reason to believe that attorneys' fees in FOTM suits are currently calibrated to produce the optimal level of private investment in fraud detection.

<sup>283</sup> See *supra* notes 205–06 and accompanying text. The first two reports, unfortunately, have been rather skimpy in the information they provide. See *supra* notes 183–84. Congress should demand greater detail in future reports.

*B. Increased Costs*

While the benefits of FOTM suits can be expected to decrease in the wake of the WBP, their costs can be expected to rise. This is because any increase in the number of SEC enforcement actions involving large public companies brought because of the program will also likely increase the number of FOTM suits filed. These sorts of “piggyback” or “me, too” suits impose real costs, but promise none of the social benefits discussed in Part I.B.2.b: They are unlikely to result in the public revelation of new information about the underlying fraud,<sup>284</sup> and they do not help to “discipline” the SEC because they come about in situations where the SEC has already done its job.

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As noted previously, many scholars have long doubted that the benefits of FOTM suits outweigh their costs, but have stopped short of advocating for their abolition due to residual empirical uncertainty. If the WBP decreases the benefits and increases the costs of FOTM suits even marginally, the program should embolden these scholars to call for more radical reforms. Even those who felt confident about the social value of FOTM suits in the pre-WBP world should feel compelled to reevaluate their position: if the WBP works as intended, it will leave little for FOTM suits to do, except generate deadweight costs. To be fair, that is one big “if.” Some may doubt that the WBP will in fact work effectively to enhance fraud detection, as the foregoing analysis assumes. A common critique of the SEC is that the agency underperforms due to resource constraints or bureaucratic pathologies short of actual corruption.<sup>285</sup> If, for either reason, the SEC does not effectively investigate the credible whistleblower tips it receives, or bring covered actions sufficient to attract them, the WBP—and fraud deterrence—will suffer, as will the WBP-based case for the abolition of FOTM suits.

As suggested by my discussion in Part II.C, I am hopeful that the WBP and accompanying reforms to the enforcement division (including the creation

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<sup>284</sup> See *supra* note 112 and accompanying text.

<sup>285</sup> Those who view the SEC as a fundamentally corrupt agency, bent on protecting fraudsters at the expense of the U.S. capital markets might expect the SEC to sabotage the program (by burying tips, refusing to bring covered actions, etc.). If this were to happen, then obviously the WBP would have little to no effect on fraud deterrence, and hence would have little to no impact on the FOTM suit cost-benefit calculation. Few, if any, informed observers take this view of the SEC, however, and it is one that this Article will not entertain. Most believe that SEC personnel are dedicated public servants or at the very least that their selfish motivations are kept in check by various forces, such as congressional oversight and investor and media scrutiny.

of OMI and the new TCR system) will make the SEC a more effective agency. Although the SEC may have more work to do in the wake of the WBP, it will also have better information. It can lean on special committees at implicated firms to help it evaluate the volumes of tips it receives, and to investigate tips that are deemed credible. The SEC can also lean on whistleblowers and, perhaps most importantly, their counsel. Whistleblower counsel may prove highly valuable to the SEC, for repeat player attorneys may come to serve as a signal of tip quality.<sup>286</sup> Numerous whistleblower practice groups have popped up at highly regarded plaintiffs'-side securities law firms in the wake of the WBP, reportedly offering to represent whistleblowers for a 20%–30% contingency fee.

But not everyone will share my optimism. Some may worry that whistleblower representation would prove unprofitable if the opportunity to bring a parallel FOTM class action were eliminated, or that lawyers might opt to pursue a high-volume portfolio model of whistleblower representation<sup>287</sup>—either eventuality would dash the hope that whistleblower counsel will aid the SEC in its administration of the WBP by serving as a signal of tip quality. It is also possible that the SEC will be too overwhelmed to effectively administer the program, even with the assistance of corporate special committees, whistleblowers, and whistleblower counsel. The SEC might also ignore tips related to fraud-on-the-market in favor of tips relating to less important but easier to win claims, like reporting violations under the Foreign Corrupt Practices Act (FCPA).<sup>288</sup> Even wise case prioritization by the SEC may leave some credible tips unaddressed, and hence some frauds unexposed.

The next Part shows why the WBP has important implications for the FOTM class action debate, even if the pessimists prove right.

#### IV. THE IDEA OF A QUI TAM SAFETY VALVE

Although a dysfunctional WBP might not justify the outright elimination of private Rule 10b-5 enforcement, it nevertheless lays the ground work for its

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<sup>286</sup> See David Freeman Engstrom, *Harnessing the Private Attorney General: Evidence from Qui Tam Litigation*, 112 COLUM. L. REV. 1244, 1257–63 (2012) (discussing the potential advantages of a specialized bar, including signaling of case quality as well as the potential disadvantages); Rapp, *supra* note 230, at 121 (observing that whistleblower counsel may “serve a valuable screening role by helping to weed out those cases that are unlikely to lead to successful enforcement action”).

<sup>287</sup> See Engstrom, *supra* note 286, at 1260, 1304, 1313 (noting that “specialized enforcers may come to ‘speculate’ in enforcement efforts or become ‘filing mills,’” but finding no empirical evidence of filing mill behavior in the FCA qui tam context); see also Nora Freeman Engstrom, *Run-of-the-Mill Justice*, 22 GEO. J. LEGAL ETHICS 1485, 1491–503 (2009).

<sup>288</sup> See generally Hansberry, *supra* note 259 (arguing that the WBP will create an FCPA “monster”).

transformation: replacing FOTM class actions with a WBP qui tam provision would result in a marked improvement over the status quo. This Part sketches how such a qui tam feature might operate, and demonstrates its superiority as a private enforcement device relative to FOTM suits.<sup>289</sup>

#### A. *What It Might Look Like*

Most readers will associate qui tam litigation with the False Claims Act (FCA), a statute dating back to the Civil War era that prohibits fraud on the federal government.<sup>290</sup> The FCA permits private parties who possess original information about violations, dubbed “relators,” to sue on behalf of the government and recover a bounty for their efforts.<sup>291</sup> The relator first files a complaint in court under seal and serves it only on the government; the Department of Justice (DOJ) then has a period of time in which to decide “whether to terminate or settle the case out from under the relator, intervene and take ‘primary responsibility’ for the litigation of the case, or

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<sup>289</sup> Scholars have raised the idea of adding a qui tam provision to the securities laws in the past. See Bucy, *supra* note 278, at 76; Casey & Niblett, *supra* note 261, at 42–46; Favro, *supra* note 253, at 40; Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes–Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91 (2007) [hereinafter *Beyond Protection*]; Rapp, *supra* note 230, at 78; Velikonja, *supra* note 43, at 1951; see also Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922(d)(1)(G), 124 Stat. 1376, 1848–49 (2010) (ordering the OIG to study whether adding a qui tam provision to the WBP would be desirable). Scholars have also recognized the analogy between FOTM class actions and qui tam litigation. See Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167 (1997). Some have gone further to observe that qui tam litigation has advantages over FOTM class actions as a method of promoting deterrence. See Rapp, *Beyond Protection*, *supra*, at 100; Geoffrey Christopher Rapp, *False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers*, 15 NEXUS 55, 59 (2010); see also Bucy, *supra* note 278, at 68 (arguing generally that qui tam mechanisms possess advantages relative to class actions as methods of private enforcement of public law); Rose, *supra* note 41, at 1354–58 (suggesting reforms that would grant the SEC greater power to oversee FOTM class actions, which would make them more closely resemble qui tam suits). In a 1996 article, Professor Janet Cooper Alexander argued for replacing the out-of-pocket measure of damages in FOTM suits with civil penalties, mentioning replacing class actions with qui tam litigation as one possible way to effect that change. See Alexander, *supra* note 36, at 1516–18. But this is the first Article to truly develop the theoretical case for replacing FOTM suits with a qui tam mechanism, and to lay out how the WBP could be amended to facilitate such a change.

<sup>290</sup> For an overview of the FCA, see Engstrom, *supra* note 286, at 1269–74.

<sup>291</sup> Specifically, the suit cannot be “based upon allegations or transactions which are the subject of a civil suit or an administrative civil money penalty proceeding in which the Government is already a party,” and is subject to dismissal if “substantially the same allegations or transactions as alleged in the action or claim were publicly disclosed” in certain government proceedings or in the news media (unless the relator voluntarily informed the government of the information prior to its public disclosure or has “knowledge that is independent of and materially adds to the publicly disclosed allegations or transactions”). 31 U.S.C. § 3730(e)(3)–(4) (2012).

decline to intervene and allow the relator to proceed alone.”<sup>292</sup> If the DOJ declines to intervene, the relator earns 25%–30% of any recovery.<sup>293</sup> That amount drops to 15%–25% in the case of DOJ intervention.<sup>294</sup> Nevertheless, relators much prefer the DOJ to intervene because it vastly improves the odds of recovery.<sup>295</sup> By some metrics, the FCA has been a huge success: it has produced “some seven thousand cases since 1986 with judgments now approaching three billion dollars annually.”<sup>296</sup>

The qui tam addition to the WBP that I imagine would operate somewhat differently from the FCA, relying heavily on the infrastructure already created by the WBP and, to an extent, built up around FOTM class actions. Instead of filing complaints under seal in court and serving them on the government, as do FCA relators, WBP whistleblowers would continue to file tip forms pursuant to existing procedures. After a designated period of time had elapsed from the date of submission, the SEC would be required to report to the whistleblower whether: (1) the matter remained under investigation; (2) the SEC determined that there is insufficient evidence of wrongdoing to warrant an enforcement action or qui tam litigation related to the tip; (3) the SEC had chosen to bring an enforcement action related to the tip; or (4) that although the SEC was not pursuing an enforcement action, qui tam litigation is permitted.

In the first scenario, the SEC would be obligated to provide subsequent reports of a similar nature at periodic intervals, until the investigation concluded. In the second scenario, qui tam litigation would be barred. The third scenario would play out just as it would today. Thus, if a “covered action” resulted from the SEC’s enforcement efforts, the whistleblower could apply for a bounty according to the steps described in Part II.A.6. Professors Anthony Casey and Anthony Niblett have argued that filing a qui tam lawsuit should be the only path to a bounty, because the added litigation costs to whistleblowers would help to screen out frivolous tips.<sup>297</sup> Requiring a whistleblower to file suit in order to be entitled to a bounty, as

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<sup>292</sup> David Freeman Engstrom, *Public Regulation of Private Enforcement: Empirical Analysis of DOJ Oversight of Qui Tam Litigation Under the False Claims Act*, 107 *NW. U. L. REV.* 1689, 1711 (2013).

<sup>293</sup> 31 U.S.C. § 3730(d)(2).

<sup>294</sup> *Id.* § 3730(d)(1).

<sup>295</sup> The likelihood of recovery in intervened cases is roughly 90%, as is the likelihood of *no* recovery in nonintervened cases. *See* Engstrom, *supra* note 292, at 1720; *see also* David Kwok, *Coordinated Private and Public Enforcement of Law: Deterrence Under Qui Tam* 12 (Feb. 8, 2010) (unpublished manuscript) (*available at* [https://editorialexpress.com/cgi-bin/conference/download.cgi?db\\_name=ALEA2010&paper\\_id=375](https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=ALEA2010&paper_id=375)) (“[T]he cases in which the DOJ is involved have higher impositions than those without DOJ participation.”).

<sup>296</sup> Engstrom, *supra* note 286, at 1246.

<sup>297</sup> *See* Casey & Niblett, *supra* note 261, at 42–46.

in a qui tam suit brought under the FCA, may indeed be an effective way to decrease the number of low quality tips. But it might also discourage high quality tips by parties who are not interested in such an undertaking, or who have important information that may not alone suffice to state a claim, but which may prove helpful to a larger investigation. Thus, preserving an opportunity for nonlitigating tipsters to recover a bounty is important.

In the fourth scenario, whistleblowers would have the option of filing a qui tam action. If no whistleblower chose to do so within a designated period of time, the SEC would remain free to bring an enforcement action at a later date (subject, of course, to the underlying statute of limitations). If, however, a qui tam action were brought, it would bar later litigation by the SEC under general principles of claim preclusion.<sup>298</sup> The parties to the qui tam litigation would be required to serve copies of all pleadings on the SEC, and, as discussed further below, the SEC would have the opportunity to weigh in at various points in the litigation. The SEC would not, however, have the option of intervening as a plaintiff alongside the whistleblower, as does the DOJ under the FCA. This approach has the benefit of streamlining enforcement efforts, and would avoid some of the odd dynamics that the FCA's structure has created.<sup>299</sup>

A whistleblower choosing to file a qui tam suit would have to establish that he “voluntarily” provided “original” information to the SEC related to the alleged fraud, and is not otherwise ineligible to recover a bounty, as these

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<sup>298</sup> As has been observed in the FCA context, this can create opportunities for collusive settlements. *See, e.g.,* Searcy v. Philips Elecs. N. Am. Corp., 117 F.3d 154, 160 (5th Cir. 1997) (warning that “a relator can boost the value of settlement by bargaining away claims on behalf of the United States”). This may seem particularly troublesome insofar as qui tam litigation may produce corporate settlements that serve to release culpable individual defendants from liability without monetary contribution. *See infra* note 307 and accompanying text. This problem could be mitigated by requiring the SEC to weigh in on the appropriateness of the settlement, as I suggest below. *See infra* text accompanying note 304. The SEC might use its influence to convince courts that settlements releasing culpable individual defendants should not be approved without meaningful personal contributions. *See infra* note 308 (noting that the SEC could be given the right to intervene at the settlement or judgment phase for the limited purpose of requesting nonmonetary relief against individual defendants).

<sup>299</sup> As noted above, a decision by the DOJ to intervene in a qui tam suit typically ensures its success, whereas non-intervention has the opposite result. *See supra* note 295. Although these divergent case outcomes could simply mean that the DOJ is good at picking high-merit qui tam cases to associate itself with, it is also possible that DOJ intervention itself influences case outcomes—for example, by exerting unique settlement pressures on defendants. *See Engstrom, supra* note 292, at 1712–13 (discussing various hypotheses). If a decision to intervene does influence case outcomes, it gives the DOJ the power to bestow favors on particular relators and their counsel. This may explain statistically significant findings by Professor David Engstrom that FCA relators who are represented by former DOJ attorneys have a higher likelihood of earning DOJ intervention (although other explanations are of course possible). *See Engstrom, supra* note 286, at 1314. The structure proposed here would eliminate this particular rent-seeking opportunity.

concepts are currently defined under WBP rules.<sup>300</sup> If multiple whistleblowers submitted tips and filed qui tam suits related to the same fraud, their suits would be consolidated in a single jurisdiction, and the court would choose who among the plaintiffs that meet this criteria should serve as the lead plaintiff, based on factors such as the relative importance of the information they provided and their ability to effectively litigate the suit.

Congress would have to decide who can raise challenges related to the voluntariness, originality, and eligibility requirements. If defendants were permitted to do so, it might predictably result in protracted litigation on these preliminary issues. Moreover, it would preclude whistleblowers from filing a qui tam complaint anonymously—in most cases defendants would be unable to challenge these issues without access to information about the whistleblower's identity.<sup>301</sup> An alternative would be to allow only the SEC to raise such challenges. This would not be unprecedented: Congress recently amended the FCA to provide that a qui tam suit cannot be dismissed on the ground that the relator is not the original source of the allegations if the DOJ objects.<sup>302</sup> Another potentially better option would be to push the issue entirely inside the agency, requiring whistleblowers to obtain a letter of standing from the SEC prior to filing suit. At the very least, the court should be required to consider the SEC's views on the whistleblower's eligibility.

To state a claim, a whistleblower would have to plead a Rule 10b-5 violation in accordance with the PSLRA's heightened pleading standards and subject to the PSLRA's discovery stay.<sup>303</sup> The whistleblower would not, however, have to plead or prove reliance, loss causation, or damages—elements that do not apply in Rule 10b-5 cases initiated by the government. The whistleblower plaintiff could seek the same monetary sanctions and disgorgement as the SEC is entitled to seek, though before ordering any

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<sup>300</sup> See *supra* Part II.A.1–2.

<sup>301</sup> The constitutionality of allowing qui tam plaintiffs to remain anonymous is beyond the scope of this Article, but for an introduction to the issue, see *United States ex rel. Doe v. Boston Scientific Corp.*, No. 4:07-CV-2467, 2009 U.S. Dist. LEXIS 59390, at \*4–13 (S.D. Tex. July 2, 2009), for a discussion of case law governing when a relator may keep their identity confidential after an FCA case is unsealed. Other constitutional questions that may be raised by my proposal are also outside the scope of this Article, but for a good introduction to the Article III standing issues raised by qui tam litigation, see Fisch, *supra* note 289, at 186–94.

<sup>302</sup> See Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10104(j)(2), 124 Stat. 119, 901–02 (amended 2010).

<sup>303</sup> As noted *infra*, this is important because the SEC's decision to allow qui tam litigation may not involve a substantial merits-screening function. See text accompanying note 323. Others have similarly advocated for PSLRA-style restrictions in qui tam litigation. See Bucy, *supra* note 278, at 68; Favro, *supra* note 253, at 40–41.

relief, the court would be instructed to solicit the views of the SEC. It would likewise be instructed to solicit the SEC's views before approving any settlement agreement, and such agreements would have to set forth the factual basis for the alleged wrongdoing and be public (with the exception of the whistleblower's identity). This would help to police against collusive settlements and more generally serve to maximize the informational benefit of the litigation to investors.<sup>304</sup>

When a plaintiff succeeds in obtaining monetary relief, the court, again with input from the SEC, would be responsible for determining the percentage of that relief that should be paid as a bounty to the plaintiff (or plaintiffs, if multiple whistleblowers joined the suit) within a predetermined range. The range should be set higher than the 10%–30% range currently available under the WBP to account for the additional costs associated with bringing the litigation.<sup>305</sup> The criteria that should guide the court's determination should mirror the criteria already used in the WBP for determining whistleblower bounties but with additional factors that take into account the whistleblower's litigation efforts.

This sketch admittedly leaves many important details to be worked out. But my goal here is not to provide a comprehensive treatment of the complicated design choices inherent in the creation of a WBP qui tam provision; rather, it is simply to provide enough context to allow the reader to evaluate the advantages of a qui tam approach relative to FOTM class actions—the topic we turn to next.<sup>306</sup>

### *B. Why It Would Be Better than the Status Quo*

Those who worry that the WBP will not capture the fraud detection benefits FOTM suits produce due to expected failures in the program's administration might not endorse the outright elimination of private Rule

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<sup>304</sup> See *supra* note 298 and accompanying text.

<sup>305</sup> Professor Engstrom warns that the tiered bounty system under the FCA creates “strong disincentives for DOJ to fully delegate enforcement authority to capable and well-resourced private enforcers,” leading to higher than optimal intervention rates. Engstrom, *supra* note 292, at 1752. As discussed above, under the regime I envision, the SEC would not have an intervention option; it would either pursue an enforcement action itself or cede the litigation to the whistleblower. See *supra* note 299 and accompanying text. I suspect that differentials in bounty payments would not be significant enough to influence this choice.

<sup>306</sup> Future research focused on the design of a WBP qui tam provision would do well to draw insights from the burgeoning empirical scholarship that is being done in the FCA context. See, e.g., Engstrom, *supra* note 286; Engstrom, *supra* note 292. Insights can also be drawn from state-level experiments with qui tam-style litigation. See, e.g., Janet Cooper Alexander, *To Skin a Cat: Qui Tam Actions as a State Legislative Response to Concepcion*, 46 U. MICH. J.L. REFORM 1203 (2013) (discussing the California Private Attorneys General Act, CAL. LAB. CODE §§ 2698–2699.5 (West 2011)). Adding a qui tam provision to the WBP also raises a variety of difficult constitutional questions that warrant additional study. See *supra* note 301.

10b-5 enforcement. But they should support a proposal that would replace FOTM suits with a WBP qui tam provision similar to the one described above.

First, adding a qui tam feature to the WBP would help to sustain the program even if the SEC proved grossly incapable of sorting through whistleblower tips. It would ensure that tips not actively being pursued by the SEC, or affirmatively judged thereby to be insubstantial, could be pursued in private litigation by eligible whistleblowers, and thereby publicly exposed. Having this option would, in turn, strengthen whistleblowers' ex ante incentives to report by affording them greater control over their probability of recovery. For similar reasons, the qui tam option would make whistleblower representation more attractive, thus aiding in the development of a robust whistleblower bar—which, as discussed above, might have the laudable effect of helping the SEC in its administration of the WBP.

Second, replacing FOTM suits with a WBP qui tam regime would offer several important advantages over the status quo. Like FOTM suits today, qui tam litigation under the WBP would likely result primarily in the imposition of corporate liability.<sup>307</sup> This is not necessarily a bad thing: one might prefer that the pursuit of individual defendants be left to the government, both because exclusive government enforcement would be less likely to overdeter honest but risk-averse corporate officers, and because the government is capable of imposing nonmonetary sanctions on individuals that are useful for deterrence but are not (and should not be) available to private enforcers.<sup>308</sup> But the fact that a WBP qui tam regime would be primarily a regime of corporate liability means that its social function would be limited in the same way as FOTM suits: its value would derive less from the sanctions it imposes than from the information it produces and the disciplining influence it might exert on the SEC.<sup>309</sup> The

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<sup>307</sup> See Favro, *supra* note 253, at 13 (“[A]llowing qui tam actions would lead relators to pursue actions against the firm—the entity most able to pay any imposed fine or settlement . . .”).

<sup>308</sup> As noted previously, attempts by corporate defendants in WBP qui tam cases to negotiate broad liability releases for culpable individual defendants who do not contribute meaningfully to settlement payments could be policed by the SEC and the courts. See *supra* note 298. But even if individual defendants were released from civil liability in a WBP qui tam case without being made to pay, it would not preclude criminal prosecution against egregious offenders. Another way to help ensure that culpable individuals are meaningfully sanctioned in WBP qui tam cases would be to grant the SEC a limited right to intervene solely to seek nonmonetary remedies against individual defendants, such as officer and director bars, although the ways in which such a right might affect settlement dynamics would need to be given further thought.

<sup>309</sup> In this way WBP qui tam cases would differ from FCA cases; in FCA cases corporate cost internalization remains a relevant goal, rendering sanction imposition independently desirable. Sanction imposition may also remain important in securities fraud cases involving primary offerings and those involving controlled companies. These cases also implicate compensatory values not at stake in FOTM

qui tam regime I propose above is far better tailored to achieve these twin goals than are FOTM suits.

Most importantly, the envisioned qui tam regime would reward private enforcers only when they produce an actual informational benefit. Only individuals who volunteer original information about securities fraud would be entitled to bring suit; socially useless private suits that merely parrot information already in the public domain would therefore be barred.<sup>310</sup> Moreover, inefficiencies that result when corporations are forced to defend dual-track litigation would be eliminated: under the envisioned regime, either the SEC would pursue litigation, or whistleblowers would, but never both. This would not only save resources, but also might have the effect of changing the litigation dynamic in healthy ways. For example, without the threat of a parallel class action, companies might be more willing both to go to trial against the SEC to prove no wrongdoing occurred and to enter into settlement agreements in which they admit that it did.<sup>311</sup> In either case, market participants would end up understanding more about the firm's governance record.<sup>312</sup> A qui tam regime would also obviate the need for expensive litigation over issues that are not essential to the deterrence mission but remain part of the FOTM suit for historical reasons, such as class certification, reliance, loss causation, and the estimation of out-of-pocket damages.<sup>313</sup> Furthermore, because the SEC would be served with all qui tam pleadings and have the opportunity to make its views known to the court, it would stand in a better position to monitor and influence the effect of private litigation on the development of fraud standards.<sup>314</sup>

A WBP qui tam regime would also do a better job of disciplining the SEC than do FOTM class actions. As noted above, a qui tam option would make

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suits. Policymakers may therefore want to carve such cases out of the general prohibition on Rule 10b-5 class actions that I advocate here, although such a carve-out would present difficult line-drawing problems and may be unnecessary given alternative remedies available to investors under section 11 of Securities Act of 1933 and state corporate law, respectively.

<sup>310</sup> See Fisch, *supra* note 289, at 201 (observing that because FCA relators “often ha[ve] unique information about the case,” they are able to “contribute to the government’s ability to enforce the law in a way that is unlikely to exist” in securities fraud class actions); Rapp, *Beyond Protection*, *supra* note 289, at 97 (noting that “[i]nstead of ‘junk lawsuits’ filed after earnings restatements, [qui-tam style] securities fraud actions would more likely be based on *new* information, thereby enhancing market efficiency”).

<sup>311</sup> See *supra* note 69 and accompanying text.

<sup>312</sup> See also Fisch, *supra* note 289, at 198–200 (discussing a variety of inefficiencies that would be eliminated if a mechanism for coordinating enforcement efforts by the SEC and the private bar existed).

<sup>313</sup> See *supra* Part I.A (discussing how Rule 10b-5 class actions have become unmoored from their common law origins).

<sup>314</sup> See Engstrom, *supra* note 60, at 638 (discussing how unrestrained profit-driven private enforcement can yield “a form of statutory drift and mission creep as private enforcers drive law enforcement efforts in new and democratically unaccountable directions”).

whistleblowing more lucrative, helping to ensure that whistleblowers emerge, as well as lawyers to represent them. These parties would have a direct financial incentive to monitor SEC investigations and enforcement actions related to their tips, and to alert Congress or the media if the SEC failed to act aggressively enough. Qui tam litigation would also provide a cleaner benchmark against which the public might evaluate the SEC's enforcement performance. The SEC could be required to augment the congressional reports already required under the WBP with detailed information about qui tam litigation and the SEC's decisions to allow or forbid it. That information would make more transparent how extensively the SEC is relying on private parties to supplement its fraud enforcement efforts.<sup>315</sup> By aligning the proof requirements in SEC and private Rule 10b-5 litigation, the envisioned qui tam regime would also allow for a more apples-to-apples comparison of case outcomes.<sup>316</sup>

Replacing FOTM suits with qui tam litigation could also have the positive effect of encouraging greater corporate self-policing and cooperation. As discussed in Part I.B.2.a, the threat of strict corporate liability in a FOTM suit may dissuade boards from engaging in self-policing efforts or from otherwise fully cooperating with an SEC investigation. The WBP already makes self-policing more attractive: faced with an increased likelihood that whistleblowers will report frauds to the SEC, boards have stronger incentives to discover and report misconduct promptly, obtaining whatever leniency they can for their firms, from both the SEC and the market. But the threat of strict corporate liability in a FOTM suit continues to create countervailing incentives. Replacing FOTM suits with qui tam litigation would change this dynamic (as would, of course, getting rid of private enforcement entirely). The elimination of dual-track litigation would mean

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<sup>315</sup> To be sure, increased transparency could also produce undesirable results if it pushes the SEC to “maximize objective and observable measures of enforcement success, such as total monetary recoveries, over harder-to-quantify and empirically contestable goals such as total illegal activity deterred or aggregate welfare gains.” Engstrom, *supra* note 60, at 681. This problem may already exist at the SEC, however, and warrants independent solutions. See, e.g., Stephen J. Choi et al., *Scandal Enforcement at the SEC: The Arc of the Option Backdating Investigations*, 15 AM. L. & ECON. REV. 542 (2013) (finding empirical support for the hypothesis that the SEC pursued more marginal investigations into options backdating as the media frenzy surrounding that scandal persisted, at the expense of pursuing other more egregious securities law violations); James Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 778 (2003) (empirical study of SEC enforcement actions finding evidence “consistent with the hypothesis that the SEC, at least during the sample period, preferred weak opponents”); Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities & Exchange Commission*, 33 HARV. J.L. & PUB. POL’Y 639, 646 (2010) (“The focus is on the number of cases brought by the Division, and, to a lesser extent, on the size of the fines collected by the SEC.”).

<sup>316</sup> The alignment would not be perfect, however, due to the continued applicability of the PSLRA's pleading standards. See *supra* note 304 and accompanying text.

that the leniency the SEC could bestow on a deserving corporation would be more potent. For example, the SEC might choose to pursue relief only against the corporate officers responsible for the fraud if the firm could demonstrate reasonable policing efforts, barring any private Rule 10b-5 litigation against the corporation;<sup>317</sup> or, if individual sanctions would fail to generate bounties sufficient to encourage future tips, the SEC might choose to impose fairly modest sanctions on the corporation and allow them to be paid through insurance.

To be sure, some may view this increased SEC leverage as problematic. The SEC could abuse its power, downplaying misconduct by favored defendants by charging them with lesser offenses, or worse yet taking no enforcement action at all related to a valid tip while simultaneously barring qui tam litigation. But this critique ignores the disciplining influences discussed above and is based on a view of the SEC as a corrupt agency that most knowledgeable observers reject.<sup>318</sup> It is worth noting, however, that there is no evidence that the DOJ has abused its authority to terminate qui tam litigation under the FCA to favor particular defendants.<sup>319</sup> In fact, the problem is quite the opposite: the DOJ essentially *never* exercises its termination right.<sup>320</sup> As Professor David Engstrom has explained, a variety of bureaucratic pathologies could explain this, including a fear by agency officials that “subsequent events may turn up evidence of wrongdoing, thus embarrassing the agency,” coupled with the realization that “the actual and reputational costs of terminating bad lawsuits can be reliably shifted to the judiciary.”<sup>321</sup> Underutilization rather than overutilization of the termination right is a much more likely scenario in the WBP qui tam context, as well. Indeed, my expectation is that except in rare cases where the tip is obviously frivolous, the right to sue would be granted if the SEC did not itself launch an investigation.<sup>322</sup> Thus, I do not expect the SEC’s decision to permit qui tam litigation to encompass much of a merits screening function (which is why I recommend preserving the PSLRA’s heightened pleading standards and discovery stay).<sup>323</sup>

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<sup>317</sup> This would comport with Professor Arlen’s recommendations. *See supra* note 269 and accompanying text.

<sup>318</sup> *See supra* note 285.

<sup>319</sup> *But cf.* Engstrom, *supra* note 292, at 1730–31, 1735 (finding intervention is less likely if the defendant is a Fortune 100 company or a top defense contractor).

<sup>320</sup> *Id.* at 1717.

<sup>321</sup> Engstrom, *supra* note 60, at 682–83.

<sup>322</sup> Prompt self-reporting by a firm would hopefully cause the SEC to launch its own investigation, leading it to preclude qui tam whistleblower litigation.

<sup>323</sup> Designing the qui tam mechanism in such a way as to encourage merits screening would certainly be desirable, however, and is not necessarily a hopeless cause. *See, e.g.*, Engstrom, *supra* note 292, at 1749 (suggesting that the government be held liable for a prevailing defendant’s fees or be

Coupling the elimination of FOTM suits with the addition of a qui tam provision to the WBP has one final, practical benefit to recommend it: it should be far more politically palatable than would be a proposal to abolish private enforcement altogether. Congress could counter charges that the reform will sacrifice fraud deterrence with persuasive arguments that the reform will, in fact, strengthen fraud deterrence. While resistance to the proposal by the powerful class action bar should be expected, it should be less intense than the resistance a proposal to eliminate all private Rule 10b-5 enforcement would provoke—Rule 10b-5 class actions lawyers could, after all, adjust to the new system by becoming WBP whistleblower counsel. The idea also finds support in the scholarly literature,<sup>324</sup> and its implementation would be relatively straightforward. Although numerous additional details would need to be worked out, the sketch I provide shows how the program could build on the substantial existing legal infrastructure created around the WBP and FOTM class actions.

To be clear, I am not suggesting that adopting a qui tam provision to replace FOTM suits is necessarily better than eliminating private Rule 10b-5 enforcement altogether (assuming the latter option were politically feasible). The WBP may work effectively without qui tam litigation, or qui tam litigation may be a cure far worse than the disease (the FCA's qui tam provision is highly controversial, and many think that its costs exceed its benefits). It is also possible that a totally different set of reforms would do better to promote optimal deterrence.<sup>325</sup> I am making the more limited point that, if preserving private Rule 10b-5 enforcement is desirable, adding a qui tam provision to the WBP would be preferable to retaining FOTM suits. Importantly, the WBP qui tam provision that I envision would not extend to any securities law violations except for violations of Rule 10b-5; thus, it would not create private enforcement where none exists today.

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required to provide qui tam plaintiffs with a minimum recovery in order to induce desired levels of case termination); Rose, *supra* note 41, at 1358 (discussing reason-giving as one way to protect against arbitrary or biased decisions).

<sup>324</sup> See *supra* note 289; see also Engstrom, *supra* note 60; Stephenson, *supra* note 41.

<sup>325</sup> See, e.g., Jonathan Macey, Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading, 105 MICH. L. REV. 1899 (2007) (arguing for a limited exception to insider trading liability that would allow for short-selling on negative inside information). Some may even prefer that the WBP fail. If one believes that financially incentivizing employees to “snitch” on their coworkers is a bad idea to begin with, one will oppose shoring up those incentives through the creation of a WBP qui tam provision. As discussed in Part III.A, an insider with knowledge of fraud would have stronger incentives to participate in a well-run WBP than to serve as a confidential informant in a FOTM suit. But the relative inferiority of FOTM suits in detecting fraud is an odd justification for their retention. A better solution for people of this mindset might be to modify the WBP so that only outsiders could participate, or to adopt the proposal advanced by Professors Casey and Niblett. See *supra* note 297 and accompanying text.

CONCLUSION

Although much has been written about the SEC's new Whistleblower Bounty Program, this Article is the first to consider the program's impact on the longstanding debate over fraud-on-the-market (FOTM) class actions. The analysis demonstrates that the program has profound implications for that debate. If the bounty program succeeds, it will replicate the fraud detection benefits of FOTM class actions while simultaneously increasing their costs—rendering them a pointless yet expensive redundancy. If the SEC proves incapable of effectively administering the bounty program, amending it to include a qui tam provision for Rule 10b-5 violations would offer several advantages over retaining FOTM class actions. Either way, the bounty program has implications for FOTM suits that policymakers should not ignore.