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Research Note

Whistleblowers and the Dodd-Frank Act

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Abstract – Protecting the rights of whistleblowers has been a major topic since the 2008 financial crisis. This research note explains why whistleblowing is important, the difference between internal and external whistleblowers, and the 2010 Dodd-Frank Act impacts to whistleblower programs.

Introduction

In recent years we have seen large companies such as Enron, WorldCom, and Lehman Brothers fall due to ethical and financial misconduct. In the case of Enron and WorldCom, profits and assets were heavily inflated by using creative but fraudulent accounting strategies. On the other hand, unethical lending standards were implemented at Lehman Brothers in order to make housing affordable during the rise of the United States housing bubble. All three of these situations not only caused their firms to declare bankruptcy but also cost millions of dollars for employees, investors, and the Federal Government.

One might ask how come these fraudulent activities were not caught before so much damage struck? In many cases, employees were aware of these activities well in advance of financial failure. However, these companies did not have a culture where confronting unethical practices was encouraged. In one example, Cynthia Cooper, internal auditor for WorldCom, brought forward an internal audit to the Board of Directors Auditing Committee even though the CFO asked that she delay her investigation. However, by that time it was too late and failure was imminent.[1]

So, what protections or processes are in place for individuals that want to bring these illegal or corrupt activities forward? This act is commonly known as "whistleblowing" and just recently has the Securities and Exchange Commission implemented such protections to encourage people to bring corporate corruption to justice.

Whistleblowers

In the 1970s Ralph Nader, United States Activist, was one of the first people to devise the term "whistleblower" or "whistleblowing." According to him, "Whistleblowing is an act of a man or woman who, believing that the public interest overrides the interest of the organization he serves, blows the whistle that the organization is in corrupt, illegal, fraudulent or harmful activity."[2] Although this overarching definition is true, there are two types of whistleblowers: internal and external. Internal whistleblowers refer to those that find unethical behavior or illegal misconduct within their organization and reports it up the chain-of-command. In contrast, external whistleblowers will report to an outside organization such as the Securities and Exchange Commission (SEC).[3]

Internal whistleblower programs are the last line of defense before employees report to an outside party and eventually cause millions of dollars in financial consequence. However, it's no surprise that employees have had their hesitations to speak up in the past. Companies were able to fire employees at any given moment before the 1960s. In the late 1970s, federal and state legislations were passed such as anti-discrimination legislations, Truth in Lending laws, the Fair Credit Reporting Act, and the Environmental Protection Act, which were intended to protect the community from illegal practices. Over the years many laws have been created for governmental purposes but not so many for the private sector.[4] To put this into context, in the early 2000s new laws were just passed to give stronger protections for individuals working in public firms. According to Steven Kohn, whistleblower protections were implemented through the Sarbanes-Oxley Act Section 806, 18 U.S.C. 1514A, which was spurred by the classic accounting cases of Enron and WorldCom in 2002.[5] Nevertheless, a Federal legislation that was recently passed in 2010 has reshaped the earlier Whistleblower Program by providing protections and incentives for employees in publically traded firms: The Dodd-Frank Act.

Dodd-Frank Act and Impacts

The Dodd-Frank Act was enacted in 2010, which allowed whistleblowers to report information to the SEC that could lead to possible sanctions over $1 million.[6] Individuals would collect a range of 10% to 30% of the money that is collected by the SEC.[7] On top of that, employees are protected under this law from employer retaliation.[8] According to Section 922 of the Dodd-Frank Act, the following protections are administered:[9]

1. *Prohibition of Retaliation* – no employer can discharge or discriminate based on the lawful act of the whistleblower. If discharge or discrimination takes place, the whistleblower is protected under this act and may bring the case forward in the U.S. District Court. Also, the whistleblower is entitled to relief from the employer that includes, reinstatement with same seniority status, two months back pay, and coverage of litigation costs.
2. *Confidentiality* – the SEC Commission will not disclose any information provided by the whistleblower, which could reveal the identity of the individual.
3. *Rights retained* – all federal and state rights will be retained.

The first payout issued under the program was awarded in August 2012 to an individual who helped the SEC interrupt a multi-million dollar fraud deal. The award was 30%, the maximum allowed under Dodd-Frank, of the $150,000 that was collected at the time. Although, during the Obama Administration the SEC has paid out upwards of $1.6 billion dollars,[10] one must look at the amount of money the government has collected. Since 2009, the government has collected $13.2 billion dollars through the False Claims Act alone, which is the "bread and butter" of the whistleblower program.[11] According to SEC Enforcement Director Robert Khuzami, "Had this whistleblower not helped to uncover the full dimensions of the scheme, it is very likely that many more investors would have been victimized."[12] As Mr. Khuzami alluded to, these payouts are a small fraction compared to the money that is being collected from deterring fraudulent activities. Furthermore, the impacts to the financial markets would be devastating as well.

Proponents of the newly refined whistleblower program have argued that the program has "turned anti-fraud efforts into a lottery."[13] They are afraid that employees will turn to the SEC instead of reporting misconduct internally first in search of a big payout. In one instance, a whistleblower has already received $104 million.[14] However, studies conducted by the Ethics Research Center have shown that 2% of whistleblowers went directly to an external party without reporting internally first.[15] The studies further showed that 82% would report big fraudulent crimes to an outside party but only 43% would do it solely for the reward.[16] This study shows that employees still respect internal whistleblowing programs and would only seek external help if the misconduct is severe and employers have not responded to the situation in a timely matter.

Conclusion

While we have seen many reforms in the past, whether it is to regulate the governmental or private sector, the Dodd-Frank Act is one that has displayed traction. We have witnessed the SEC pay out its' first award in August 2012, only two years after the program was created. If we look at the awards as well as the amount of tips that are being sent to the SEC (about eight tips a day),[17] one can conclude that employees are feeling more comfortable than ever reporting illegal behavior. However, the government's involvements in these cases are not always needed if the company has an established internal whistleblower program. Evidence has shown that employees are willing to look internally before seeking the protection of the Dodd-Frank Act.

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