

New Insights from Research on the Impact of U.S. Whistleblowing Regulatory Regimes

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Outline

1. Background on U.S. whistleblowing environment
2. Concerns would-be whistleblowers face
3. Do whistleblowers help regulators?
4. Overall assessment

Background on U.S. environment

- False Claims Act (1863) – actions against contractors that defraud the federal government
- Insider Trading and Securities Fraud Enforcement Act (1988) – offers rewards of up to 10%, but only 6 claimants for a total of \$1.2MM

Background on U.S. environment

- Tax Relief and Health Care Act (2006)
 - Rewards for information about violations of tax law
- Sarbanes-Oxley Act (2002)
 - Establishes procedures to file internal complaints
 - Protects anonymity of whistleblower
 - Prohibits retaliation
- Dodd-Frank (2011)
 - Monetary incentives between 10%-30% of sanctions
 - Must offer original information that leads to a successful enforcement action

Dodd-Frank – 2016 Annual Report

- Tips received:

2011	2012	2013	2014	2015	2016
334*	3,001	3,238	3,620	3,923	4,218

- Types of allegations:
 - Corporate disclosures and financials (938), offering fraud (646), manipulation (472), insider trading (262)
- Rewards:
 - In 2016: \$57MM to 13 whistleblowers
 - Since 2011: \$111MM to 34 whistleblowers
 - Largest award: \$30MM in September 2014
 - Ten largest awards ~ \$100MM

Costs of blowing the whistle

- Retaliation
 - Loss of job / pay increase / promotion
 - Harassment and intimidation
 - Being “blacklisted” in the profession
- *Ex ante* probability of receiving a reward is low
 - Only 0.2% of tips have resulted in a reward
 - Information must be new to regulators
- Will regulators even listen?
 - Harry Markopolos: *“In May 2000, I turned over everything I knew to the SEC. Five times I reported my concerns, and no one would listen until it was far too late.”*

Do whistleblowers help regulators?

- Are enforcement outcomes different when a whistleblower is involved?
 - Firm penalties
 - Employee penalties
 - Other penalties (e.g., the firm's auditor)
- We examine all SEC enforcement actions since SOX
- Whistleblowers are identified from OSHA complaints

Do whistleblowers help regulators?

- No whistleblowing (N = 510)

	Firm penalties	Employee penalties	Prison sentences	Other penalties
Mean	\$5.1MM	\$23.5MM	23.6 months	\$4.8MM

- Whistleblowing (N = 148)

	Firm penalties	Employee penalties	Prison sentences	Other penalties
Mean	\$74.2MM	\$62.0MM	34.7 months	\$58.4MM

Do whistleblowers help regulators?

$$Penalties = \alpha + \beta WB + \gamma Controls + \varepsilon$$

- Controls include:

- % Initial abnormal return
- Violation period
- # C-level respondents
- # Code violations

- WB involvement in enforcement process is associated with:

- Larger firm penalties
- Larger employee penalties
- Longer prison sentences
- Larger “other” penalties

Do whistleblowers help regulators?

- Both “tipsters” and “non-tipsters” are associated with enforcement outcomes
- Time to discovery is shorter when WB is involved
 - Regulatory proceedings period is not longer (except for non-tipster WB involvement)
- Punch line: Whistleblowers add value to regulators

Overall assessment

- Has U.S. whistleblowing program had a net positive impact on corporate behavior?
- Difficult to answer
 - Cannot observe the counterfactual
 - Cannot observe or quantify all the costs and benefits
- Reasons for both optimism and caution going forward...

Reasons for optimism

- Whistleblowing awards under Dodd-Frank have been more common than with prior whistleblowing programs
- Wilde (2017, *The Accounting Review*) – “...firms subject to whistleblowing allegations exhibit significant decreases in financial reporting and tax aggressiveness.”
 - Deterrence effect persists for about two years

Reasons for caution

- Financial incentives encourage both legitimate and frivolous complaints
- Difficult and costly to distinguish the two

Reasons for caution

- If regulators provide financial incentives to encourage whistleblowing, do firms provide financial incentives to *discourage* whistleblowing?
- We studied 663 firms accused of financial misreporting from 1996-2011.
- We examined the number of stock options granted to “rank and file” employees during misreporting period.

Reasons for caution

	Control firms	Misreporting firms
Rank and file option grants	1.62%	2.49%
	N = 10,070	N = 1,243

	Before violation	During violation	After violation
Rank and file option grants	2.17%	2.49%	1.67%
	N = 1,812	N = 1,243	N = 2,612

- Misreporting firms grant more employee stock options during periods of misreporting

Reasons for caution

- Does it work? Are larger stock option grants associated with a reduced incidence of employee whistleblowing?

	No Whistleblowing	Whistleblowing
Rank and file option grants	2.44%	1.37%
	N = 705	N = 63

- Whistleblowers are less likely to emerge when their employer provides financial incentives to remain quiet

Reasons for caution

- WSJ (February 25, 2015) – “SEC Probes Companies’ Treatment of Whistleblowers”

“In recent weeks the agency has sent letters to a number of companies asking for years of nondisclosure agreements, employment contracts and other documents...”

“...these documents sometimes include clauses that impede employees from telling the government about wrongdoing at the company or other potential securities-law violations...”

“In some cases, the firms require employees to agree to forgo any benefits from government probes, effectively removing the financial incentive for participating in the SEC program.”

My view

- Totality of the evidence to date suggests whistleblowing provisions in Dodd-Frank are a net positive for the U.S. reporting environment
- There is no panacea for corporate fraud
- The effectiveness of any whistleblowing regime is a function of its specific features, implementation, and long-term commitment from regulators

Thank You
