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# ENCOURAGING LITIGATION: WHY DODD-FRANK GOES TOO FAR IN ELIMINATING THE PROCEDURAL DIFFICULTIES IN SARBANES-OXLEY

*Jessica Luhrs**

## I. INTRODUCTION

In the wake of the recent financial crisis, widely touted as "the Great Recession,"[1] the government and public have struggled to identify a proper solution in order to prevent another catastrophic hit to the national economy. One of the most difficult aspects of this endeavor has been understanding the sophisticated and exotic investment schemes that contributed to this crisis. Investment products such as credit default swaps, collateralized debt obligations, and other derivatives were poorly understood and, despite their exponential growth in the years leading up to the crisis, were poorly regulated.[2] As such, a national financial crisis spanned borders, highlighting the weakness of an interconnected global economy composed of financial instruments beyond the understanding of many investors and regulators.

The Dodd-Frank Act is a recent response to this crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), signed into law by President Obama on July 21, 2010, institutes many changes to the way the Securities and Exchange Commission ("the SEC") regulates the banking and financial services industries.[3] The legislation creates a council of regulators to monitor economic risks, creates a new

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1. Kristin N. Johnson, *From Diagnosing the Dilemma to Finding a Cure: Post-Crisis Regulation of Financial Markets*, 40 SETON HALL L. REV. 1299, 1300 (2010).

2. *Id*.

3. Keir D. Gumbs, *Covington Burlington, LLP Client Advisory: Dodd Frank Beefs Up SEC and CFTC Enforcement*, 1855 PLI/Corp 413, 415 (PLI Corp. Law & Practice, Course Handbook Ser. No. 27014, 2010).

agency to regulate consumer financial products, and sets new standards for trading derivatives.[4] Further, Dodd-Frank includes whistle-blower protections, shareholder approvals of golden parachute payments and say-on-pay votes, disclosures of hedging and leadership structures, and compensation disclosure requirements.[5] Proponents of Dodd-Frank promise that it will reduce the chances of another crisis and allow regulators to better handle one, should it arrive.[6] They further tout its capacity to restore investor confidence, protect consumers and encourage economic growth.[7] In contrast, opponents lament that Dodd-Frank "is a 2,300-page legislative monster . . . that expands the scope and the powers of ineffective bureaucracies."[8]

Whatever the public's estimation of Dodd-Frank as a whole, one section in particular is the subject of hot debate. The sweeping whistle-blower protections included in Dodd-Frank have garnered significant attention, particularly because they dramatically decrease the barriers and increase the incentives for corporate whistle-blowers.[9] Specifically, Dodd-Frank amends many provisions in the Sarbanes-Oxley Act to broaden both the class of individuals who may be considered whistle-blowers, as well as to include more employers and additional causes of action. While many critics of Sarbanes-Oxley argue that it did not go far enough in protecting whistle-blowers, this article argues that Dodd-Frank has gone too far in eliminating the procedural difficulties in Sarbanes-Oxley by drastically lowering the obstacles to filing claims, without providing safeguards against the inevitable onslaught of meritless or fraudulent claims. Furthermore, Dodd-Frank disincentivizes transparency as a means of self-regulation, thus placing even more responsibility for regulating financial markets in the hands of a resource-strapped agency that may not be equipped to identify, understand and address problems in a timely manner.

The first part of this article will identify the specific whistle-blower protections included in Dodd-Frank, followed by a comparison to previous rules under Sarbanes-Oxley, and conclude that Dodd-Frank skews the incentive structure such that the SEC will surely face an onslaught of false or meritless claims. Next, self-regulation as an effective means of market regulation along with government oversight will be discussed. This discussion will highlight another shortcoming of Dodd-Frank, insofar as it

4. Damian Palette & Aaron Lucchetti, *Law Remakes U.S. Political Landscape*, WALL ST. J., July 16, 2010, *available at* http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html.

5. Ryan J. Maierson, *Dodd-Frank Wall Street Reform and Consumer Protection Act: The General Counsel's Quick Reference Guide*, 1855 PLI/Corp 371, 374 (PLI Corp Law & Practice, Course Handbook Ser. No. 27014, 2010).

6. Palette & Lucchetti, *supra* note 4.

7. *Id*.

8. *Id*. (quoting Sen. Richard Shelby (R., Ala.)).

9. Maierson, *supra* note 5, at 374–75.

discourages market transparency as a means of market regulation. Finally, solutions to the problems inherent in Dodd-Frank will be offered, including repairing the whistle-blower incentive structure, encouraging transparency and internal corporate whistle-blower processes, and publicly prosecuting false claims to establish a clear no-tolerance policy.

## II. EXPANDED WHISTLE-BLOWER PROTECTIONS UNDER DODD-FRANK

As defined in Dodd-Frank, a whistle-blower includes any person or group providing any information that relates to any violation of securities law.[10] Specifically, whistle-blowers may provide information pertaining to a violation of any provision of the Securities Exchange Act of 1934, criminal retaliation and violation of any other law, rule or regulation that is within the jurisdiction of the SEC.[11] In addition, whistle-blowers may provide the SEC with reports of financial fraud by employees of a covered employer.[12]

The class of whistle-blowers entitled to an award does not include employees of certain governmental or regulatory agencies, or those who were employed by such agencies when they obtained the information leading to their claims.[13] In addition, employees convicted of a criminal violation related to the activities giving rise to their whistle-blowing claim are excluded, as are those who obtained the information giving rise to their claim in the course of an audit required under securities law and who could not lawfully submit information under § 10A of the Securities Exchange Act.[14] Finally, those who knowingly provide false information may not receive an award.[15] These exclusions are narrow, however, and therefore one commentator has noted that "even an attorney who discloses the information in violation of the attorney/client privilege seems to be eligible to receive a bounty (unless such attorney can somehow be criminally convicted for this impropriety)."[16]

Importantly, whistle-blowers must provide "original information" not known to the SEC, and not "exclusively derived" from an allegation made in an official hearing, government report, audit, investigation, or from the

10. Maierson, *supra* note 5, at 374.
11. *Id*.
12. *Id*.
13. Esta E. Stecher, *Dodd-Frank Act Whistleblower Provisions: Dodd-Frank Act Contains Several New and Expanded Whistleblower Provisions, Including Mandatory Rewards, Publications*, 1849 PLI/Corp 861, 864 (PLI Corp Law & Practice, Course Handbook Ser. No. 24008, 2010).
14. *Id*.
15. *Id*.
16. John C. Coffee, Jr., *New York Law Journal—Hidden Impacts of the Dodd-Frank Act*, 1849 PLI/Corp 871, 874 (PLI Corp. Law & Practice, Course Handbook Ser. No. 24008, 2010).

media.[17] Increasing the scope of Dodd-Frank, information supplied by a whistle-blower may be related to securities violations that occurred either before or after the passage of Dodd-Frank.[18] Where the information provided by a whistle-blower is insufficient to lead to "successful enforcement" of an action, however, the SEC may refuse to pay out a bounty.[19] If the SEC makes a minimal award or no award at all, the whistle-blower may appeal the SEC's decision to a court of appeals.[20]

Retaliation against a whistle-blower is explicitly forbidden in Dodd-Frank.[21] Employers may not "discharge, demote, suspend, threaten, harass, [or otherwise] discriminate against the whistle-blower in the terms and conditions of employment because of any lawful act done by the whistle-blower" in providing the SEC with information, or initiating or testifying in an SEC investigation or judicial administrative action based upon this information, or for making disclosures protected under Sarbanes-Oxley.[22]

Whistle-blowers alleging retaliation may sue in federal district court, and relief may include reinstatement of prior seniority, double back pay with interest, and compensation for litigation costs including expert witnesses and reasonable attorneys' fees.[23] Notably, the burden of proof for whistle-blowers alleging a *prima facie* case of retaliation is significantly lower under Dodd-Frank than under other federal anti-retaliation statutes.[24] Whereas in other federal laws employees must show that the protected conduct—that is, the conduct they allege served as a basis for their employer's retaliation—was a determining or significant factor in the retaliation, under Dodd-Frank employees need only show that the protected conduct was a *contributing* factor.[25] To defeat this claim, an employer must then provide clear and convincing evidence that they would have taken the same action were it not for the employee's protected conduct.[26]

Claims of retaliation must be brought within six years after the retaliation, or within three years after facts material to the right of action were or should have been discovered, but in any case within ten years after the retaliation.[27] Sarbanes-Oxley claims must be brought within 180 days

17. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub L. No. 111-203, § 922, 124 Stat 1376, 1841–42 (2010).

18. Maierson, *supra* note 5, at 374–75.

19. Coffee, *supra* note 16, at 875.

20. *Id*. (noting that this ability to appeal could result in the SEC's litigation docket containing a new class of bounty denials and appeals cases).

21. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, §748.

22. *Id*.

23. Maierson, *supra* note 5, at 374–75; Miranda Tolar, *Whistleblowers in the Corporate Context: And Employer's Perspective*, ASPATORE, Nov. 2010, at *4, *available at* 2010 WL 4774893.

24. *Expansion of Whistleblower Protection: The Dodd-Frank Act*, COOLEY LLP (Aug. 4, 2010), http://www.cooley.com/expansion-of-whistleblower-protection-the-dodd-frank-act.

25. *Id*.

26. *Id*.

27. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, §922.

of the date on which the violation occurred, or the date when the whistle-blower learned of the action.[28]

Dodd-Frank amends the Commodity Exchange Act and the Securities Exchange Act of 1934 to provide a mandatory reward for those whistle-blowers that bring original information and meet the other requirements as set forth in Dodd-Frank.[29] Whistle-blowers may recover an amount between ten percent and thirty percent of the total monetary sanctions imposed under Dodd-Frank.[30] When determining the amount of an award, the SEC may consider the significance of the information provided by the whistle-blower, the degree of assistance by the whistle-blower and his or her legal representative, and the interests of the SEC in deterrence by making an award to the whistle-blower.[31] However, a whistle-blower must reveal his or her identity in order to collect the award.[32]

Dodd-Frank provides funding for whistle-blower awards by establishing a Securities and Exchange Commission Investor Protection Fund and a Commodity Futures Trading Commission Customer Protection Fund in the U.S. Treasury.[33] These funds will be partially funded by some of the monetary penalties brought under the securities laws.[34]

## III. A DEPARTURE FROM SARBANES-OXLEY

Prior to Dodd-Frank, Sarbanes-Oxley set forth the rules for reporting information regarding financial fraud, including protections for whistle-blowers. Passed in 2002 in reaction to the Enron and WorldCom scandals, Sarbanes-Oxley set forth unprecedented anti-retaliation protections for whistle-blowers and was lauded as one of the "most protective anti-retaliation provisions in the world."[35] Despite its celebrated passage, however, in the first three years only 3.6% of whistle-blowers were successful in their claims under the act, and on appeal, only 6.5% of whistle-blowers were successful.[36] Scholars have attributed this low success rate in part to a strict application of procedural and statutory requirements under Sarbanes-Oxley that resulted in most cases failing to

28. Esta E. Stecher, *Sullivan & Cromwell LLP—Dodd-Frank Act Whistleblower Provisions: Dodd-Frank Act Contains Several New and Expanded Whistleblower Provisions, Including Mandatory Rewards, Publications*, 1849 PLI/Corp 861, 865 (PLI Corp. Law & Practice, Course Handbook Ser. No. 24008, 2010).

29. Stecher, *supra* note 28, at 864.

30. Maierson, *supra* note 9, at 374.

31. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, §922.

32. Maierson, *supra* note 9, at 375.

33. Stecher, *supra* note 28, at 864.

34. *Id*.

35. Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 65 (2007).

36. Moberly, *supra* note 35, at 65.

meet the legal standards of a Sarbanes-Oxley claim and thus never reaching a determination of the facts on the merits.[37] Indeed, 66.7% of cases brought to the Occupational Safety and Health Administration ("OSHA") were rejected, and 95.2% of the cases appealed to administrative law judges were rejected.[38] Some of these procedural and statutory requirements are discussed below.

Under Sarbanes-Oxley, whistle-blowers included only those employees providing information regarding financial fraud.[39] In these cases, whistle-blowers reported violations to the OSHA, and Department of Labor processes were used in retaliation cases.[40]

Whistle-blowers could only bring retaliation claims against publicly traded companies. In order to bring a successful suit, whistle-blowers working for private subsidiaries of public companies had to prove that the subsidiary was either an alter ego of the publicly traded parent company, or an agent of that company.[41]

Under Sarbanes-Oxley, whistle-blowers alleging retaliation first filed complaints with OSHA, which then conducted an investigation and issued preliminary orders.[42] A complaint was required to be filed with OSHA within ninety days of the date on which the violation occurred.[43] Not surprisingly, this short filing requirement eliminated many whistle-blower claims; according to one study, in 2006, fifteen percent of the Sarbanes-Oxley whistle-blower claims were dismissed for failure to file a timely claim.[44] Another scholar suggests that the failure rate for claims brought to the OSHA based solely on the statute of limitations was eighteen percent, and as high as one-third for cases brought to administrative law judges.[45]

In the event that either party objected to the results of the OSHA investigation and orders, an administrative judge within the Department of Labor conducted an evidentiary hearing and issued an appealable decision.[46] In the case of an appeal to the Department of Labor's Administrative Review Board, if the board failed to issue a final decision within 180 days of filing the complaint, the whistle-blower could bring an action in federal court, where it would be reviewed *de novo*.[47]

The Dodd-Frank amendments mark a significant departure from the

37. Moberly, *supra* note 35, at 71.
38. *Id*.
39. Maierson, *supra* note 9, at 374.
40. *Id*.
41. Tolar, *supra* note 23, at 2.
42. *Id*.
43. *See* 18 U.S.C. § 1514A(b)(2)(D) (2010).
44. Jisoo Kim, *Confessions of a Whistleblower: The Need to Reform the Whistleblower Provision of the Sarbanes-Oxley Act*, 43 WM. & MARY L. REV. 241, 251 (2009).
45. Moberly, *supra* note 35, at 72.
46. Tolar, *supra* note 23, at 2.
47. Tolar, *supra* note 23, at 2.

original Sarbanes-Oxley rules in several respects. First, unlike Sarbanes-Oxley, Dodd-Frank covers both public companies and subsidiaries or affiliates whose financial information is included in its financial statements.[48] This effectively encompasses most subsidiaries and affiliates of public companies.[49] Dodd-Frank also protects employees of nationally recognized statistical rating organizations.[50]

Second, while it was unclear whether Sarbanes-Oxley suits in federal court were entitled to a jury, under Dodd-Frank, litigants have the express right to a jury trial.[51] This is particularly significant because juries are often skeptical about employers in whistle-blower cases, and because these suits often involve complicated financial transactions that may be difficult to explain to a jury.[52] Therefore the right to a jury trial will likely prove advantageous to whistle-blowers under Dodd-Frank.

Third, Dodd-Frank likely renders arbitration agreements of Sarbanes-Oxley claims unenforceable. Specifically, Dodd-Frank states that "[n]o predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section."[53] In addition, Dodd-Frank most likely nullifies any post-termination waivers of Sarbanes-Oxley claims.[54] This means that if an employee signed an agreement not to file a Sarbanes-Oxley claim upon termination of employment, that agreement will not be enforced.

Finally, whistle-blowers who win retaliation claims are entitled to double back pay with interest under Dodd-Frank, as opposed to merely back pay under Sarbanes-Oxley.[55] Dodd-Frank also explicitly provides for reinstatement with seniority,[56] whereas under Sarbanes-Oxley whistle-blowers were not always reinstated even after a court order.[57] In fact, the Second Circuit ruled that courts lacked jurisdiction to enforce preliminary orders of reinstatement under Sarbanes-Oxley.[58] Thus, employees who were formerly only entitled to back pay after wrongful termination under Sarbanes-Oxley may now receive double back pay as well as reinstatement to their previous position of seniority under Dodd-Frank.

48. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, §929A.

49. Tolar, *supra* note 23, at 2.

50. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922(b).

51. *Id*.

52. Tolar, *supra* note 23, at 13.

53. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922(c).

54. Tolar, *supra* note 23, at 3.

55. *Id*. at 4.

56. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922(a).

57. Jisoo Kim, Comment, *Confessions of a Whistleblower: The Need To Reform the Whistleblower Provision of the Sarbanes-Oxley Act*, 43 J. MARSHALL L. REV. 241, 242–43; 254–55; 259; 262–63 (2009).

58. Kim, *supra* note 57, at 262.

## IV. AN INVITATION TO FILE FALSE AND MERITLESS CLAIMS

The myriad of expanded provisions under Dodd-Frank create a skewed incentive system for whistle-blowers. Barriers to filing claims have been drastically reduced. The statute of limitations has been extended from a mere ninety days under Sarbanes-Oxley to 180 days,[59] or in the case of retaliation, between three and six years for employers protected by the SEA under Dodd-Frank.[60] The class of whistle-blowers has been expanded, as have the types of companies within the scope of Dodd-Frank. Now, nearly any whistle-blower reporting any securities violation[61] against a broad range of public or private companies[62] will be covered by Dodd-Frank. Additionally, the burden of proof has been lowered for establishing a *prima facie* case of retaliation. Employees now need only show that the protected action was a *contributing* factor, rather than a determining or significant, factor, leading to the unfavorable personnel action giving rise to their claim.[63] Combined, these new rules reduce the likelihood that a whistle-blower's claim will be thrown out for failure to comply with the statutory formalities of Dodd-Frank. Employees are more likely to fall within the temporal statutory formalities with the longer statute of limitations. Employees are also more likely to have the requisite amount of proof in any retaliation complaints under Dodd-Frank because they no longer need to show anything near causation. Furthermore, for employers to defeat such retaliation claims, they must provide clear and convincing evidence that they would have acted the same way towards the employee in the absence of the protected conduct.[64] This provides additional protection for whistle-blowers because the clear and convincing standard is higher than the previous requirement of merely articulating a legitimate and non-discriminatory reason for conducting the personnel action.[65]

After whistle-blower claims survive the more lenient procedural and statutory requirements of Dodd-Frank, they are also likely to face more favorable treatment in trial. Under Dodd-Frank, Sarbanes-Oxley claims are now entitled to jury trials in federal court with large monetary awards at stake, thus increasing the likelihood that whistle-blowers who might not otherwise be able to afford counsel will be able to obtain an attorney on a contingent fee basis to aggressively litigate their claims.[66] Indeed,

59. Stecher, *supra* note 13, at 866.

60. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922. *See also* 18 U.S.C. § 1514A(b)(2)(D) (2010).

61. Maierson, *supra* note 5, at 373.

62. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922(a).

63. *See Expansion of Whistleblower Protection*, *supra* note 24.

64. *Id*.

65. *See Expansion of Whistleblower Protection*, *supra* note 24.

66. *See Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922*; 18 U.S.C. § 1514A(b)(2)(E).

commentators have predicted that more plaintiffs' attorneys will enter the field, drawn by the potentially staggering cash bounties.[67] They may even begin soliciting whistle-blowers who otherwise might not have considered filing a claim.[68] Further, contingency fee agreements might face lax regulation; firms could enter into a one-third contingency agreement with a would-be whistle-blower, and unlike fee awards in class action cases, judicial approval is not required for this fee.[69]

Jury trials are also likely to lead to more favorable results for whistle-blowers, as juries are generally suspicious of employers in whistle-blower cases.[70] This combination of competent legal counsel and sympathetic juries is likely to result in a significant increase in the number of successful whistle-blower claims, particularly when compared to the low success rate of Sarbanes-Oxley claims.[71]

On the other hand, Dodd-Frank provides strong incentives to bypass internal corporate regulatory measures and instead engage in a profit-seeking race. Successful whistle-blowers are entitled to a large chunk of the penalty levied against an employer, between ten percent and thirty percent.[72] Legal commentators have opined that this payout is "too much."[73] Indeed, given that SEC actions sometimes settle for between \$100 million and \$800 million, and that corporate defendants often settle with the SEC, even ten percent of the penalty is extraordinarily large.[74] Because whistle-blowers must provide original information not previously reported to the SEC, they are likely to rush to the SEC before utilizing internal corporate remedies in order to ensure that they are the first to provide the information.[75] If employees brought their concerns to internal counsel before the SEC, they would run the risk that their employers would report the claims to the SEC first, to ensure that the employee could not provide original information to the SEC.

The assistance of counsel may help weed out some meritless claims, but this incentive structure nonetheless provides little penalty for filing a weak claim on the off chance that it is successful. Attorneys are likely to build stronger cases by supplementing the whistle-blower's testimony with other evidence.[76] The SEC, an already resource-strapped agency,[77] is thus

67. Coffee, *supra* note 16, at 874.
68. *Id*.
69. *Id*. at 874.
70. *See* Tolar, *supra* note 23, at 13.
71. Moberly, *supra* note 35, at 94–95.
72. Maierson, *supra* note 5, at 374.
73. Christopher Wiener, *Blowing the Whistle on Van Asdale: Analysis and Recommendations*, 62 HASTINGS L.J. 531, 556 (2010).
74. Coffee, *supra* note 16, at 873.
75. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922.
76. Coffee, *supra* note 16, at 874.
77. Jim Puzzanghera, *SEC Chief Warns Against Budget Cuts*, LOS ANGELES TIMES, Feb. 5, 2011,

setting itself up to be inundated with both false and meritless claims brought by whistle-blowers seeking little more than a huge monetary payout. While Dodd-Frank includes an allocation of penalty fines to finance the prosecution of cases and payouts to whistle-blowers, it is unclear how it will be able to efficiently resolve a substantial number of cases if much of its time is wasted on empty claims.

These factors add up to create a strong incentive for whistle-blowers to attempt to file weak and meritless claims. Dodd-Frank cautions that whistle-blowers bringing false claims will not be entitled to a monetary award, but does not contain express language outlining a penalty for bringing such a claim.[78] As a result, plaintiff's law firms have been inundated with calls from would-be whistle-blowers eager to bring a claim and collect a bounty award, a trend that seems likely to continue.[79] Certainly law firms that accept cases on a contingent fee basis will weed out some weak claims, but it is likely that a large number of claims will still reach the SEC.

## V. MARKET SELF-REGULATION AS A SUPPLEMENT TO GOVERNMENT OVERSIGHT

Many of the inherent problems in Dodd-Frank's whistle-blower protections could be eliminated by scaling back the incentives for whistle-blowers and instead providing strong market incentives for self-regulation as a supplement to government oversight.

While Dodd-Frank creates a strong incentive for whistle-blowers to report perceived violations as quickly as possible, some critics argue that it still falls short of the inherent benefits of self-regulation, as opposed to direct government regulation under Dodd-Frank. This is because, unlike the SEC, the financial industry can access, asses and react to market information quickly. Particularly in complex financial markets, the ability to react to problems immediately is crucial, as opposed to waiting for a drawn-out SEC investigation.[80] By discouraging whistle-blowers from alerting their employers to potential problems first, Dodd-Frank essentially ensures that problems will not be addressed immediately. Further, some commentators suggest that direct government regulation of the financial sector is inefficient because it incorrectly allocates risk and, as a result, the

*available at* http://articles.latimes.com/2011/feb/05/business/la-fi-sec-schapiro-20110205.

78. Stecher, *supra* note 13, at 864 (2010).

79. Maxwell Kennerly, *The Idiot's Guide Whistleblowing Under the Dodd-Frank Wall Street Reform Act*, LITIGATION & TRIAL-THE LAW BLOG OF PLAINTIFF'S ATTORNEY MAX KENNERLY (Sept. 10, 2010), http://www.litigationandtrial.com/2010/09/articles/the-law/for-people/the-idiots-guide-whistleblowing-under-the-doddfrank-wall-street-reform-act/.

80. Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 670 (2010).

cost of capital increases.[81] In this vein, it is argued that market forces alone can incentivize financial firms to act with "due diligence," so long as those markets are efficient and transparent.[82] Certainly self-regulation of financial markets has been problematic in recent years, but this does not mean that the concept cannot be applied in new ways.

History has shown that market self-regulation can be extremely effective, and also that pure government oversight is rife with problems. Indeed, in so called "top-down, centralized" regulatory regimes, critics argue that the government has insufficient knowledge to identify root causes of problems, design solutions, implement rules, and motivate regulated industries to comply with rules.[83] In this vein, the centralized SEC regulatory body under Dodd-Frank could have inherent problems by nature of being a "top-down" government regulatory body.

Proponents of self-regulation also tout its potential to create a sense of ownership and participation in rule making, as well as to foster shared values and encourage voluntary compliance with rules made in accord with these values.[84] When private industry is involved in rule making, it becomes a compromise that recognizes the unique circumstances facing each industry. While, as skeptics are quick to point out, self-regulation can lead to collective action problems and even self-serving, illusory regulation,[85] these characterizations ignore the potential for efficient, effective regulation by pairing self-regulation with government oversight.

One example of effective self-regulation of markets is the disclosure-based regulatory system found in the 1934 Securities Exchange Act, passed by Congress in the wake of the Great Depression in order to regulate Wall Street.[86] Mandatory disclosures and antifraud measures, such as § 10(b), were principle among the regulations in this act.[87] Subsequent judicial interpretation of § 10(b) both narrowed the range of activities that fall within the scope of the regulatory power of that act and set a high burden of proof for private plaintiffs bringing claims under § 10(b).[88] This narrow interpretation of § 10(b) reflects a disclosure-based regulatory system, the favored regulatory policy of the past several decades.[89] The theory behind a disclosure-based system is that when investors have sufficient information about the firms in which they invest, they make rational

81. Carsten Gerner-Beuerle, *The Market for Securities and its Regulation Through Gatekeepers*, 23 TEMP. INT'L & COMP. L.J. 317, 321 (2009).

82. *Id*.

83. Omarova, *supra* note 80, at 672.

84. *Id*. at 671.

85. *Id*. at 672.

86. *See* Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 65 (2009).

87. *See* Colombo, *supra* note 86, at 65.

88. *See id*. at 67.

89. *See* Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1092 (2007).

choices and markets function efficiently.[90] This policy gives deference to individual choice and reduces government interference, suggesting that the best way to ensure that markets perform efficiently is to require firms to disclose financial data, not by encouraging an onslaught of private litigation by setting a low burden of proof for § 10(b) claims.[91] In this way, markets self-regulate by voluntarily disclosing data to investors and the government, and the government regulates markets by mandating and enforcing the rule of public disclosure.

Whereas the 1934 Securities Exchange Act set a high burden of proof for private litigants to decrease private litigation as a regulatory means and instead encourage transparency amongst financial firms, the Dodd-Frank Act encourages litigation as a means of regulation rather than inter-organizational transparency. By encouraging whistle-blowers to find and report fraud directly to the SEC, Dodd-Frank also encourages companies to decrease transparency in order to prevent whistle-blowers from discovering potentially harmful information. As such, this ripple effect harms investors seeking information about the companies in which they invest, and the SEC's ability to regulate the industry as a whole. Further, because investors have less information about the companies in which they invest, their decisions cannot act as a means of regulation. That is, their investment in or aversion to certain companies cannot determine the market value of those companies, and therefore market prices do not reflect the way informed, rational consumers would value those companies in an efficient, transparent market.

In contrast, if the barriers to litigation were higher for whistle-blowers, firms would have greater incentive to be transparent and open with employees, thus encouraging them to report issues internally so that they could be resolved efficiently and effectively. Further, transparency would increase the chances that the SEC would be privy to information about employers, and therefore decrease employees' opportunities to provide the SEC with "original" information.[92] Only after internal means of regulation were exhausted should whistle-blowers turn to litigation. Transparency and internal remedies foster a better corporate culture and sense of confidence amongst employees and investors alike, rendering this means of self-regulation a favorable solution.

Transparency has another important effect in self-regulation. Unlike government agencies, sophisticated investors have a strong incentive and ability to analyze companies to identify potential risks and problems. Indeed, they are better equipped to access and analyze market data in real time, and to determine which issues pose significant threats to the industry

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90. Dalley, *supra* note 89, at 1109.
91. *See id*. at 1092.
92. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922.

as a whole.[93] Hedge funds and investment firms, for example, often have entire departments dedicated to researching the companies in which they invest. These companies have significantly more resources than government investigators, and can prompt other companies to address problems by publishing reports and findings that discourage other investors from investing in a particular company and, in turn, encourage the company to address the problem or face real financial losses. This is because intermediaries such as investment firms "rely on their reputation in attracting business."[94] By effectively encouraging companies to become less transparent, however, Dodd-Frank chips away at an important means of regulation.

Dodd-Frank does take a step in the right direction by moving away from the OSHA regulatory mechanisms, as used by Sarbanes-Oxley, and instead utilizing the expertise of the SEC to investigate whistle-blower claims. Unlike the SEC, the OSHA had little securities fraud experience and was therefore ill-equipped to delve into the complex world of financial markets.[95] Nonetheless, the SEC simply lacks the resources to identify and respond to all cases of financial fraud in real time, particularly when compared to private firms and investors. Its regulatory power should therefore be supplemented by some form of market self-regulation, such as transparency.

## VI. CURBING FALSE CLAIMS

Both the SEC and private employers will need to take deliberate steps to curb false claims. As written, Dodd-Frank provides little disincentive for attempting to file a meritless claim because of the huge cash rewards at stake for a successful claim.

Employers have several options to discourage employees from bypassing internal reporting mechanisms. First, employers can improve internal reporting programs by adding cash bonuses. These bonuses need not match the massive potential payouts of SEC claims because they will offer the distinct advantage of a quick payout without the pain of protracted litigation. In addition, employers must ensure that managers can identify potential whistle-blower complaints to ensure either internal resolution or self-reporting to the SEC, before the employee goes directly to the SEC.[96]

Further, employers can continue a practice instituted in response to Sarbanes-Oxley, whereby many employers require employees to annually certify that they were not aware of any wrongdoing regarding the

93. Tolar, *supra* note 23.

94. Gerner-Beuerle, *supra* note 81, at 321.

95. *See* Jisoo Kim, *Confessions of a Whistleblower: The Need to Reform the Whistleblower Provision of the Sarbanes-Oxley Act*, 43 J. MARSHALL L. REV. 241 (2009).

96. Tolar, *supra* note 23, at 7.

employer's finances or financial reporting.[97] This practice acts as a strong defense against false claims. Nonetheless, in light of the probable unenforceability of arbitration and severance agreements under Dodd-Frank, employers must carefully craft these certifications to ensure compliance with the rules.[98]

In addition, it is imperative that employers implement strict anti-retaliation policies. This will help ensure that, should a whistle-blower bring a retaliation claim, they will not be able to prove the causal nexus element of a *prima facie* case of retaliation.[99] It would also behoove employers to keep records of e-mails and other documents that might provide a lawful explanation for the alleged retaliation.[100] This would allow employers to catch cases of retaliation internally and remedy them or report them to the SEC immediately. In addition, it would reassure employees that retaliation claims were being taken seriously and institute a no-tolerance policy for retaliation against employees.

Finally, the importance of creating a corporate culture that is friendly to internal whistle-blowing should not be understated. The Enron and WorldCom scandals, which influenced the development and passage of Sarbanes-Oxley,[101] illuminated the problems with discouraging insiders from coming forward with information about misconduct.[102] In Congressional hearings prior to the passage of that act, for example, an Enron whistle-blower testified about the intimidating nature of Enron executives, as well as the hostile environment that discouraged internal reporting.[103] The passage of Sarbanes-Oxley's whistle-blower protections was intended in part to overcome such hostile corporate environments by encouraging whistle-blowers to come forward.[104] By ensuring that employees feel comfortable and safe discussing their concerns internally, however, employers can avoid the costs involved in defending against SEC investigations spurred by whistle-blower claims. As always, any claims that could not be resolved internally could be self-reported to the SEC.

The SEC must also work to reduce the number of false or meritless claims, particularly by publicly sanctioning whistle-blowers and attorneys that file claims with no objective possibility of success on the merits, to set a clear no-tolerance policy. If Dodd-Frank itself does not provide disincentives for meritless claims, then the SEC must demonstrate that only serious claims will be tolerated. This could also include collaboration with

97. Tolar, *supra* note 23, at 7.
98. *Id*.
99. *Id*. at 7–8.
100. *Id*. at 9.
101. Wiener, *supra* note 73, at 533.
102. *Id.* at 534.
103. *Id.*
104. *Id*.

state bar associations to penalize attorneys who knowingly file meritless or false claims with the SEC.

## VII. CONCLUSION

As would-be whistle-blowers line up to file suits under Dodd-Frank, it will be crucial for the SEC to set some boundaries by penalizing those who knowingly file false claims, and by strictly adhering to the requirements that whistle-blowers provide original information. The original information requirement is itself likely to preclude many claims, but should nonetheless be publicized to ensure that meritless claims are not filed at all.

Furthermore, employers must create internal measures for employees to report perceived frauds and violations, and would be wise to create smaller bounties for employees who highlight real concerns within the company. This will ensure that employees have more incentive to resolve their concerns internally, decrease the chance that they can provide the SEC with original information, and foster a better workplace environment.

In addition, the SEC should consider supplementing its regulatory efforts with some form of market self-regulation. A disclosure-based system, for example, could be an effective way to increase transparency and foster efficient regulation.

By addressing some of the shortcomings inherent in Dodd-Frank, and exploring alternative means of regulation, the SEC can incentivize and regulate an efficient financial market. Particularly in the face of the recent financial crisis, efficient regulation is all the more important, and the government cannot afford to waste resources on defending against unnecessary litigation. Therefore Dodd-Frank's shortcomings with regards to whistle-blower incentives must be addressed to allow the SEC to regulate financial markets as the nation emerges from financial crisis into economic recovery.

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