

CALCULATING SEC WHISTLEBLOWER AWARDS:
A THEORETICAL APPROACH

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The Dodd-Frank Act provides that SEC whistleblower awards must equal not less than 10 and not more than 30 percent of the monetary penalties collected in the action to which they relate; SEC Rule 21F-6 provides criteria that the SEC may consider in determining the award percentage within the statutory bounds. When applying the Rule 21F-6 criteria, the SEC is required to think only in percentage terms, ignoring the dollar payout the award will actually yield. Last June the SEC proposed to change this, at least in cases where the existing methodology would yield an award less than \$2 million or greater than \$30 million. The proposed revisions to Rule 21F-6 have garnered controversy and have not yet been implemented. Do they make sense? To begin to answer that question requires an understanding of the purpose of whistleblower awards and an evaluation of how well the existing award calculation methodology advances that purpose. This Article provides both. The analysis suggests that the controversial proposed amendments to Rule 21F-6 are warranted, but incomplete.

INTRODUCTION

After eight years in operation, the SEC’s Whistleblower Program is undergoing retrospective review. Last summer the SEC put out for public comment a lengthy release proposing a variety of amendments to the program’s rules.¹ Among the most controversial is a proposed amendment to Rule 21F-6, which sets forth the criteria for determining the amount of whistleblower awards. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which created the Whistleblower Program, requires that the aggregate amount awarded to an eligible whistleblower or group of whistleblowers whose tip(s) led to a “covered action”—defined as an SEC action in which monetary sanctions in excess of \$1,000,000 are ordered—equal not less than 10% and not more than 30% of the monetary sanctions collected in the covered action and certain related actions.² Within this range, the statute grants the SEC

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¹ Whistleblower Program Rules, 83 Fed. Reg. 140 (proposed July 20, 2018) (to be codified at 17 C.F.R. pts. 240 and 249).

² 15 U.S.C. § 78u-6(b)(1).

discretion to determine the award amount, while setting forth certain non-exclusive criteria that the SEC shall take into consideration in the exercise of its discretion.³ Rule 21F-6, in turn, lists factors (including but not limited to those specified in the statute) that the SEC may consider “[i]n exercising its discretion to determine the appropriate award percentage”; these factors may cause the SEC to, in its discretion, “increase or decrease the award percentage.”⁴

As written, Rule 21F-6 requires that the SEC consider these criteria in determining the appropriate award *percentage*, seemingly without regard to the total *dollars* the award would yield for the whistleblower. Chairman Clayton has dubbed this “the percentage formula” for determining whistleblower awards; this article will refer to it as “the percentage method.”⁵ The proposed revisions to Rule 21F-6 would free the SEC to consider the dollar amount of an award, but only in circumscribed ways and under limited circumstances: when an award would be very small in dollar terms (in which case an upward adjustment may be warranted) and, more controversially, when an award would be extremely large in dollar terms (in which case a downward adjustment may be warranted).⁶ Commissioner Jackson and former Commissioner Stein have expressed concern that affording the SEC discretion to adjust downward large dollar awards may jeopardize the goals of the Whistleblower Program.⁷

A fundamental question is lurking in this debate: why should the percentage method be the baseline for determining SEC whistleblower awards in the first place? Congress did not think hard about this question when it imposed the requirement that whistleblower awards must equal 10 to 30 percent of the amount of monetary sanctions collected in a covered action.⁸ Nor does it appear that the SEC thought hard about this question when it decided to restrict itself to the percentage method as a way of

³ Id. § 78u-6(c)(1).

⁴ 17 C.F.R. § 240.21F-6.

⁵ Commissioner Jay Clayton, Statement on Amendments to the Commission’s Whistleblower Program Rules, SEC (June 28, 2018), <https://www.sec.gov/news/public-statement/statement-open-meeting-amendments-commissions-whistleblower-program-rules>.

⁶ See *infra* Part II.C.

⁷ Commissioner Kara M. Stein, Statement on Proposed Amendments to the Commission’s Whistleblower Program Rules, SEC (June 28, 2018), <https://www.sec.gov/news/public-statement/statement-stein-whistleblower-062818>; Commissioner Robert J. Jackson, Statement on Proposed Rules Regarding SEC Whistleblower Program, SEC (June 28, 2018), <https://www.sec.gov/news/public-statement/jackson-statement-whistleblowers-062818>.

⁸ SEC’s Office of the Inspector General, Evaluation of the SEC’s Whistleblower Program 22, Rep. No. 511 (2013) [hereinafter *OIG Report*] (“whistleblower award amounts were not a debated part of the Dodd-Frank Act”).

determining what an award should be within the statutory 10 to 30 percent range. The Commission did observe when it originally adopted Rule 21F-6 that the methodology is “[s]imilar to the approach used by the Department of Justice and Internal Revenue Service” in their payment of whistleblower awards under the False Claims Act and IRS Whistleblowers Program, respectively.⁹ The percentage method also resembles the preferred approach for determining the fee award paid to class action attorneys. But these analogies, while superficially appealing, do not necessarily support use of the percentage method in the context of SEC whistleblower awards.

This Article returns to first principles, articulating what an award calculation methodology should strive to achieve in light of the purpose of the Whistleblower Program and exploring how well the percentage method lives up to these expectations. It proceeds in four parts. Part I provides a brief overview of the SEC’s Whistleblower Program. Part II explains in greater detail the current method employed by the SEC for determining the amount of whistleblower awards, reports data on the whistleblower awards that the SEC has granted to date, and describes the recently proposed amendments to Rule 21F-6 and the controversy they have provoked.

Part III.A turns to consider the purpose of the Whistleblower Program. The starting premise is that the Whistleblower Program is designed to encourage tips by altering the internal cost-benefit calculation a potential whistleblower might be expected to conduct when making the decision whether to come forward. But encouraging tips is not an end in itself: it is a means to help the SEC in its deterrence mission. Not all tips will have this effect; to the contrary, some will impose more costs on the SEC than benefits. A more refined statement of the goal of the Whistleblower Program is thus to encourage desirable tips (*viz.*, those that create more benefits than costs and thus push the SEC closer to its goal of optimal deterrence), without simultaneously encouraging the submission of *undesirable tips* (*viz.*, those that create net costs and thus undermine the SEC’s deterrence objective).

Part III.B evaluates how well the percentage method advances this purpose. It demonstrates that the percentage method laudably creates differential incentives to report based on tip desirability: whistleblowers with relatively more desirable tips, all else equal, should expect higher awards than those with relatively

⁹ See Securities Whistleblower Incentives and Protections, Exchange Act Release No. 64,545, 76 Fed. Reg. 34,300, 34,331 (May 25, 2011) [hereinafter WP Release]. Subject to various requirements, the former entitles those who bring a qui tam suit on behalf of the government to between 15-30% of the proceeds of the action (31 U.S.C. § 3730(d)) and the latter entitles individuals who tip off the IRS about tax evaders to bounties between 10-30% of the taxes the IRS collects as a result of the tip (26 U.S.C. § 7623; 26 C.F.R. § 301.7623-4).

less desirable tips, meaning they will find the benefits of reporting to exceed the costs more often. But the percentage method does not ensure that awards will not vastly exceed what is *necessary* to incentivize whistleblowers with desirable tips to come forward. Nor does it ensure that awards will not be so high as to encourage even undesirable tips or, conversely, that they will be high *enough* so as to encourage desirable tips. This will all depend on how the expected value of awards compares to the actual costs whistleblowers expect to bear by coming forward. The percentage method, as currently applied, is insensitive to actual whistleblower costs.

Part IV explains that the proposed reforms to Rule 21F-6 would fix this problem in the subset of cases to which they would apply, by inviting the SEC to consider the dollar amount of the award and to make adjustments depending on how the amount would affect whistleblower incentives. While the analysis suggests that the proposed reforms to Rule 21F-6 are warranted, it also suggests two other reforms that could improve the functioning of the Whistleblower Program. First, the program would better align whistleblowers' incentives to tip with the SEC's deterrence mission if awards were more closely tethered to the value of all penalties imposed in the covered action rather than simply to monetary penalties collected. Second, the SEC should be required to be more transparent about the percentages it is awarding and why. The SEC almost never makes the percentage it has determined to award public. This opacity is unnecessary and likely increases the risk discount that potential whistleblowers apply to expected awards when deciding whether the benefits of tipping outweigh the costs.

Part V briefly concludes.

I. THE SEC'S WHISTLEBLOWER PROGRAM: A SHORT PRIMER

The current framework for the SEC's Whistleblower Program (WP) is laid out in the Dodd-Frank Act¹⁰ and in SEC implementing rules adopted in 2011.¹¹ The program entitles "whistleblowers"—defined as individuals (not corporations or other entities) who provide the SEC with information about possible securities law violations pursuant to specified procedures¹²—to a monetary award if they meet the following criteria. First, a whistleblower must have provided information to the SEC "voluntarily."¹³ Second, that information must have been

¹⁰ 15 U.S.C. § 78u-6.

¹¹ See generally WP Release, *supra* note 9.

¹² 17 C.F.R. § 240.21F-2(a)(1).

¹³ See Amanda M. Rose, Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate, 108 NW. L. REV. 1235, 1261 (2014) (discussing this requirement).

“original.”¹⁴ 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”).¹⁵ Finally, the whistleblower must not otherwise be ineligible for an award.¹⁶ If these criteria are met, the whistleblower is entitled, by statute, to share in a whistleblower award of between 10 and 30 percent of the sanctions collected in the covered action and in certain “related actions,” if procedural requirements for claiming an award are followed.¹⁷

The SEC’s “Office of the Whistleblower” (OWB), housed within the SEC’s Division of Enforcement, is tasked with administering the WP.¹⁸ The OWB is currently staffed by a chief, two assistant directors, thirteen attorneys, four paralegals, and an administrative assistant.¹⁹ Among other things, the OWB maintains a website (www.sec.gov/whistleblower) which provides information about the WP as well as links to the forms required to submit a tip (Form TCR) and apply for an award (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 “TCR System”), a centralized database for the “prioritization, assignment, and tracking of TCRs received from the public.”²⁰

Once in the TCR system, a whistleblower’s tip is triaged by the Enforcement Division’s “Office of Market Intelligence” (“OMI”).²¹ OMI evaluates each tip and assigns those identified as “sufficiently specific, timely, and credible to warrant the further

¹⁴ “Original information” is defined in the Dodd-Frank Act 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.” 15 U.S.C. § 78u-6(a)(3). See also Rose, *supra* note 13 at 1262-63.

¹⁵ See *id.* at 1263-65.

¹⁶ See *id.* at 1265-68.

¹⁷ See *id.* at 1268-70.

¹⁸ See 15 U.S.C. § 78u-7(d).

¹⁹ SEC Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2018, 6 [hereinafter WP 2018 Report].

²⁰ SEC Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2012, 4 [hereinafter WP 2012 Report]. Whistleblowers also have the option to input their tip directly into the TCR System via an online version of Form TCR. For more information on the TCR System, see Ben Protess & Azem Ahmed, *With New Firepower, SEC Tracks Bigger Game*, N.Y. Times DealBook (May 21, 2012); Sarah N. Lynch & Matthew Goldstein, *Exclusive: SEC Builds New Tips Machine to Catch the Next Madoff*, Reuters.Com (July 27, 2011); Bruce Carton, *Details Emerge on SEC Office of Market Intelligence*, SecuritiesDocket.com (Feb. 9, 2010).

²¹ Protess & Ahmed, *supra* note 20.

allocation of [SEC] resources” to appropriate enforcement staff.²² 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.”²³

After a final judgment is entered in a covered action, the OWB posts on its website a “Notice of Covered Action.”²⁴ Whistleblowers then have 90 days to file a claim for an award based on that covered action, using Form WB-APP.²⁵ 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.²⁶ It will determine whether any of the claimants meet the criteria for a whistleblower award and, if so, the appropriate percentage of collected sanctions to award them.²⁷ 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 as between multiple whistleblowers) is not appealable so long as the award falls within the required 10-30% range.²⁸

In addition to requiring the payment of whistleblower awards on the terms set forth above, the Dodd-Frank Act also contains provisions to protect SEC whistleblowers from workplace retaliation. Employers are prohibited 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.²⁹ This provision is enforceable by the SEC.³⁰ Moreover, a whistleblower who believes his or her employer has violated this provision may sue for reinstatement, two times any back pay owed, and for fees and costs.³¹ Unlike Sarbanes-Oxley’s anti-retaliation provision,

²² WP 2012 Report, supra note 20, 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.

²³ Id. at 3.

²⁴ 17 C.F.R. § 240.21F-10(a).

²⁵ Id.

²⁶ Id. § 240.21F-10(d).

²⁷ This involves multiple layers of review. See WP 2012 Report, supra note 20, at 71; OIG Report, supra note 8 at 5.

²⁸ 17 C.F.R. § 240.21F-13(a).

²⁹ 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).

³⁰ 17 C.F.R. § 240.21F-2(b)(2).

³¹ 15 U.S.C. § 78u-6(h)(1)(C).

which requires claims be brought through the Department of Labor,³² the WP’s anti-retaliation provision allows whistleblowers to sue directly in federal court.³³ It also affords plaintiffs a more generous statute of limitations.³⁴ To be entitled to this protection, whistleblowers need not qualify for a whistleblower 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.³⁵

The SEC is also required to keep a whistleblower’s identity confidential unless and until it is required to be disclosed to a defendant in a public proceeding, or unless the SEC deems it necessary to share it with certain other authorities (in which case those authorities must keep it confidential).³⁶ A whistleblower also has the option of remaining anonymous up to the point of receiving payment of a whistleblower award, at which time the whistleblower’s identity must be disclosed to the SEC.³⁷ 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.³⁸ (Non-anonymous whistleblowers must make such a declaration directly on their Form TCRs.³⁹) Finally, the WP makes it unlawful to take actions to impede an individual from becoming a whistleblower, including by threatening to enforce a confidentiality agreement.⁴⁰

II. CALCULATING AWARDS: CURRENT PRACTICE, PROPOSED REFORMS

The SEC recently issued a lengthy release proposing

³² See OSHA Fact Sheet: Filing Whistleblower Complaints under the Sarbanes-Oxley Act, available at <http://www.osha.gov/Publications/osha-factsheet-sox-act.pdf>.

³³ 15 U.S.C. § 78u-6(h)(1)(B)(i).

³⁴ *Id.* § 78u-6(h)(1)(B)(iii). For a discussion of the problems with Sarbanes-Oxley’s anti-retaliation provision, see Terry Morehead Dworkin, *SOX and Whistleblowing*, 105 Mich. L. Rev. 1757, 1764-67 (2007). For a discussion of how the WP’s anti-retaliation provision seeks to avoid these problems, see Rachel Beller, *Whistleblower Legislation of the East and West*, 7 N.Y.U. J. L. & Bus. 873, 914-15 (2011).

³⁵ 17 C.F.R. § 240.21F-2(b).

³⁶ 15 U.S.C. § 78u-6(h)(2); 17 C.F.R. § 240.21F-7.

³⁷ See *id.* §§ 240.21F-7(b), 240.21F-9(c) & 240.21F-10(c).

³⁸ See *id.* §§ 240.21F-7(b)(1) & 240.21F-9(c); 15 U.S.C. § 78u-6(d)(2).

³⁹ 17 C.F.R. § 240.21F-9(b).

⁴⁰ See 17 C.F.R. § 240.21F-17. The SEC has taken steps to enforce this prohibition. See KBR, Inc., Exchange Act Release No. 74619 (Apr. 1, 2015) (requiring KBR to amend its confidentiality agreement so that it would not impede the purposes of the WP); Blue Linx Holdings, Inc., Exchange Act Release No. 78528 (Aug. 10, 2016) (finding Blue Linx in violation by use of a non-disclosure

numerous amendments to the rules governing the WP. Of particular interest for purposes of this Article are proposed amendments to Rule 21F-6, which governs the way in which the SEC determines the size of whistleblower awards. This Part describes the currently prescribed method for calculating whistleblower awards and the track record of awards granted using this methodology. It also explains the proposed modifications to Rule 21F-6.

A. Current Methodology for Determining Awards Amounts

If one or more whistleblowers meet the eligibility criteria for an award and follow the required procedures for making a claim, the SEC is statutorily required to award them, in the aggregate, at least 10 but not more than 30 percent of the monetary sanctions collected in the covered action.⁴¹ The SEC is also statutorily required to pay eligible whistleblowers amounts equal to 10-30% of the monetary sanctions collected in “related actions,”⁴² if specified claims procedures are followed.⁴³

The Dodd-Frank Act leaves the determination of the amount of an award, within the 10-30% statutory bounds, to the discretion of the SEC.⁴⁴ The Act provides, however, that in exercising this discretion the SEC shall take into consideration—

- (I) the significance of the information provided by the whistleblower to the success of the covered judicial or administrative action;

agreement which forced employees to either choose between identifying themselves to the company as whistleblowers or potentially losing their severance pay and benefits); Homestreet, Inc. and Darrell van Amen, Exchange Act Release No. 79844 (Jan. 19, 2017) (finding HomeStreet in violation because it had taken steps to determine who the whistleblower was after receiving document requests from the SEC).

⁴¹ 15 U.S.C. § 78u-6(b)(1).

⁴² See 15 U.S.C. § 78u-6(b)(1); 17 C.F.R. § 240.21F-11.

⁴³ See *id.* § 240.21F-11 (detailing these procedures). A “related action” exists 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,” an SRO, or a state Attorney General in a criminal case. 15 U.S.C. § 78u-6(a)(5); 17 C.F.R. § 240.21F-b(1). “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). To receive 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. *Id.* § 240.21F-3(b)(2).

⁴⁴ *Id.* § 78u-6(c)(1)(A); 17 C.F.R. § 240.21F-5(a).

(II) the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;

(III) the programmatic interest of the [SEC] in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws; and

(IV) such additional relevant factors as the [SEC] may establish by rule or regulation[.]⁴⁵

The SEC is statutorily forbidden from taking “into consideration the balance of the [Investor Protection] Fund” (IPF) when determining the size of a whistleblower award.⁴⁶ The IPF was created by the Dodd-Frank Act to fund SEC whistleblower awards, as well as the SEC Inspector General’s suggestion program.⁴⁷ It was granted a one-time infusion of \$451,909,954 at its inception and has three replenishment sources.⁴⁸ First, if its balance drops to \$300 million, the SEC is directed to deposit into the IPF any monetary sanctions the SEC collects that are not paid into a fund for victims under section 308 of the Sarbanes-Oxley Act or otherwise distributed to victims (this money would normally go to the United States Treasury).⁴⁹ If the balance drops to \$200 million, the SEC must also deposit into the IPF any money in a section 308 fund that is not distributed to victims.⁵⁰ And if there is not enough money in the IPF to pay a whistleblower 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.⁵¹

Rule 21F-6 further governs the SEC’s exercise of discretion when determining whistleblower awards. The rule lists factors that the SEC may consider “in relation to the unique facts and circumstances of each case,” and provides that the SEC “may increase or decrease the award percentage based on its analysis of these factors.”⁵² In deciding whether to increase the amount of a

⁴⁵ 15 U.S.C. § 78u-6(c)(1)(B)(i).

⁴⁶ Id. § 78u-6(c)(1)(B)(ii).

⁴⁷ See 15 U.S.C. § 78u-6(g)(2).

⁴⁸ SEC Fiscal Year 2012 Agency Financial Report at 99, <https://www.sec.gov/about/secpar/secfr2012.pdf>.

⁴⁹ 15 U.S.C. § 78u-6(g)(3)(A)(i).

⁵⁰ Id. § 78u-6(g)(3)(A)(ii).

⁵¹ Id. § 78u-6(g)(3)(B). The IPF is also entitled to keep 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).

⁵² 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).

whistleblower’s award, the rule requires the SEC to consider the three factors enumerated in the Dodd-Frank Act—the significance of the information provided to the success of the action,⁵³ the degree of assistance provided by the whistleblower,⁵⁴ and the SEC’s “programmatically interest in deterring violations of the securities laws”⁵⁵—as well as a fourth: the extent to which the whistleblower participated in internal compliance systems.⁵⁶ In deciding whether to decrease the amount of a whistleblower’s award, the rule requires the SEC to consider: (1) the “culpability or involvement of the whistleblower in matters associated” with the covered action or related action⁵⁷; (2) whether the whistleblower unreasonably delayed in reporting the suspected securities violations⁵⁸; 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.”⁵⁹

For each plus and minus factor, Rule 21F-6 provides from two to seven considerations that “the Commission may take into account, among other things” in evaluating the factor.⁶⁰ No weight is assigned to these considerations nor, for that matter, to the plus or minus factors themselves. Instead, the stated criteria in Rule 21F-6 are merely guidelines, and do not create 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.”⁶¹ The full text of Rule 21F-6 is set forth in Appendix A.

B. Data on Awards Granted

From the inception of the WP to the close of the SEC’s 2018 fiscal year, the SEC issued whistleblower awards to 59 individuals totaling over \$326 million.⁶² The majority of the awards have been for less than \$2 million, and the vast majority have been for less than \$5 million.⁶³ But there have been a handful of substantially larger awards. See Figure 1. The largest awards in the program’s history

⁵³ 15 U.S.C. § 78u-6(c)(1)(B)(i)(I); see also 17 C.F.R. § 240.21F-6(a)(1).

⁵⁴ 15 U.S.C. § 78u-6(c)(1)(B)(i)(II); see also 17 C.F.R. § 240.21F-6(a)(2).

⁵⁵ 15 U.S.C. § 78u-6(c)(1)(B)(i)(III); see also 17 C.F.R. § 240.21F-6(a)(3).

⁵⁶ Id. § 240.21F-6(a)(4).

⁵⁷ Id. § 240.21F-6(b)(1).

⁵⁸ Id. § 240.21F-6(b)(2).

⁵⁹ Id. § 240.21F-6(b)(3).

⁶⁰ Id. § 240.21F-6.

⁶¹ WP Release, *supra* note 9, at 34,331.

⁶² See WP 2018 Report, *supra* note 19 at 1.

⁶³ Of the 59 individual award determinations as of the close of FY2018, 52 included a disclosed estimated dollar amount. Of that subset, 52% (27) had estimated award payouts of less than \$2M and 73% (38) had estimated award payouts of less than \$5M.

were issued last year: in March 2018, \$83 million was awarded in a covered action, with two whistleblowers splitting a \$50 million award and a third receiving a \$33 million award, and in September 2018 \$54 million was awarded in a covered action, with one whistleblower receiving a \$39 million award and another a \$15 million award.⁶⁴ Prior to these awards, the biggest dollar award was issued to a single whistleblower in September 2014; it was estimated to payout between \$30 and 35 million.⁶⁵ After the close of FY2018, in March 2019, \$50 million was awarded in a covered action, with one whistleblower receiving a \$37 million award and another receiving a \$13 million award.⁶⁶

Little can be gleaned about the SEC's habits in setting award percentages from the heavily redacted award determination orders that are published on the SEC's website, nor from the press releases that often (but not always) accompany these orders.⁶⁷ With rare exceptions, these documents do not reveal information about the underlying offense that gave rise to the covered action. They tend to include only a rote recitation that the criteria in Rule 21F-6 were considered in setting the percentage. And, in recent years at least, these documents almost always omit the actual percentage awarded. According to my review, early in the program's history the SEC routinely disclosed the percentage awarded, but since 2015 it has done so only once.⁶⁸ By contrast, the SEC almost always announces the likely or actual dollar amount of the award.⁶⁹

⁶⁴ See SEC Announces Its Largest-Ever Whistleblower Awards (March 19, 2018), <https://www.sec.gov/news/press-release/2018-44>; SEC Awards More Than \$54 Million to Two Whistleblowers (Sept. 6, 2018), <https://www.sec.gov/news/press-release/2018-179>.

⁶⁵ See SEC Announces Largest-Ever Whistleblower Award (Sept. 22, 2014), <https://www.sec.gov/news/press-release/2014-206>.

⁶⁶ See SEC Awards \$50 Million to Two Whistleblowers (March 26, 2019), <https://www.sec.gov/news/press-release/2019-42>.

⁶⁷ In its annual report to Congress, the SEC provides in summary fashion some characteristics of successful whistleblowers. See, e.g., WP 2018 Report, *supra* note 19 at 16-17. The report does not, however, shed any light on the percentages awarded to whistleblowers or how the SEC has applied the Rule 21F-6 criteria.

⁶⁸ This shift in practice coincides temporally with increasing average award payouts in dollar terms. Based on my review of individual awards that include disclosed estimates of payout amounts, from the program's inception through 2015 the mean individual award was approximately \$3.4M (median approximately \$419,000). From 2016 to the close of FY2018, the mean individual award has more than doubled to approximately \$7.4 million (median approximately \$3.5M).

⁶⁹ Thirty-nine individual awards have been announced since 2016. With respect to all but one, the SEC disclosed the estimated dollar payout of the award but omitted the percentage of collected sanctions awarded.

C. Proposed Revisions to Rule 21F-6

Rule 21F-6, in its existing form, requires the SEC to determine whistleblower awards using the percentage method, without considering the total dollars that the percentage awarded would yield the whistleblower. So in deciding that a 25% award is appropriate based on the factors laid out in the rule, the SEC is required to ignore that this would yield only \$250,000 in a covered action with \$1 million in monetary sanctions collected or a whopping \$125 million in a covered action with \$500 million in monetary sanctions collected. The proposed amendments to Rule 21F-6 would change this, allowing the SEC to consider dollar amounts in making award determinations, but only at the margins.

The first proposed change to the rule would liberate the SEC to consider dollar amounts in cases involving very small awards. Specifically, if the monetary award that would result from application of the current criteria using the percentage method would lead to a payout of less than \$2 million (or any such greater amount that the SEC may periodically establish), the SEC would have the authority to adjust the award upward “to ensure that the total payout to the whistleblower more appropriately achieves the program’s objectives of rewarding meritorious whistleblowers and sufficiently incentivizing future whistleblowers who might otherwise be concerned about the low dollar amount of a potential award.”⁷⁰ The SEC “anticipate[s] that . . . there would be a presumption in favor of some award enhancement, though the precise amount of the enhancement may vary from case to case depending on the unique facts and circumstances at issue.”⁷¹ Such upward modification is barred, however, if any of the current criteria for a downward adjustment apply or if the whistleblower was culpably involved in the misconduct giving rise to the covered action.⁷² In addition, any upward adjustment cannot raise the payout above \$2 million, nor may it result in the total amount awarded to all whistleblowers in the covered action exceeding 30%.⁷³

The second proposed change to Rule 21F-6 would require the SEC to consider dollar amounts in certain cases involving potentially very large awards. If a whistleblower’s original information led to one or more successful covered or related actions that, collectively, resulted in or will likely result in the collection of \$100 million or more in monetary sanctions (or any such higher amount that the SEC may periodically establish), the proposed amendments provide the SEC with additional instructions for

⁷⁰ 83 Fed. Reg. at 37,748.

⁷¹ 83 Fed. Reg. at 34,712.

⁷² 83 Fed. Reg. at 37,748.

⁷³ *Id.*

fashioning the appropriate percentage. First, in considering the existing Rule 21F-6 criteria for upward and downward adjustments, the SEC would be required to “consider the impact of the adjustments on both the award percentage *and* the approximate corresponding dollar amount of the award.”⁷⁴ Second, if the payout determined after applying those criteria is \$30 million or higher, the proposed amendments would require the SEC to “consider whether that amount exceeds what is reasonably necessary to reward the whistleblower and to incentivize similarly situated whistleblowers.”⁷⁵ If it finds that it is, the Commission is instructed to “adjust the total payout downward to an amount that it finds is sufficient to achieve those goals.”⁷⁶ In no event, however, may the downward adjustment “yield a potential award payout (as assessed by the [SEC] at the time that it makes the award determination) below \$30 million, nor may any downward adjustment result in the total amount awarded to all meritorious whistleblowers, collectively, for each covered or related action, falling below 10 percent of the monetary sanctions collected in that action.”⁷⁷

In defense of this amendment to Rule 21F-6, the proposing release explains “there is a potential that as the payout to a whistleblower grows beyond the \$30 million floor, the marginal benefit of each additional dollar paid may decrease to such an extent that, in terms of furthering the program’s overall goals, the payout may be more than is reasonably necessary.”⁷⁸ The proposing release also points to the preservation of the IPF as a basis for the amendment. The release explains that large awards “could

⁷⁴ 83 Fed. Reg. 34,749 (emphasis added).

⁷⁵ Id. In “determining whether a payout exceeds what is appropriate to achieve the program’s objectives,” the SEC “would carefully assess the potential payout in relation to both any unusually detrimental circumstances that impact the whistleblower and the level of financial incentive that may be necessary to encourage future similarly situated whistleblowers to come forward.” Id. at 34,715. See also id. at 34,715-16 (giving examples of unusually detrimental circumstances and financial incentive considerations).

⁷⁶ Id. at 34,749.

⁷⁷ Id. With respect to the amount of any downward adjustment, the proposing release imagines “a sliding scale that corresponds with the overall size of the potential award in dollar terms.” Id. at 34,714. “In our view, this sliding-scale approach would make sense because the larger the dollar amount of the payout away from the \$30 million floor, the greater the likelihood of diminishing marginal benefits to the program from each additional dollar paid to the whistleblower.” Id. at 34,716.

⁷⁸ In the SEC’s judgment, “\$30 million represents a reasonable line at which to draw the floor.” Id. at 34,715. The release supports this judgment by pointing out that an individual who received \$30 million, even after taxes, would “find himself or herself in the range of the top 99.5 percentile to 99.9 percentile of the U.S. population by net worth” and, if invested modestly, could produce an “a reasonable lifetime income stream for most potential whistleblowers.” Id. at 34,716.

substantially diminish the IPF, requiring the [SEC] to direct more funds to replenish the IPF rather than making that money available to the United States Treasury, where they could be used for other important public purposes.”⁷⁹ The amendment “would help ensure that the [IPF] that Congress has established to pay meritorious whistleblowers is used in a manner that effectively and appropriately leverages the IPF to further the Commission’s law enforcement objectives.”⁸⁰

If past is prologue, the package of amendments to Rule 21F-6 would benefit a greater number of whistleblowers than they would disadvantage, given that there have been many more awards of less than \$2 million than there have been awards of \$30 million or more (by a margin of 9 to 1).⁸¹ But critics contend that the SEC should only be allowed to consider dollar amounts as a basis for increasing awards of less than \$2 million, not decreasing those in excess of \$30 million. This reflects a preference for higher whistleblower awards in general, and also more certain ones, in order to give whistleblowers strong incentives to come forward despite the risks they may face. SEC Commissioner Robert Jackson, for example, has argued that allowing the SEC to deviate from the percentage method to reduce very large awards could deter risk-averse whistleblowers from coming forward by making award amounts less predictable.⁸² Former SEC Commissioner Kara Stein has also expressed concern that allowing the SEC to deviate from the percentage method to reduce a large award could be “used as a means to weaken the Whistleblower Program.”⁸³ The National Whistleblower Legal Defense & Education Fund has also spoken out against this proposed amendment.⁸⁴

III. A Theoretical Approach to Award Calculation

Lurking behind the debate over the desirability of the proposed amendments to Rule 21F-6 is a more fundamental question: why should the percentage method be the primary method for determining SEC whistleblower awards anyway, as opposed to

⁷⁹ Id. at 34,704.

⁸⁰ Id. The large whistleblower awards issued in March 2018 caused the balance of the IPF to drop for the first time below the \$300 million threshold that triggers the statutory replenishment mechanism. Id. at 34,704 n.9, 37,715.

⁸¹ Based on my review of awards with estimated payouts disclosed as of the end of FY2018, the SEC has granted 27 individual awards estimated to payout less than \$2 million and 3 individual awards estimated to payout \$30 million or more.

⁸² See Jackson, *supra* note 7.

⁸³ See Stein, *supra* note 7.

⁸⁴ Nicholas Piwonka, *Proposed SEC Rule Will Hurt Whistleblower Program*, Whistleblower Protection Blog (July 5, 2018), <https://www.whistleblowersblog.org/2018/07/articles/dodd-frank-whistleblowers/proposed-sec-whistleblower-rule/>.

some other methodology? Only once we understand the function the percentage method serves can we intelligently assess whether the SEC's proposed rule revisions are desirable.

A. The Purpose of Whistleblower Awards

We must begin with the purpose of whistleblower awards. Competing methodologies for computing awards must, after all, be evaluated based on how well they further that purpose. This Article assumes that the purpose of whistleblower awards is to incentivize individuals to submit tips to the SEC, with the ultimate goal of more efficiently deterring securities law violations. That the award program is meant to incentivize whistleblowers is supported by the very title of the statutory provision giving birth to it (“Securities Whistleblower *Incentives* and Protection”⁸⁵), is consistent with the manner in which the SEC has framed and discussed whistleblower awards,⁸⁶ and is the most logical basis for government to provide financial awards to whistleblowers.⁸⁷

⁸⁵ 15 U.S.C. § 78u-6.

⁸⁶ See, e.g., *SEC Issues \$4 Million Whistleblower Award*, SEC (Sept. 20, 2016) (Jane Norberg, Acting Chief of the Office of the Whistleblower, stated that the Whistleblower program “continues to incentivize whistleblowers to come forward with solid information that helps us bring violators to justice before more wrongdoing can occur”), <https://www.sec.gov/news/pressrelease/2016-188.html>; Chairman Mary L. Schapiro, *Opening Statement at SEC Open Meeting: Item 2 — Whistleblower Program*, SEC (May 25, 2011) (in discussing the proposed whistleblower rules, Chairman Schapiro stated the program was a part of the SEC’s “effort to enhance the agency’s capacity to detect and prevent fraud” and that the new rules were drafted to “incentivize those close to a fraud to come forward and provide information to the Commission”), <https://www.sec.gov/news/speech/2011/spch052511mls-item2.htm>; Commissioner Luis A. Aguilar, *Incentivizing Whistleblowers to Bring Fraud to Light*, SEC (May 25, 2011) (stating that the “goal of the whistleblower program is to create a system that incentivizes individuals to come forward with high quality information to help the Commission expose fraud”), <https://www.sec.gov/news/speech/2011/spch052511laa-item2.htm>.

⁸⁷ See, e.g., Steven Shavell, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 579 (2004) (discussing the utilitarian function of state-paid rewards for reporting law violations). One might counter that whistleblowers *deserve* financial awards for their bravery in stepping forward; but there is no evidence that Congress meant to empower bureaucrats at the SEC to pay whistleblowers based on notions of moral desert, divorced from the incentive effects such awards would have on whistleblowers going forward. Another equally implausible notion is that a whistleblower has some sort of property right in the monetary recovery their tip helped to produce. Simply being aware of misconduct does not entitle one to a stake in the penalties or disgorgement the perpetrator of that misconduct may owe as a result, even if one incurred costs to learn of the information; turning that information over to the government does not magically create such a property interest. To be sure, the holder of the information in a sense “owns” the information that they have acquired and, if not otherwise compelled by law, need not turn it over to government authorities. They will presumably do so only if

More precisely, I assume that the promise of a whistleblower award is designed to alter the internal cost-benefit calculation a potential whistleblower engages in when deciding whether to report wrongdoing or remain silent. If we assume that whistleblowers are rational actors, they will not submit a tip if the expected gains from doing so do not exceed the expected losses. The costs of blowing the whistle can be significant, including psychic discomfort and potential workplace retaliation and industry blacklisting. The Dodd-Frank Act seeks to reduce these costs through the promise of confidentiality and retaliation protection, but cannot eliminate them entirely. The benefits from blowing the whistle naturally include any gratification that comes from doing the right thing as well as the possible avoidance of complicity in wrongdoing and resultant liability exposure. The Dodd-Frank Act seeks to increase the benefits of reporting by adding a potential financial award to the list.⁸⁸

A rational actor, in deciding whether the prospect of a whistleblower award tips the scales in favor of reporting, would calculate the expected value of that award (the product of the award's anticipated magnitude and probability). Next, she would discount the expected value to reflect both the time value of money (whistleblower awards can take years to receive⁸⁹) and to compensate her for its riskiness (assuming she is risk averse). The riskiness of an expected award is in part a function of the probability it will materialize (the tip might not produce a covered action or the SEC might find the whistleblower ineligible for an award). It is also a function of the certainty of the assumptions that underlie the calculation of the expected award. To calculate an expected award a potential whistleblower must estimate several variables: the likelihood that a covered action will result from her tip, the likelihood that she will be determined eligible for an award, the likely amount of an eventual award, and the likelihood she will have to share it with others. The more uncertain the estimation of these variables, the more a risk averse potential whistleblower will discount the expected value of the anticipated award when deciding

they perceive it to be in their best interest. This, of course, takes us back to the incentive rationale for whistleblower awards.

⁸⁸ With respect to some sorts of misconduct, the introduction of financial benefits for reporting may operate to reduce the perceived psychic benefits from doing so, potentially resulting in less whistleblowing activity. 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 (2010). This phenomenon is unlikely to occur in the context of SEC whistleblowing, however. See Rose, *supra* note 13 at 1275-77 (explaining why).

⁸⁹ Frustration over the delay recently led a whistleblower to initiate litigation against the SEC. See Rachel Graf, *SEC Must Decide on Teva Whistleblower Award*, D.C. Circuit Told (May 1, 2019), <https://www.law360.com/securities/articles/1154926>.

whether blowing the whistle is worth the costs.

This is not to suggest that potential whistleblowers will actually sit down and do math before deciding whether to come forward. But it is realistic to expect that they will consider, at a gut level at least, the harm that may come to them by reporting and compare it to the likely benefits. It is also realistic to expect that individuals who would be unwilling to come forward in the absence of the whistleblower award program—those whose minds the program seeks to change—will think about how big of an award they might get if they report, how likely the award is, how long they would have to wait for it, and how much risk they are willing to bear. They may not quantify the variables expressly and feed them into a formula, but they can be expected to consider them intuitively in reaching a decision.⁹⁰

The SEC's Whistleblower Program seeks to encourage a greater number of tips by changing individuals' internal cost-benefit calculation as discussed above. But encouraging a greater number of tips is not an end in itself. Rather, it is designed to aid the SEC in its enforcement mission, which this Article assumes to be the deterrence of securities law violations. To be justified, a deterrence-focused enforcement regime must save more in social costs from securities law violations deterred than it produces in enforcement costs; an optimal deterrence regime would minimize the sum of these costs. Whistleblower awards can work to reduce both variables. Private individuals often possess information about securities law violations that would be costly for the SEC to discover on its own; encouraging whistleblower tips can therefore help the SEC save on investigative costs it otherwise would have incurred. The lure of an award can also deter a greater number of violations than would otherwise be possible by increasing the likelihood that securities law violators will be caught. An individual contemplating a securities law violation would weigh the benefits of committing the violation against the costs of being caught, discounted by the likelihood of being caught. If the whistleblower program increases the likelihood of being caught, individuals will therefore find fewer

⁹⁰ An SEC choice not to pursue a tip eliminates any probability of an award, and it also might lessen the probability that a tipster will be discovered and therefore experience costs such as workplace retaliation or industry blacklisting. The cost side of the whistleblower's cost-benefit equation, in other words, could be dependent on a factor that is related to the probability of an award and hence the award's expected value. This would call for an even more sophisticated analysis than the one imagined in the text, and it is not realistic to expect even counseled whistleblowers to know how to model conditional expectations the way a mathematician would. That said, whistleblowers could very well appreciate that in the event their tip were not pursued, they would experience fewer costs, and this might lead them to find tipping worthwhile in more scenarios than the discussion above suggests.

violations worthwhile.

Betterment of the SEC's enforcement regime is not, however, the inevitable consequence of a whistleblower award program, because the program itself creates costs. These include the cost of sorting through tips to determine which are worthy of pursuit, the cost of mistakenly pursuing tips that turn out not to be fruitful, as well as the cost of the award payments themselves—money that could be put to other socially valuable use if not paid out to whistleblowers. To the extent the program encourages individuals to bypass or undermine a company's internal compliance system (often the most direct and effective way to identify and halt violations), that too produces costs that need to be taken into account. Depending on the nature and quantity of the tips elicited and the amounts paid out in awards, these costs could outweigh the benefits of the program.⁹¹

Whistleblower award programs like the SEC's therefore face a challenge: they need to encourage whistleblowers with *desirable tips* to come forward (*viz.*, those that create more benefits than costs and thus push the SEC closer to its goal of optimal deterrence), without simultaneously encouraging the submission of *undesirable tips* (*viz.*, those that create net costs and thus undermine the SEC's deterrence objective).⁹² Even if the SEC could costlessly identify and weed out tips that are not worthy of pursuit, the program should strive to avoid award payouts that exceed what is necessary to achieve the desired incentives, given that those funds could be put to higher-valued social use.

It is difficult to define with greater precision which tips are “desirable” and which are not. Tip desirability is a continuum, and where along that continuum tips become more burdensome than helpful to the SEC will be a function, in part, of how efficiently the SEC can sort through tips and identify which are worthy of pursuit.

⁹¹ Weak tips could also have a deleterious *ex ante* effect on the behavior of would-be securities law violators. For example, if weak tips lead to erroneous liability, it could weaken market participants' incentive to comply with the law by decreasing the expected benefit of compliance relative to violation. See Yehonatan Givati, *A Theory of Whistleblower Rewards*, 45 J. LEG. STUD. 43, 45 (2016). Weak tips could also embolden would-be securities law violators by decreasing the probability of detection, if the SEC diverts resources that would otherwise be spent detecting misconduct to sorting through tips. Cf. Anthony J. Casey & Anthony Niblett, *Noise Reduction: The Screening Value of Qui Tam*, 91 WASH. U. L. REV. 1169, 1190-92 (2014).

⁹² Professor David Engstrom refers to this as the “Goldilock's Challenge.” See David Freeman Engstrom, *Whither Whistleblowing? Bounty Regimes, Regulatory Context, and the Challenge of Optimal Design*, 15 Theoretical Inquiries in Law 605, 613 (2014); see also Casey & Niblett, *supra* note 91 at 1196; Marsha Ferziger & Daniel G. Currell, *Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs*, 1999 U. Ill. L. Rev. 1141, 1171-72.

It will also be a function of both the strength of the suspicion that underlies the tip and the nature of the misconduct the tip relates to. Oftentimes whistleblowers do not know with certitude that a securities law violation has occurred; instead, they suspect with a particular level of probability that a violation has occurred based on incomplete information.⁹³ All else equal, tips based on higher probability suspicions are more likely to produce deterrence benefits and less likely to produce wasted costs than tips based on relatively lower probability suspicions, given that they are more likely to lead to the discovery of a securities law violation as opposed to innocent conduct. Tips that relate to relatively more serious misconduct, again all else equal, are also more likely to lead to net deterrence benefits than those that relate to relatively less serious misconduct, given that the social costs of the violations deterred as a result of such tips will be greater. Because the desirability of a tip is a function of both the probability it will unearth a violation and the level of social harm caused by the violation suspected, a relatively higher probability tip related to a relatively less serious violation might have the same desirability as a relatively lower probability tip related to a relatively more serious violation.

The SEC's covered action requirement operates to create differential incentives for individuals to report depending on tip desirability, thus understood. Recall that in order to be eligible for a whistleblower award, the Dodd-Frank Act requires that the tip lead to a "covered action," which means an SEC enforcement action resulting in the imposition of at least \$1 million in monetary penalties. This requirement discourages tips related to suspected misconduct that is not serious enough to warrant this level of punishment. Presumably, Congress believed that encouraging such tips would not produce sufficient deterrence benefits to outweigh the costs—*i.e.*, that such tips would be "undesirable."

The covered action requirement may also create differential incentives to report depending on how serious the suspected misconduct is, even when that misconduct *would* warrant at least \$1 million in monetary penalties. To see this, recall that a rational actor would calculate the expected value of a potential whistleblower award by multiplying its anticipated magnitude by its probability. To the extent that the SEC is more likely to pursue a case the more serious the misconduct, whistleblowers who suspect more serious misconduct will view a covered action as more likely than those who suspect less serious misconduct; thus, all else equal, they will be more likely to come forward because awards will have a higher expected value to them.

The covered action requirement likewise creates stronger

⁹³ Tips that are knowingly false are discouraged by the covered action requirement and by the requirement that tips be submitted under penalty of perjury.

incentives for individuals with higher probability suspicions to come forward. This is because individuals with stronger suspicions will also view a covered action as more likely to result from their tip than potential whistleblowers with weaker suspicions. Thus, all else equal, potential awards will have a higher expected value in their eyes.

While the covered action requirement creates differential incentives to report based on tip desirability, it does not *ensure* that the whistleblower program will succeed in encouraging desirable tips without also encouraging undesirable tips. That will ultimately depend on the expected costs of whistleblowing relative to the amount of expected awards, and the latter depends not just on the award's probability but also on its anticipated magnitude. An award's magnitude will depend, of course, on the award calculation methodology.

Take an extreme but illustrative example: If every eligible whistleblower received an award of \$1 billion and typical whistleblowing costs were \$100, individuals with extremely low probability suspicions relating to even minor offenses would be encouraged to report, so long as the offense could conceivably warrant the imposition of at least \$1 million in sanctions. The deluge of tips would predictably move the SEC further from, not closer to, its goal of optimal deterrence by producing more in costs than deterrence benefits.⁹⁴ Moreover, even if the SEC could costlessly identify and weed out those tips not worthy of pursuit, it would end up spending much more in award payouts than would be necessary to incentivize whistleblowers, thus wasting money that could be put to higher-valued social use. Conversely, if typical whistleblowing costs were \$1 billion and every whistleblower entitled to an award received only \$100, the program would not encourage anyone to come forward, including individuals with strong probability suspicions about misconduct that imposes significant costs on society.

The foregoing suggests some important factors to keep in

⁹⁴ Even risk-averse individuals with low probability tips would find it rational to come forward in this scenario, but the promise of this sort of jackpot might operate to change people's risk preferences. Individuals are often willing to make low cost wagers on small probability events with high payoffs, even when the expected payoff is less than the cost of the bet—thus displaying risk-seeking behavior. See, e.g., Daniel Kahneman and Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, 47 *Econometrica* 263 (1979); Thomas A. Garret & Russell S. Sobel, Gamblers Favor Skewness, Not Risk: Further Evidence from United States' Lottery Games, 63 *Econ. Letters* 85-90 (1999). Extremely large whistleblower awards relative to whistleblowing costs might trigger this "lottery mentality," leading to an even larger deluge of low probability tips than would be expected under our working assumption that whistleblowers are risk averse.

mind when evaluating a whistleblower award calculation methodology. Most importantly, such a methodology should strive to produce award amounts that, on a discounted expected value basis, exceed the costs potential whistleblowers with desirable but not undesirable tips expect to bear. Even if the SEC could costlessly sort through tips, award amounts should not be set arbitrarily high because the funds in excess of what is needed to achieve the program's goals could be redeployed to more socially productive uses. This does not mean that the SEC should strive to set award amounts with complete precision, such that not one extra dollar is spent above what is necessary to create the right incentives for whistleblowers to report. Just as undesirable tips produce costs that detract from the efficiency gains of a whistleblower program, so too does the program's administration; thus, the costs associated with implementing an award calculation methodology is a factor to be considered. Finally, the ease of predicting award amounts using the methodology is also important. The higher the level of certainty with which a potential whistleblower can estimate an expected award, the smaller the risk discount they can be expected to apply, and hence the smaller the award needs to be to achieve the same incentive effect.

B. Evaluating the Percentage Method

Let us now evaluate the methodology currently used to calculate SEC whistleblower awards. As explained above, today such awards must be set at an amount not less than 10 and not more than 30 percent of the monetary penalties collected in a covered action and any related actions, with adjustments between those extremes done on a percentage basis in light of the criteria set forth in Rule 21F-6.

One virtue of this methodology is that it is fairly simple to administer. Determining the 10% minimum and 30% maximum award value requires a straightforward and elementary calculation. Determining where within this broad range the actual percentage awarded should fall requires SEC deliberation of the factors laid out in Rule 21F-6, but the SEC will be in possession of the facts necessary to assess each factor without the need for significant additional investigation. It can also weigh the factors however it chooses, without the risk of judicial second-guessing.

Another virtue of the percentage method is that it, like the covered action requirement, creates differential incentives for whistleblowers to come forward based on tip desirability. Whereas the covered action requirement achieves this through its impact on the probability of an award, the percentage method achieves this through its impact on award magnitude. To see this, consider first

the Dodd-Frank Act requirement that awards equal between 10 and 30% of monetary penalties collected. The penalty imposed on a defendant should be correlated to the seriousness of the violation being punished. All else equal, tying whistleblower awards to penalties imposed should therefore create stronger incentives for whistleblowers to come forward the more serious the misconduct suspected: expected awards will be higher and therefore more likely, when combined with any other benefits of reporting, to outweigh expected whistleblowing costs.⁹⁵

But to explain this logic is to reveal an important shortcoming of the percentage method as currently applied. The percentage method does not award whistleblowers a percentage of the value of the *penalties imposed*. It awards whistleblowers a percentage of the *monetary* penalties imposed that are *subsequently collected*. A correlation between this figure and the severity of the misconduct will likely exist, but it will be weaker than the correlation between the value of punishment imposed and the severity of the misconduct. How much the SEC collects in monetary penalties is, after all, not just a function of the size of the monetary penalty it chooses to impose, it is also a function of the defendant's ability to pay. (Even the SEC cannot squeeze blood out of a turnip.) The monetary penalties collected in an enforcement action against an individual, for example, will typically be substantially more limited than the monetary penalties collected in an enforcement action against a public company, because of disparate solvency

⁹⁵ I assume that whistleblower costs and the severity of the misconduct are exogenous to one another. If whistleblower costs rose in scale with the severity of the misconduct, the percentage method would not have the sorting effect described in the text. The relationship between whistleblower costs and the severity of the misconduct to which a tip relates is not easy to discern. The costs whistleblowers sometimes incur as a result of lost future employment opportunities might bear an inverse relationship to the severity of the misconduct. One might imagine that a whistleblower is less—not more—likely to be punished by potential future employers if it is known that the tip the whistleblower provided involved a severe securities law violation as opposed to a more technical violation that carries with it less social opprobrium. We tend, after all, to call individuals who report zoning infractions “snitches” and those who help identify murderers “heroes.” For similar reasons, reporting on severe violations might produce less internal angst than reporting on other types of violations, meaning psychic costs may also bear an inverse relationship to the severity of the misconduct. There is a positive association, consistently observed in the empirical literature on whistleblowing, between the seriousness or magnitude of the wrongdoing and the level of whistleblowing activity (Marcia P. Miceli, et al., Whistleblowing in Organizations 78 (2008)); this is consistent with the idea that whistleblowing costs tend to be lower, rather than higher, when the wrongdoing is serious. But workplace retaliation, which itself can result in significant emotional harm, might be more likely the more severe the misconduct. Social scientists have theorized that the seriousness of the wrongdoing is one of several factors that may help predict workplace retaliation, a proposition that finds some (albeit less than universal) support in empirical studies. *Id.* at 101-130.

constraints. The SEC may impose severe non-monetary penalties on defendants as a supplement to, or substitute for, monetary penalties, such as officer and director bars, referral to the DOJ for criminal prosecution, structural reforms, as well as other forms of injunctive relief.⁹⁶ Although the SEC often stresses that non-monetary remedies are critically important to its deterrence mission,⁹⁷ non-monetary relief is given no value in setting the Dodd-Frank Act's 10 and 30 percent award boundaries.

By tying awards to money collected instead of the value of punishment imposed, the percentage method may bias the tip pool in a problematic way. Many commentators believe that the SEC should fine public companies less and pursue individual wrongdoers

⁹⁶ See 2018 Sec. and Exchange Comm'n Div. of Enf't Ann. Rep. 12-13, <https://www.sec.gov/files/enforcement-annual-report-2018.pdf> (discussing non-monetary remedies) [hereinafter SEC 2018 Enforcement Report].

⁹⁷ See, e.g., *id.* at 13 (“One of the most important things that the Commission can do to protect investors is to remove bad actors from positions where they can engage in future wrongdoing”). The co-director of the SEC's enforcement division recently remarked:

The Commission has at its disposal a wide variety of remedies and relief. And in the Division of Enforcement we think carefully about what of those tools to recommend to the Commission in every case. What we do not do is assess large penalties simply for the sake of counting them up at the end of the year. For that reason, the effectiveness of our program cannot be measured with resort to any one quantitative measure, but instead requires a nuanced and qualitative evaluation of our overall impact on achieving our investor and market integrity protection mission

Steven Peikin, Remedies and Relief in SEC Enforcement Actions, SEC (Oct. 3, 2018), <https://www.sec.gov/news/speech/speech-peikin-100318>. See also Stephanie Avakian, Measuring the Impact of the SEC's Enforcement Program, SEC (Sept. 20, 2018) (arguing that statistics such as the dollar amount of judgements do not “provide a full and meaningful picture of the quality, nature, and effectiveness of the [Division of Enforcement's] efforts”), <https://www.sec.gov/news/speech/speech-avakian-092018>.

more.⁹⁸ Cases against individual defendants, while recovering smaller dollar amounts, can have a far greater deterrence impact than cases against corporate defendants. Individual defendants are more likely to pay out of their own pocket, and they also face severe non-monetary penalties. Pursuing individuals is harder than pursuing public companies; the agents that control the latter are often willing to settle and let the company's shareholders or insurance company bear the cost, whereas individuals facing real personal consequences are more likely to fight charges, requiring the SEC to bear its burden of proof.⁹⁹ It is thus precisely with respect to these cases that whistleblower tips could be most impactful, by helping the SEC discover the evidence of personal misconduct that it will need to prevail. But if potential whistleblowers expect that their tip will provoke the SEC to pursue individual defendants rather than a deep-pocketed corporate defendant, they will be less likely to blow the whistle than if the opposite were true. The percentage methodology in this way sends a questionable signal to potential whistleblowers. It also reinforces any natural tendency the SEC has to favor suits against public companies because they are easier to resolve.¹⁰⁰

⁹⁸ See, e.g., Zachary Kouwe, Judge Rejects Settlement Over Merrill Bonuses, NY Times, Sept. 14, 2009, at A1 (noting the “long-standing criticism that the SEC has largely failed to prosecute cases against corporate executives, opting for quick settlements in which companies themselves are penalized instead of their leaders”); Jonathan R. Macey, The Distorting Incentives Facing the U.S. Securities and Exchange Commission, 33 Harv. J. Law & Pub. Policy 639, 651 (2010) (critiquing the “SEC’s tendency to resist prosecuting corporate executives and instead to pursue prompt settlements against corporate defendants”); Gretchen Morgenson, Fining Bankers, Not Shareholders, for Banks’ Misconduct, N.Y. Times (Feb. 6, 2016) (noting that hundred-billion dollar fines levied on banking firms has produced little change on banking culture, primarily because corporate executives are not held personally responsible for violations of securities regulations), https://www.nytimes.com/2016/02/07/business/fining-bankers-not-shareholders-for-banks-misconduct.html?_r=0; James A. Kaplan, Why Corporate Fraud Is on the Rise, Forbes (June 10, 2010) (discussing how, amongst other things, the SEC needs to hold corporate executives and directors more accountable in order to deter corporate fraud), <https://www.forbes.com/2010/06/10/corporate-fraud-executive-compensation-personal-finance-risk-list-2-10-kaplan.html#7c6164e83aeb>.

⁹⁹ See SEC 2018 Enforcement Report, supra note 96 at 14 (“individuals are more likely to litigate and the ensuing litigation is resource intensive”); Macey, supra note 98 at 646.

¹⁰⁰ Both the False Claims Act and the IRS Whistleblower Program tie awards to monetary penalties collected. See supra note 9. But revenue-generation is an important goal in both of those contexts. False Claims Act suits seek to recover money that the federal government has wrongly been forced to pay out and IRS enforcement seeks to recover wrongly withheld tax revenue; favoring tips that promise to lead to the recovery of the most money for the federal government is thus sensible policy. The SEC’s enforcement mission, by contrast, is not revenue-generation: it is to optimally deter securities law violations with the ultimate goal of protecting investors and our capital markets. This mission is not necessarily advanced by favoring tips that promise to lead to the highest collection of

The criteria that Rule 21F-6 instructs the SEC to consider in setting the actual award percentage within the broad 10-30% range also potentially operate to create differential incentives to report depending on tip desirability. These factors instruct, *inter alia*, that the more specific the information, the more important the tip in relation to the SEC's "programmatically interest in deterrence," and the more timely the tip, the larger the award a whistleblower can expect. The whistleblower's participation in, or undermining of, its employer's internal compliance system is also a factor the SEC is instructed by the rule to consider in setting the award percentage. These factors reward tips that are more likely to produce net deterrence benefits.

The actual work the Rule 21F-6 criteria do to differentially incentivize desirable tips is questionable, however. Rule 21F-6 does not require that the SEC assign any particular weight to any particular factor, and its discretion to award percentages within the 10-30% statutory range is judicially unreviewable. In its public award determination orders, the SEC has been very opaque about the effect it has given to the Rule 21F-6 criteria. Indeed, most of the time the SEC does not even publish the percentage awarded.¹⁰¹ This makes it difficult for potential whistleblowers to estimate their likely award percentage with any confidence, complicating the already difficult task of deciding whether tipping is worthwhile. Potential whistleblowers might conservatively assume that they will obtain the 10% minimum award, or else account for the uncertainty surrounding a higher anticipated percentage by steeply discounting the expected award. Whistleblowers who retain counsel with experience representing successful claimants may be able to guess at a likely award percentage with greater confidence, but of course legal representation comes at a cost. The consequence is that potential whistleblowers will be more likely to find that the personal costs of coming forward exceed the benefits than would be the case if the SEC were more transparent about how it sets award percentages.

This points up another important weakness of the percentage method, both as adopted in the Dodd-Frank Act and as carried forward in Rule 21F-6. While the percentage method creates differential incentives to report based on tip desirability, it—like the covered action requirement—is essentially blind to whistleblowers' actual costs.¹⁰² If the penalties imposed in a covered action reflect

monetary penalties. Cf. Ferziger & Currell, *supra* note 92 at 1182-83 (similarly observing that agencies that are not primarily revenue-seeking, such as the Customs Service, should not condition whistleblower bounty payments on monetary penalties collected).

¹⁰¹ See *supra* note 69 and accompanying text.

¹⁰² Whistleblower costs are not obviously correlated with the monetary penalties collected in a covered action (see *supra* note 95), nor are they a factor that the

its deterrence value, then capping whistleblower awards at a fraction of monetary penalties collected ensures that an award will not exceed the deterrence value of the tip (ignoring enforcement and administrative costs). But the percentage method does not ensure that awards will not vastly exceed what is *necessary* to incentivize whistleblowers to come forward. Nor does it ensure that awards will not be so high as to encourage undesirable tips or, conversely, that they will be high *enough* so as to encourage desirable tips. This will all depend on the actual costs whistleblowers expect to bear by coming forward, which again the SEC does not currently take into consideration when setting award amounts.¹⁰³

One could imagine an alternative award calculation methodology keyed to whistleblower costs rather than the penalty imposed. For example, whistleblowers whose tips resulted in a covered action could be guaranteed a set multiple of any costs they incurred from coming forward, with the multiple set to reflect the minimum probability of success the SEC wants the tips elicited to possess in the eyes of whistleblowers, with a kicker to offset risk aversion.¹⁰⁴ If the SEC wanted to encourage tips with relatively

SEC is required to consider in setting the award percentage. Rule 21F-6 lists “[a]ny unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action” as one of six sub-factors that the SEC has the *option* to consider as part of its analysis of the degree of assistance provided by the whistleblower—itsself one of seven plus/minus factors that the SEC may weigh however it likes in determining the award percentage. 17 C.F.R. § 240.21F-6(a)(2)(vi). This is the only reference to whistleblower costs in the entirety of Rule 21F-6.

¹⁰³ Cf. Robert Howse & Ronald J. Daniels, *Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy*, *Corporate Decision-Making in Canada* 536 (1995) (“[I]t is clear that using a percentage of the fines ultimately levied against the corporation as a basis for bounties paid to whistleblowers may cause payments to diverge systematically from the levels necessary to compensate whistleblowers for the risk of loss to their human capital from corporate retaliation”).

¹⁰⁴ This cost-based methodology can be derived from a simple set of assumptions. First, potential whistleblowers will not report to the SEC if the expected benefits from doing so do not exceed the expected costs. Assume that a whistleblower award is the only benefit a whistleblower expects to receive from reporting and, for simplicity, ignore the time value of money and assume that whistleblowers expect to incur the same costs whether or not their tip results in a covered action. Under these circumstances, a potential whistleblower would not report unless the anticipated award payment, multiplied by its probability, exceeded the expected value of the whistleblower’s costs. This condition can be expressed algebraically as $A * P_A > C$, where A denotes the anticipated award payment, P_A denotes the probability of the award, and C denotes the expected value of whistleblowing costs. Rearranged, this condition reveals that a whistleblower must anticipate an award that exceeds the expected value of their costs divided by the probability of an award: $A > C/P_A$. In other words, if a whistleblower has a 10% probability of recovering an award, the anticipated award magnitude must exceed 10 times the expected value of the whistleblower’s costs for tipping to be potentially worthwhile. And if a whistleblower has a 1% probability of recovering

lower probabilities of success if they relate to relatively more severe misconduct, it could apply different multipliers in cases involving different types of allegations (e.g., a higher multiple could be promised to whistleblowers whose tips lead to the discovery of a scienter-based offense).

If implemented well, a cost-based method would more reliably incentivize reporting than does the percentage method. But it would be administratively more burdensome to apply and, importantly, it would encourage reporting even if the award payout would exceed the deterrence benefits produced by the tip. Just as the percentage method is disconnected from whistleblowing costs, the cost-based method is disconnected from the actual deterrence benefits achieved as a result of the tip. *What is needed is a hybrid approach that takes both the deterrence value of the tip and whistleblower costs into account.*

IV. Implications for Reform

The proposed revisions to Rule 21F-6 move precisely in this direction. The proposed revisions would allow the SEC, in a subset of cases at least, to consider the dollar amount of an award in order

an award, the anticipated award magnitude would need to be 100 times higher than the expected value of the whistleblowers' costs to make tipping potentially sensible. If whistleblowers were risk neutral rational actors, the award amounts would need to exceed these figures by just a penny to induce reporting; in reality, they would need to be adjusted upward by an amount sufficient to offset the discount potential whistleblowers would apply as a result of risk aversion. Now observe that the SEC could—and indeed should—decide the minimum probability of success it wants the tips the whistleblower program elicits to possess in the eyes of potential whistleblowers. Recall that if the program encourages too many undesirable tips, it can undermine the value of the program; the SEC is best positioned to figure out where to draw the line. Observe also that SEC is capable of identifying the award enhancement it thinks is necessary to offset risk aversion on the part of whistleblowers with tips of the desired strength. If the SEC made these determinations via rulemaking, in particular cases it could then calculate whistleblower awards by calculating the costs the whistleblower incurred by coming forward, dividing it by the chosen probability of tip success, and multiplying the quotient by the rate of enhancement determined necessary to offset risk aversion. Assume, for example, that the SEC determines that it only wants tips from whistleblowers who believe they have at least a 5% probability of receiving an award, and that it estimates that a 20% enhancement is necessary to offset the typical level of risk aversion experienced by this sort of whistleblower. The SEC would then compute awards in individual cases by determining a value for the whistleblower's costs, denoted C, and plugging it into the following formula: $A = (C/.05)*1.20$. Simplified, this equation indicates that the SEC should award an amount equal to 24 times a whistleblower's costs. If this multiple were publicized, and if it were based on an accurate assessment of the discount that whistleblowers with tips of the desired strength would apply to an anticipated award based on risk aversion, rational actors who believe their tips have a 5% or greater probability of leading to an award would reliably be incentivized to report, and rational actors with weaker tips would not.

to determine whether the award would be too small, or larger than necessary, to reward the whistleblower and incentivize desirable tips in the future, and to adjust the award upward or downward if it so finds (within the statutory bounds). This would invite the SEC to focus on whistleblower costs, which are essentially ignored under the current methodology, within a percentage framework that is tied (albeit imperfectly) to the deterrence benefit produced by the tip. Such a hybrid approach is attractive from a theoretical perspective for the reasons outlined above.¹⁰⁵

It becomes unattractive only if we assume that the SEC will intentionally or inadvertently get the adjustments wrong, or will consume so many resources in making the adjustments, that the change would produce more costs than benefits. The SEC could use the authority to make downward adjustments to eliminate unnecessary excess payouts to whistleblowers and to discourage undesirable tips, both laudable objectives¹⁰⁶; but downward adjustments could also operate to discourage even desirable tips if they go too far.¹⁰⁷ Is this a significant concern?

The ability of the SEC to go “too far” is limited in the proposed rule. The SEC would only be authorized to make downward adjustments based on dollar amounts in cases likely to lead to the collection of \$100 million or more in monetary penalties, and the SEC could not adjust the award below \$30 million or 10% of the collected monetary penalties, whichever is higher. Of course, there may be situations where a potential whistleblower would not find it rational to come forward unless he expected to be awarded more than \$30 million in the event a covered action resulted from his tip. But the potential impact of the rule will be limited to this subset, and the costs of administering the adjustment would be cabined concomitantly.

How would those falling within this subset be affected? Commissioner Jackson has suggested that these individuals would be deterred from reporting on the margins, because the change would increase the uncertainty surrounding a potential

¹⁰⁵ The hybrid percentage/dollar approach envisioned in the proposed rule bears a resemblance to what has become a common method used by courts in setting plaintiffs’ attorneys’ fees in class actions: courts calculate fees in the first instance as a percentage of the recovery, but compare the dollar value of the award thus generated to an estimate of the attorneys’ actual costs (a “lodestar”) to check whether adjustment is warranted. See Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees and Expenses in Class Action Settlements: 1993-2008*, 7 J. EMP. LEG. STUDS. 248, 267 (2010); Theodore Eisenberg, et. al., *Attorneys’ Fees in Class Actions: 2009-2013*, 92 N.Y.U. L. REV. 937, 945 (2017).

¹⁰⁶ The potential for awards in excess of \$30 million to prompt undesirable tips is exacerbated due to the lottery mentality discussed *supra* at note 94.

¹⁰⁷ Upward adjustments, if too great, could also operate to encourage undesirable tips. Given that the objections to the proposed revisions to Rule 21F-6 focus on downward adjustments, I focus on downward adjustments in the text.

whistleblower's calculation of their expected award, leading to a larger risk discount.¹⁰⁸ The added uncertainty, he has observed, would include *political* uncertainty: even if whistleblowers trust the current SEC to use the discretion the proposed rule affords wisely, a future SEC may be hostile to the program.¹⁰⁹

A close examination of the reality of the program today suggests that Commissioner Jackson's concerns, while theoretically sound, may be practically unwarranted. As previously explained, it is monumentally difficult for a whistleblower to predict with any confidence the percentage they will be awarded within the 10-30% range under existing practice. Not only is the SEC incredibly opaque concerning the weight it assigns to the various factors identified in the rule,¹¹⁰ it rarely ever discloses the percentage it has awarded. In those cases leading to whistleblower awards of \$1 million or more, the SEC has *never* revealed the percentage awarded. In light of this, it is likely that whistleblowers today already assume conservatively that they will receive only 10% of monetary penalties collected. If this is the case, then the proposed rule revisions will not have the impact Commissioner Jackson fears, given that they would not permit adjustments below the 10% statutory floor.

The proposed revisions might actually do more to alleviate uncertainty than exacerbate it. To see this, consider why it might be that the SEC behaves in such a non-transparent way in setting award percentages, despite the obvious negative impact on the whistleblower program.¹¹¹ A cynic might suggest that those within

¹⁰⁸ See Jackson, *supra* note 7 (“by increasing the uncertainty associated with the amounts of our awards, we decrease the value of those payments to whistleblowers at the moment when they decide whether to come forward—so we can expect that, under this proposal, fewer will come forward, and fewer frauds will be discovered in time to protect investors”).

¹⁰⁹ *Id.*

¹¹⁰ The IRS Whistleblower Program is much more transparent regarding the impact of plus/minus factors on the percentage awarded. *See* 26 C.F.R. § 301.7623-4 (*vis-à-vis* whistleblowers who provided substantial assistance, the IRS begins at 15 percent, then considers positive factors, which can operate to increase the award to 22 or 30 percent; the IRS next considers the presence and significance of any negative factors, which may lead it to reduce a 22 percent award to 18 percent or reduce a 30 percent award to 26 percent or 22 percent).

¹¹¹ Information about percentages would be much more helpful than information about the dollar amount of the awards, which the SEC does routinely publish, because dollar amounts are dependent on the monetary sanctions collected in a particular case (the details of which are almost always redacted); a potential whistleblower has no basis to assume that the sanctions in their action and hence their award would be comparable. Publishing percentages along with the criteria that the SEC used to determine the percentage would be more helpful, because it would allow the whistleblower to better predict the percentage they would be awarded, which they could then apply to the collections they anticipate in order to determine if blowing the whistle is worth the risk. There is no reason the SEC

the SEC responsible for determining award percentages enjoy their power to dole out (or withhold) significant sums of government money to whistleblowers without public scrutiny; perhaps they use their discretion to richly reward their friends and punish their enemies. I doubt this is the case, but the public has no way of knowing for sure.¹¹² A less cynical, and in my view more plausible, explanation is that the SEC is *already* taking dollar amounts into account in setting awards because, well, it makes good sense to do so. My guess is that if the percentages were disclosed, we would observe an inverse relationship between the percentage awarded by the SEC to whistleblowers in a covered action and the monetary penalties collected, holding all else equal, with the percentages especially sensitive to dollar amounts when the awards are very small or very large (and thus particularly likely to be insufficient to induce reporting or, conversely, beyond what is necessary to induce reporting, given whistleblowers' costs).¹¹³ The SEC probably keeps the percentages it awards confidential in order to avoid criticism that it is not complying with Rule 21F-6, which as currently written does not permit consideration of the dollar value of the award.¹¹⁴ If this

could not publish this information while still maintaining whistleblower confidentiality. Indeed, revealing dollar amounts is more likely to provide information that would allow someone to guess at a whistleblower's identity than would revealing percentages. Revealing *both* the dollar amount and the percentage awarded in a particular covered action would jeopardize whistleblower confidentiality, because it would make it easy to identify the enforcement action to which the award relates; if the SEC wanted to give a sense of the dollar magnitude of awards it might instead provide aggregated data (e.g., "Over the past year we have awarded over \$100 million to seven individuals, including 4 awards in excess of \$10 million") or provide a vague description or general range of the dollar magnitude of the award along with the percentage in particular cases (e.g., "Whistleblower X received a 20% award, which will yield a multi-million dollar payout").

¹¹² I believe that most individuals at the SEC are dedicated public servants with a high level of moral integrity. Moreover, there are several layers of internal review of award determinations within the SEC that should operate to constrain this sort of self-serving behavior, as well as the threat of Congressional oversight. See WP 2018 Report, *supra* note 19 at 14 ("Most award claim recommendations . . . generally go through a multi-tiered, robust review process, including review and comment by Enforcement's Office Chief Counsel and the Commission's Office of General Counsel").

¹¹³ Courts appear to behave in a similar way when awarding class counsel fees. Empirical studies reveal that courts award smaller percentages the higher the dollar value of a settlement. See Eisenberg & Miller, *supra* note 105 at 263-265 (documenting the existence of a scaling effect, in which the fee percent decreases as the class recovery increases); Eisenberg, et al., *supra* note 105 at 947-48 (same).

¹¹⁴ It may be that the SEC is proposing these changes because it has faced criticism from award claimants contesting the percentage awarded them on precisely this ground. See, e.g., SEC Release No. 73174 p.3 n.4 (Sept. 22, 2014) (\$30 million award claimant, contesting the percentage awarded, "suggested that a factor

reading of the tea leaves is correct, the SEC might become more transparent regarding the percentages it is awarding and why if Rule 21F-6 is changed to make lawful the consideration of dollar amounts.

For the foregoing reasons, I support the proposed revisions to Rule 21F-6.¹¹⁵ But I also view them as incomplete. The analysis in the last section points up another glaring problem with the award calculation methodology that ought to be addressed: Whistleblower awards should be tied to the value of the *punishment imposed* in the covered action resulting from the whistleblower’s tip, rather than the amount of *monetary penalties collected*. This would better align a whistleblower’s incentive to tip with what should be the SEC’s enforcement priority—catching the most egregious misconduct, not just the misconduct that is most likely to result in the collection of large monetary penalties.¹¹⁶ Congressional action would be required to untether the calculation of the 10% floor and 30% ceiling from monetary penalties collected, but nothing in the Dodd-Frank Act prevents the SEC from adopting a rule that would allow it to consider the value of non-monetary penalties in deciding what the award amount should be within the statutory bounds. Indeed, the existing Rule 21F-6 criteria are best read to permit the SEC to take this into account already.¹¹⁷ But the rule could and should be revised

beyond those specified in Rule 21F-6 may have been considered” in setting the award percentage and also asserted that his or her “award is below the average percentage amount awarded to other successful claimants to date”), <https://www.sec.gov/rules/other/2014/34-73174.pdf>.

¹¹⁵ Indeed, I might even support a rule change allowing the SEC to consider dollar amounts, within the statutory 10-30% parameters, in all cases, not just those cases that fall at the extreme margin. But requiring the SEC to consider the incentive effects of the dollar value of awards in all cases would impose greater administrative costs on the agency, and it would create greater opportunities for distortion if the SEC exercised its adjustment power unwisely. The benefits of such a change might be worth it, but this presents a harder question—one I do not attempt to resolve here.

¹¹⁶ Derivative litigation provides an apt analogy: courts recognize that plaintiffs’ attorneys can generate value for a company even when they reach non-monetary settlements, and thus require the corporation to pay attorneys’ fees in such cases under the substantial benefit variant of the common fund rule. *See* Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 *Del. J. Corp. L.* 1, 2 (1999) (“Early cases seemed to require the creation of a ‘common fund,’ that is, a pool of money from which these fees would be paid. In recent years, however, . . . in the absence of a common fund, the courts have been willing to award attorneys’ fees to the plaintiff if the derivative litigation resulted in a ‘substantial or common benefit’ to the corporation . . .”).

¹¹⁷ One of the sub-factors that the SEC may consider when addressing the impact of the tip on its “programmatic interest in deterring violations of the securities laws” is “the degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers’ submission of significant information and assistance, *even in cases where*

to *require* that the SEC do so explicitly and in every case.

This could be achieved by requiring the SEC to apply the percentage it otherwise determines appropriate using existing Rule 21F-6 criteria to the *combined* value of the monetary and non-monetary penalties imposed in the case, in order to arrive at the ideal whistleblower award amount.¹¹⁸ The SEC would then be required to make payments to the whistleblower as monetary penalties are collected until that dollar target is hit, subject to the 30% statutory ceiling. This approach would require that the SEC assign a dollar value equivalent to non-monetary penalties. This would be a difficult but worthwhile exercise. Not only would it improve the whistleblower program by tying anticipated awards more closely to the SEC's deterrence objectives, but it would also force the SEC to reflect deliberatively on the relative value of the various remedial tools available to it, perhaps leading to better enforcement choices. It might also benefit the SEC in its ongoing conversation with Congress regarding the proper lens through which to evaluate the SEC's enforcement program. The SEC has repeatedly urged Congress not to evaluate the effectiveness of its enforcement program by looking narrowly at quantitative measures like monetary penalties collected, emphasizing how important non-monetary penalties can be in promoting deterrence.¹¹⁹ Congress might be more willing to heed this advice if the value of non-monetary penalties could be expressed using a common, objective metric. If assigning a monetary equivalent to non-monetary penalties were viewed as too difficult, however, a simpler alternative exists. Rule 21F-6 could be revised to require an upward adjustment of the award percentage in the event a covered action involved the imposition of substantial non-monetary penalties. A whistleblower's entitlement to this upward adjustment, and its magnitude, should be clear and predictable.

More broadly, the SEC should be more transparent about the weight it assigns to the Rule 21F-6 criteria and about the actual percentages that it is awarding in covered actions. As noted above, this might occur naturally if Rule 21F-6 is revised to allow the SEC to consider dollar amounts in extreme cases, but to ensure greater transparency the SEC should be required to publish the percentage awarded to whistleblowers in every covered action as well to disclose in greater detail how and why it arrived at the percentage it did, unless the disclosure would jeopardize the whistleblower's

the monetary sanctions available for collection are limited." 17 C.F.R. § 240.21F-6(a)(3)(ii) (emphasis added).

¹¹⁸ This amount would be subject to adjustment if called for under the SEC's proposed revisions to Rule 21F-6.

¹¹⁹ See *supra* note 97.

confidentiality.¹²⁰ By increasing the predictability of award percentages, this change would reduce the risk discount potential whistleblowers would otherwise apply to an expected award.

V. Conclusion

Any reform to the whistleblower award calculation methodology should be evaluated in terms of how well it advances the goals of the WP. This Article posits that the WP is designed to incentivize individuals to submit tips to the SEC that will advance the SEC's deterrence mission without simultaneously encouraging tips that will detract from that mission. The current percentage methodology for calculating whistleblower awards creates differential incentives to tip based on tip desirability, but it fails to consider whether the award amounts produced by the methodology will actually be sufficient to elicit desirable tips or, conversely, will be higher than necessary to do so and possibly even so high as to encourage undesirable tips. That will depend on how the anticipated dollar amount of a potential award compares to the costs whistleblowers expect to bear by coming forward.

The proposed changes to Rule 21F-6 would remedy this shortcoming by allowing the SEC to consider the dollar amount of awards produced by the percentage method, at least in a subset of cases, and to make adjustments in light of the incentive effects. While the reform gives the SEC additional discretion in setting award amounts, it is not clear that the result will be increased uncertainty as Commissioner Jackson has warned; to the contrary, the reform may lead the SEC to be more transparent regarding how it determines award amounts than it is today. Under current practice, the SEC routinely discloses the dollar amount of awards but almost never discloses the percentage, an odd practice given that disclosing percentages would allow potential whistleblowers to anticipate their awards with greater certainty.¹²¹ If the SEC is withholding information about percentages to hide the fact that it is already taking dollar amounts into account in setting the award percentage, the reform will reduce this incentive for obfuscation.

While I support the reforms to Rule 21F-6 that the SEC has proposed, the analysis in this Article suggests at least two more that should be considered. First, the SEC should be required to be more transparent about the percentages it is awarding and why. Increasing the predictability of award amounts will cause potential whistleblower to apply a lower risk discount to their expected awards. Second, reforms that would better tie whistleblower awards to penalties imposed, as opposed to monetary penalties collected,

¹²⁰ See supra note 111.

¹²¹ See supra note 111.

should be considered. Such reforms would better align a whistleblower's incentive to tip with the SEC's deterrence mission and could produce collateral benefits for the agency.

Appendix A

Rule 21F-6 Criteria for determining amount of award.

In exercising its discretion to determine the appropriate award percentage, the Commission may consider the following factors in relation to the unique facts and circumstances of each case, and may increase or decrease the award percentage based on its analysis of these factors. In the event that awards are determined for multiple whistleblowers in connection an action, these factors will be used to determine the relative allocation of awards among the whistleblowers.

(a) *Factors that may increase the amount of a whistleblower's award.* In determining whether to increase the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) *Significance of the information provided by the whistleblower.* The Commission will assess the significance of the information provided by a whistleblower to the success of the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) The nature of the information provided by the whistleblower and how it related to the successful enforcement action, including whether the reliability and completeness of the information provided to the Commission by the whistleblower resulted in the conservation of Commission resources;

(ii) The degree to which the information provided by the whistleblower supported one or more successful claims brought in the Commission or related action.

(2) *Assistance provided by the whistleblower.* The Commission will assess the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance by, for example, helping to explain complex transactions, interpreting key evidence, or identifying new and productive lines of inquiry;

(ii) The timeliness of the whistleblower's initial report to the Commission or to an internal compliance or reporting system of business organizations committing, or impacted by, the securities violations, where appropriate;

(iii) The resources conserved as a result of the whistleblower's assistance;

(iv) Whether the whistleblower appropriately encouraged or authorized others to assist the staff of the Commission who might otherwise not have participated in the investigation or related action;

(v) The efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the authorities in the recovery of the fruits and instrumentalities of the violations; and

(vi) Any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action.

(3) *Law enforcement interest.* The Commission will assess its programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In considering this factor, the Commission may take into account, among other things:

(i) The degree to which an award enhances the Commission's ability to enforce the Federal securities laws and protect investors; and

(ii) The degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submission of significant information and assistance, even in cases where the monetary sanctions available for collection are limited or potential monetary sanctions were reduced or eliminated by the Commission because an entity self-reported a securities violation following the whistleblower's related internal disclosure, report, or submission.

(iii) Whether the subject matter of the action is a Commission priority, whether the reported misconduct involves regulated entities or fiduciaries, whether the whistleblower exposed an industry-wide practice, the type and severity of the securities violations, the age and duration of misconduct, the number of violations, and the isolated, repetitive, or ongoing nature of the violations; and

(iv) The dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or

threatened by the underlying violations, and the number of individuals or entities harmed.

(4) *Participation in internal compliance systems.* The Commission will assess whether, and the extent to which, the whistleblower and any legal representative of the whistleblower participated in internal compliance systems. In considering this factor, the Commission may take into account, among other things:

(i) Whether, and the extent to which, a whistleblower reported the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission; and

(ii) Whether, and the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations.

(b) *Factors that may decrease the amount of a whistleblower's award.* In determining whether to decrease the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) *Culpability.* The Commission will assess the culpability or involvement of the whistleblower in matters associated with the Commission's action or related actions. In considering this factor, the Commission may take into account, among other things:

(i) The whistleblower's role in the securities violations;

(ii) The whistleblower's education, training, experience, and position of responsibility at the time the violations occurred;

(iii) Whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations;

(iv) Whether the whistleblower financially benefitted from the violations;

(v) Whether the whistleblower is a recidivist;

(vi) The egregiousness of the underlying fraud committed by the whistleblower; and

(vii) Whether the whistleblower knowingly interfered with the Commission's investigation of the violations or related enforcement actions.

(2) *Unreasonable reporting delay.* The Commission will assess whether the whistleblower unreasonably delayed reporting the securities violations. In considering this factor, the Commission may take into account, among other things:

- (i) Whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;
- (ii) Whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and
- (iii) Whether there was a legitimate reason for the whistleblower to delay reporting the violations.

(3) *Interference with internal compliance and reporting systems.* The Commission will assess, 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. In considering this factor, the Commission will take into account whether there is evidence provided to the Commission that the whistleblower knowingly:

- (i) Interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation;
- (ii) Made any material false, fictitious, or fraudulent statements or representations that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations; and
- (iii) Provided any false writing or document knowing the writing or document contained any false, fictitious or fraudulent statements or entries that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations.

