Whistleblower Bounties in European Capital Markets Law?

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'Year of the bounty hunter', was the title used by the Economist recently to describe one potential effect of the Dodd Frank Act of 2010. With this Act, the US legislator built upon the venerable tradition, dating back to the Federal Claims Act of 1863, of offering financial rewards to whistleblowers. Similar instruments have since been introduced into US capital markets law: The Insider Trading and Securities Enforcement Act of 1988 authorized the SEC to pay premiums for information on insider market abuses. The Dodd Frank Act has vastly expanded the existing award system: By adding section 21F to the Securities and Exchange Act, whistleblowers became entitled to a reward of between 10% and 30% for volunteering new information that leads to the SEC imposing a fine of at least one million US dollars.

The European Commission, in its recently presented Proposal for a Market Abuse Regulation, has taken up this regulatory idea. Under the heading 'Reporting of Violations', Article 29 (1) of the draft regulation states that Member States shall put in place effective mechanisms to encourage reporting of breaches of the market abuse regulation to competent authorities. In addition, Article 29 (2) enables Member States to grant financial incentives to persons who submit salient information on market abuse. There is little detail to explain reasons behind the introduction of such a reward program into European capital markets law. The Commission's impact assessment contains only brief references to potential deterrent effects and adds only that stronger whistleblower protection and financial incentives are a highly efficient regulatory strategy, as they involve lower costs.

Given this lack of policy discussion, it is high time to have a closer look at the pros and cons of reward programs for whistleblowers. In their favour, one may point to the comparative advantages of using company insiders as whistleblowers: While many capital market abuses are difficult to detect from the outside, employees of a company may come across evidence as part of their daily activities, making them particularly cost-effective gatherers of information. As rational actors however, these potential informants would only sound the alarm where the individual benefits of notification outweighed the potential negatives (threatened dismissal, social ostracism, etc). Financial incentives could tip the cost-benefit balance in favour of making a submission, resulting ideally in a higher rate of notifications and an increase in securities fraud detection and public confidence in European capital markets.

On the other hand, there are also potential drawbacks: (1) The promise of a reward may engender a 'lottery mentality' and increase the number of unreliable submissions. (2) The supervisory authorities must first 'separate the wheat from the chaff' which would require additional administrative resources. (3) Financial incentives for external whistleblowing may weaken the effectiveness of internal compliance programs by leading employees to contact external authorities directly rather than going through the internal whistleblower hotline. (4) Cultural differences in the treatment of whistleblowing may limit its effectiveness: While in the US, Time Magazine named three whistleblowers as 'Persons of the Year' in 2002, in Germany, for example, whistleblowing may bring up dark national memories of denunciation as practiced under the Nazi regime and later under the Ministry of State Security in the former communist East Germany.

Appropriate structuring of the reward program would go a long way to ameliorating some of these potential counter-arguments: (1) Well written regulation may reduce the danger of abuse. (2) Requiring initial reporting to internal compliance programs before then turning to external authorities could ensure the effectiveness of internal corporate compliance programs. (3) Legislators could deal with general scepticism in public attitudes towards whistleblowing by adopting a broad campaign of reshaping social attitudes. This approach seems to have worked in the UK, where the Public Interest Disclosure Act of 1998 has altered social awareness and attitudes towards whistleblowing. In some respects, this is similar to the leniency programs used in European competition law.

Deeper exploration of these arguments and counter-arguments and review of the (scant) empirical evidence on the success or undesired side-effects of whistleblower programs in capital markets law must be undertaken elsewhere. From a regulatory perspective, however, it is worth noting that there is a range of mechanisms to choose from when encouraging informants to 'blow the whistle': (1) effective protection against retaliation, (2) a statutory obligation to report, (3) the imposition of fines for a failure to notify, and (4) financial incentives for informants.

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