REGULATORY REPORT CARD | March 2014

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AGENCY

US Securities and Exchange Commission (SEC)

Rule title
Securities Whistleblower Incentives and Protections

RIN	3235-AK78
Publication Date	June 13, 2011
Stage	Final

RULE SUMMARY

This regulation implements a program required under Dodd-Frank in which the Securities and Exchange Commission (SEC) pays rewards to whistleblowers who provide original information that leads to the successful prosecution of a violation of federal securities laws involving a monetary sanction exceeding $1 million. The reward can range from 10 percent to 20 percent of the sanction. This rules lays out the requirements that whistleblowers must adhere to in order to be eligible to receive an award. The rule also prohibits firms from retaliating against whistleblowers.

COMMENTARY

The regulation offers rewards to whistleblowers because Dodd-Frank requires it. The analysis explains theoretically why the regulation can be expected to lead to more whistleblowing, but it never explains why the current amount of whistleblowing is suboptimal. In general, the analysis reads more like an afterthought that was used to justify decisions already made rather than to inform the decision-making process. It is difficult to distinguish between the “economic analysis” section of the rule and the rest of the preamble. In fact, this analysis does not bear much resemblance to the types of economic analysis that are done by most executive branch agencies. There was no identification of a systemic problem that the agency was seeking to solve through regulation. Nor was there any monetization of benefits or costs. Instead, the commission simply asserted some possible benefits and costs to particular parts of the rule and offered little or no evidence to suggest these benefits and costs might be real.

This rule’s economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce’s study, “SEC Regulatory Analysis: ‘A Long Way to Go and a Short Time to Get There.’”
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OPENNESS	Score	Comments
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1A
2. How verifiable are the data used in the analysis?	1	1B
3. How verifiable are the models and assumptions used in the analysis?	3	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	11	

ANALYSIS	Score	Comments
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	2	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	4	

USE	Score	Comments
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	3	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	1	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	3C
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	3D
Total Use (Sum of 9–12)	5	

Total Score	**20**	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria.
This analysis was scored on a scale from zero to 60 points.

OPENNESS			
Criterion	**Score**	Com. No.	Comment
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1	Keyword and RIN searches readily turn up the regulation on regulations.gov. It can also be found easily on the SEC web site via the "regulations" link or via a Google search. The economic analysis is in the notice.
2. How verifiable are the data used in the analysis?	1	2	There are no calculations and no data, except for the Paperwork Reduction Act section. Calculations in this section are based on "staff estimates" and internal SEC data.
3. How verifiable are the models and assumptions used in the analysis?	3	3	The hypothesis that a segment of whistleblowers will not come forward if internal reporting is mandatory is the principal theory underlying the analysis. Analysis cites published law and economics articles on whistleblowers' motivations and in support of the incentive-based approach.
4. Was the analysis comprehensible to an informed layperson?	2	4	The analysis is very brief, consisting mostly of some reasoning and some citations in support of the regulation the commission chose to adopt. The reasoning is relatively clear; the empirical support less so. A helpful flow chart shows how the process set forth in the regulation works. There is little jargon because there is little analysis.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	3	5A	The analysis mentions four main goals of the rule: (1) to encourage high quality whistleblowing submissions and discourage frivolous submissions, (2) to encourage whistleblowers to come forward early, (3) to establish fair and transparent procedures, and (4) to promote effective internal compliance programs within firms. These are all activities, not outcomes. In addition, on page 34363, the analysis asserts that early detection of securities violations, heightened investor trust in markets, more efficient capital allocation, and improvements in corporate governance structures are all desired outcomes of the rule.
Does the analysis identify how these outcomes are to be measured?	0	5B	Neither the inputs/activities listed above nor the ultimate outcomes are measured.
Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	2	5C	The analysis argues that financial incentives will induce more whistleblowing on the margin and that offering larger financial incentives for internal reporting will elicit more whistleblowing than mandatory internal reporting. This shows how the regulation could lead to more whistleblowing but not ultimate outcomes. Claims that reduced fraud and improved compliance will improve investor confidence and capital allocation are assertions, not a well-developed causal theory.

Does the analysis present credible empirical support for the theory?	2	5D	The analysis cites several published scholarly articles in support of the argument that incentives will increase whistleblowing, but it is not always clear whether these provide empirical support or just outline a similar theory. One working paper does apparently show that firms change their governance in response to whistleblowing, which is one link in the causal chain but by no means the only one.
Does the analysis adequately assess uncertainty about the outcomes?	0	5E	An increase in reporting is assumed to occur with certainty. There is no discussion of uncertainty regarding outcomes.
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0		
Does the analysis identify a market failure or other systemic problem?	0	6A	The regulation is largely justified because the Dodd-Frank law required it. There is no clear demonstration that some ultimate outcome of interest to citizens is less than optimal for some reason that could be remedied by an increase in whistleblowing.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	0	6B	Why the amount of whistleblowing is currently less than optimal is never explained.
Does the analysis present credible empirical support for the theory?	0	6C	It is not clear whether cited sources have empirical information relevant to a systemic problem. Sources are cited as authorities that agree with statements in the analysis; if they have empirical information, it is not generally summarized.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	The problem is assumed to exist with certainty.
7. How well does the analysis assess the effectiveness of alternative approaches?	2		
Does the analysis enumerate other alternatives to address the problem?	3	7A	The regulation provides incentives for a whistleblower to report violations internally but leaves the decision to the whistleblower. The analysis says the SEC considered mandatory internal reporting requirements, or mandatory internal reporting unless the commission directs otherwise, instead of providing incentives for internal reporting. So really this was a choice between voluntary internal reporting or several types of mandatory internal reporting. The original proposal that the whistleblower submit two different forms was condensed to one form. The focus is on how to get more whistleblowing rather than alternative means to get tips or accomplish outcomes.

Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	3	7B	The alternatives consist of an incentive-based voluntary approach and several mandatory approaches. All seek to assist enforcement of securities laws through the same means: elicitation of information. Some other tweaks are extremely narrow: how many days to give whistleblowers to come forward, whether or not to encourage violations of attorney client privilege, and whether to reward people who themselves violated securities laws. However, these are really just minor considerations within a larger framework that seems to have been decided from the outset.
Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	1	7C	The analysis asserts that the alternatives will lead to less reporting of violations, but it does not attempt to measure how much less.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	0	7D	The baseline is not very clear. The analysis section compares voluntary vs. mandatory internal reporting without comparing any of these to the state of the world in the absence of the regulation.
8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	1	8A	There is very little discussion of costs in the economic analysis section. The word "cost" is used occasionally as a synonym for "disadvantage." Thus, a reduction in reporting of whistleblowing under a mandatory approach vs. an incentive-based approach is characterized as a cost.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	2	8B	A small paperwork burden is calculated in the Paperwork Reduction Act section. This is the only cost estimated. The analysis mentions costs of increased litigation, costs to the whistleblowers themselves (such as factors that might make the whistleblower more or less likely to come forward), and also costs to the Investor Protection fund.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	0	8C	There is no discussion of changes in prices of goods or services resulting from the rule.
Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	3	8D	The analysis notes that several commenters argued rewards for whistleblowers could discourage internal reporting so the whistleblower can collect a reward for external reporting. It claims the regulation is tailored so that whistleblowers are rewarded for continuing to report internally. The potential for frivolous lawsuits also receives brief discussion.
If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	0	8E	There is no discussion of cost uncertainty.
Does the analysis identify the alternative that maximizes net benefits?	1	8F	In a few cases, the analysis claims alternatives do not have a "cost-benefit advantage," which appears to be a synonym for net benefits, and it presents some qualitative reasoning in support of this claim. But since neither benefits nor costs are calculated, there is no comparison of net benefits in the conventional sense.

Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	There is no relevant discussion.
Does the analysis identify all parties who would bear costs and assess the incidence of costs?	2	8H	The analysis identifies firms that might bear increased compliance and litigation costs, whistleblowers who might bear retaliation from employers, and taxpayers who will ultimately have to pay for the investor protection fund. These costs are not quantified. Competition discussion recognizes a "concern" that the rule may disproportionately burden small companies but presents several reasons for why this is unlikely to occur.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	1	8I	There is little relevant discussion. Beyond some broad assertions that the regulation promotes efficiency and capital formation, the regulation's objective of promoting whistleblowing is not well linked to overall social benefits or benefits for particular groups.
USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	3	9	Text of notice cites the economic analysis section in support of the decision not to include a mandatory internal reporting requirement. It is not clear if the economic analysis section was done before this decision was made, but it is hard to see how the commission could have reached this decision without employing something like the reasoning used in the economic analysis section. The decision to create this program was determined by the law.
10. Did the agency maximize net benefits or explain why it chose another alternative?	1	10	The analysis did not calculate costs, benefits, or net benefits. The analysis did present some reasoning suggesting why some mandatory reporting alternatives would lead to less reporting.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	11	No goals or measures were articulated, and the economic analysis is not sufficient to develop them.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	12	It is clear that the SEC will be able to track whistleblower tips and identify which ones led to significant enforcement actions. So the SEC will have the data to assess whether this regulation generates more useful tips. It is not clear the SEC has sufficient data to assess the effect on ultimate outcomes.