Whistleblower Protections but no Rewards: EU Commission Proposes a New Directive
Introduction

On the 17th of April 2018 the European Commission adopted a package of measures to increase protections for whistleblowers (European Commission Newsroom, 2018). This is good news, as whistleblower protection in Europe has been uneven and in some member states non-existent. Transparency International (2013) rated a disappointing four European countries as having adequate or extensive protection. In a report by Wolfe et al (2014), several European countries, including Germany, France and Italy, were judged to have inadequate laws with respect to several aspects of whistleblower protection, although France and Italy recently improved them considerably.

Corruption, fraud of various types, and related forms of economic crime are widespread almost everywhere in the world (See e.g. Dyck et al 2014, and Global Crime Survey 2016). Criminal organizations such as drug cartels, have become increasingly sophisticated and their ability to use the international financial markets has made it ever more difficult for law enforcement agencies to discover them with more traditional law enforcement tools (see e.g. Radu 2016 for an overview). Incentivizing whistleblowers through protection and rewards can prove effective at getting information on these hard-to-detect crimes. Whistleblower protection is central for ensuring democratic values such as freedom of speech and fair elections, and recent cases also suggest that it may be central for protecting investigative journalists and their sources.

The Need for Protection and Possibly Rewards

On February 26 2018 Ján Kuciak, a Slovakian journalist, was murdered in his home for investigating political connections to organized crime in the heart of Europe (Washington Post, 2018); Daphne Caruana Galizia was killed on 16th of October 2017 by a car bomb while she had been writing about corruption in Malta in connection with the Panama papers (Financial Times, 2018a); Maria Efimova, an employee at a private bank that claimed that her employer had illegally moved funds for Maltese politicians, is under an arrest warrant from Malta and Cyprus on seemingly unrelated charges (The Guardian, 2018); and Hervé Falciani, who blew the whistle on the bank he was working for in Switzerland that helped clients evade billions of dollars in taxes, was arrested in April in Spain after an arrest warrant issued by Switzerland on March 19th, though he has now been released on bail (Financial Times, 2018b).

While some EU countries recently improved whistleblower protection, some seem to be heading in the opposite direction. An extreme example is Germany. A provision packed into the German Data Retention Framework of 2015 allows for prison sentences of up to 3 years for the handling of “stolen data”, and journalists are no longer protected against search and seizure (European Digital Rights, 2017). This provision was included despite Germany’s problems with underreporting of corporate crime. On the need of whistleblowing in the country, consider Volkswagen’s emissions scandal in 2015 when the public learned that the company had installed defeat devices in millions of diesel cars to ‘cheat’ on environmental emissions standards and increase pollution all over the world. The response of management was to blame a set of “rouge engineers” (Congressional Hearing, 2015), while we now know that power points on how to circumvent U.S. emissions tests by a top technology executive circulated within the company as early as 2006 (New York Times, 2016). Excess diesel emissions were associated 38 000 premature deaths in 2015 (Anenberg et al, 2017), implying that whistleblowing could have saved thousands of lives, yet the wrongdoing went on for close to a decade without anyone blowing the whistle. Cheating on emissions tests also turned out to be an industry wide phenomenon.
Germany also has a history of treating whistleblowers poorly. Consider for example the case where a German nurse brought a complaint to her employer in December of 2004 over poor treatment of patients, and she was fired in January 2005. Her employer cited repeated illness as the reason for being fired, the nurse claimed that it was retaliation for speaking out about poor conditions. The nurse then filed a complaint in German Labor Court which was dismissed in August 2005. She then brought the claim to the European Convention of Human Rights, alleging that her right to expression under article 10 of the European Convention of Human Rights had been violated by her employer. She won that case in 2011, and Germany was ordered to pay the nurse 10 000 Euro in non-pecuniary damages, and 5000 for costs and expenses (Heinish V Germany 2011).

Large firms do not appear to be doing better. Even after the Siemens scandal in 2008, when the company was discovered pursuing a long-term, extensive and systematic strategy of bribing foreign governments and purchasing agencies, and promises about a drastic change in corporate governance. Recent cases suggest that the corporate culture at Siemens has not improved. Meng-Lin Liu, a compliance officer at Siemens China, brought attention to alleged kickbacks paid in connection with equipment sales to army hospitals in China to the chief financial officer for healthcare in China. He was fired after reporting internally and filed a claim alleging violations of the Foreign Corrupt Practices Act. Siemens lawyers argued that since he was no longer an employee, he was not entitled to protection under Dodd-Franks definition of “whistleblower” (Forbes, 2014).

The situation in such an important European country like Germany suggests that protection applying across all member states is needed, and the experience of other countries further suggest that protection may not be enough. In the UK, the country recognized to have some of the best protections in the EU (Wolfe 2014, Transparency International 2013), whistleblowers are still experiencing pushback. The recent case of Jes Staley, Barclays Bank’s CEO is enlightening. He ordered his security team to unveil the identity of an uncomfortable whistleblower, going so far as to request video footage of the person who bought the postage for the letter. Yet, the Financial Conduct Authority and the Prudential Regulation Authority (FiCA & PRA) decided to just fine him £642 000 – a small fraction of his pay package that year (Reuters, 2018). Cases like this suggest that the US Congress was right in pushing for rewards. The mild sanctions established by the UK regulators sent a loud and clear message to prospective whistleblowers: even in the UK, where protection was judged as high in the above-mentioned reports, a CEO that violates the law trying to uncover someone reporting his potential mismanagement (probably not to give him a premium), will just have to pay a mild fine, if he is caught of course!

In the following we review the new proposal for whistleblower protections and argue that evidence from the US suggests that financial incentives for whistleblowers may still be needed to ensure an adequate level of reporting. We then consider objections to monetary rewards which are praised by regulators in the US, while EU agencies remains hesitant. Finally, we conclude with suggestions on how to improve the European legislation.

**The EU Proposed Directive Versus US Developments**

The new Directive includes mandatory establishment of internal reporting channels for firms with more than 50 employees that should allow for anonymous claims (Article 5). It includes prohibition against a wide range of retaliation (Article 14); and the burden of proof is reversed in case of alleged retaliation (Article 15). Who counts as a whistleblower under the Directive is defined widely to encompass subcontractors, trainees, and people associated with a wrongdoing firm in a “work-related context” (Article 2).
The Directive is bound to improve the situation for whistleblowers given the current uneven protection. It bears similarities with the US Sarbanes-Oxley act of 2002 (SOX), but it goes beyond SOX in that it applies more broadly. Since SOX, the legal debate in the US has increasingly focused on rewards to whistleblowers as protections alone are often insufficient to ensure an adequate level of reporting.

After the financial crisis, the US concluded in the Dodd-Frank Act of 2008 that protections were insufficient, and that above and beyond protections, Dodd-Frank allows for rewards to whistleblowers who report wrongdoings in securities trading where the sanction against the wrongdoing party exceeds 1$ million.

The use of rewards was not unfamiliar to the US before Dodd-Frank. They had formerly concluded that in the tax area, whistleblowers who report tax evasion should be eligible for rewards through the Tax Relief and Health Care Act of 2006 which established the Internal Revenue Service “Office of the Whistleblower”. Although previously to 2006 whistleblowers could receive rewards at the IRS, this was entirely up to the agency’s discretion.

In the procurement area, whistleblowers are also eligible for rewards in the US under the False Claims Act (FCA) enacted in 1863. The commitment to rewards was reaffirmed in 1986 when revisions to the act reinvigorated the whistleblower or “qui tam” provisions of act (for an overview of reward programs, see Nyreröd & Spagnolo 2017).

Despite being regarded as having some of the best whistleblower protections in the world (see e.g. Wolfe et al 2014), the US did not settle for protections alone in key regulatory areas. The new EU directive does not address rewards at all which is unfortunate given their law enforcement potential if they are coupled with independent and competent judicial institutions.

Although the US experiment with whistleblower rewards is working, the only EU institution to evaluate reward policies to our knowledge is the UK’s PRA & FiCA on the request of the UK parliament. Their assessment concludes strongly against rewards, yet they do not provide any evidence to back up their negative assessment and make claims that later evidence has refuted. In the following, we review the concerns raised by critics of reward programs, primarily the PRA & FiCA.

**Evidence on the Effectiveness of Rewards**

Under reward programs in the U.S whistleblowers can receive a percentage of the fine imposed on the wrongdoing firm or person. The range is usually between 15-30% of the sanctions against the firm, and of the money recovered. The exact reward percentage within the range is determined by how central the whistleblowers information was to unearth and sanction the wrongdoing.

One fundamental concern with rewards is their cost effectiveness. Some argue that they can come with a costly government structure and that they attract a lot of meritless claims by opportunist employees, which increase the administrative costs (PRA & FiCA 2014, Ebersole 2011).

On the other hand, many argue that they can be a cost-effective tool in an age when governments are looking for austere economic policies (Engstrom 2014). Some argue that they are at least as efficient as classical “command and control” methods of enforcement, such as selecting random persons or firms for audit. We evaluate cost-effectiveness with respect to three important effects: deterrence, increased quality of claims, and increase quantity of claims.
A significant part of determining cost-effectiveness is the extent to which whistleblowing has any significant deterrence effects on future misbehavior. Johannesen & Stolper (2017) found that whistleblowing had deterrence effects in the off-shore banking sector. They studied the stock market reaction before and after the whistleblower Heinrich Kieber leaked important tax document from the Liechtenstein based LGT Bank. They found abnormal stock returns in the period after the leak, and the market value of banks known to derive some of their revenues from offshore activities decreased.

Wilde (2017) also provide evidence that whistleblowing deters financial misreporting and tax aggressiveness. Using a dataset of retaliation complaints filed with OSHA between 2003 through 2010 on violations of paragraph 806 which outlaw’s retaliation against employees who provide evidence of fraud, he found that firms subject to whistleblower allegations exhibited decreases in financial misreporting and tax aggressiveness.

As for experimental evidence, Abbink and Wu (2017) conducted laboratory experiments studying collusive bribery, corruption, and the effects of whistleblower rewards on deterrence. They find that amnesty for whistleblowers and rewards strongly deter illegal transactions in a one-shot setting, but in repeated interaction the deterrence effect is limited. Their results support a reward mechanism, especially for petty forms of bribery (which are more like one-shot games).

Bigoni et al (2012) conducted laboratory experiments on leniency policies and rewards as tools to fight cartel formation. They find that rewards financed by the fines imposed on the other cartel participants had a strong effect on average price (returning it to a competitive level). In the model setting, this implies that rewards have a deterring and desisting effect on cartel formation.

Another central question is whether rewards increase the quality and quantity of claims. PRA & FiCA (2014) writes that “There is as yet no empirical evidence of incentives leading to an increase in the number or quality of disclosures received by regulators” (PRA & FiCA 2014, p.2).

As for increased quality, there is evidence suggesting that this claim is untrue. Dyck et al (2010) compared whistleblowing in the health care sector where rewards are available through the FCA with non-healthcare sectors where they are not. They found that 41% of fraud cases are detected by employees in the healthcare sector. That number was only 14% for other sectors, a difference highly statistically significant (at the 1% level) despite a small sample size (Dyck et al 2010, p. 2247).

More recently, Call et al (2017) examined empirically the link between whistleblowing and (i) penalties, (ii) prison sentences, and (iii) duration of regulatory enforcement actions for financial misrepresentation. They found that whistleblowers’ involvement in financial misrepresentation enforcement actions was correlated with higher monetary sanctions for the wrongdoing firm and increased jail time for culpable executives. They also found that enforcement proceedings began quicker, and further that whistleblower involvement increased the likelihood that criminal sanctions were imposed by 8.58%, and that criminal sanctions were imposed against the targeted wrongdoer increased by 6.64%.

Another highly contested point is the relation between the quantity and quality of claims and regulatory effectiveness. Some argue that rewards may attract a lot of meritless claims by employees who are either malicious or hope to reap some reward (PRA & FiCA 2014, Ebersole 2011). This does seem to have been the case with some reward programs, but not to the extent many opponents of rewards argue, and this effect does not render rewards a futile or ineffective policy approach, see Nyreröd & Spagnolo (2017) for a thorough discussion.

There are, however, valuable lessons to be learned from the quantity of claims received and the percentage of claims determined to have merit from, for example, the IRS Whistleblower Office. At the IRS there has
been a significant backlog of claims, and an exceedingly small number of claimants receive rewards. The IRS program, under 7623(a), does not have a threshold for claims to be considered, and the vast majority of claims fall under 7623(a). These are lessons for optimal design, but not an insurmountable obstacle for effective reward programs. One way around this problem is to have a threshold for claims to be considered. Another is the FCA model, where persons pursue litigation on their own if the Department of Justice declines to join, thereby taking on the risks and costs of losing in court.

Concerns over administrative burden and costly government structures are not salient enough to warrant a rejection of reward policies, as benefit in deterrence and quality outweigh the administrative costs of reviewing even large quantities of incorrect claims.

**Entrapment and Malicious Claims**

Another central concern has been that “Some market participants might seek to ‘entrap’ others into, for example, an insider dealing conspiracy, to blow the whistle and benefit financially”, FiCA & PRA (2014).

There are presently good ways of preventing this issue, which does not seem to have been salient in the U.S. experience with these policies. Regarding the FCA, for example, when the relator (whistleblower) initiated or planned the wrongdoing, courts can reduce the reward below 15% as they see fit (False Claims Act, 31 U.S.C. §3730 (d) (3)). The IRS has similar restrictions that in cases where the whistleblower planned and initiated the tax evasion, they may considerably reduce or deny any reward. If the whistleblower is convicted of criminal conduct related to the suit, then they should deny her any reward (Internal Revenue Code, 26 U.S.C §7623 (b) (3)).

These restrictions on reward payouts is probably the reason why, judging from the reports by the U.S agencies, entrapment has not emerged as a salient issue in the US experience with the various programs. As for evidence, the National Whistleblower Center (2014) claims they did not find a single case of entrapment in over 10 000 cases in which the planner and initiator of the wrongdoing received an award. Of course this does not exclude the possibility that a poorly run European agency/regulator might mismanage the whistleblower program to the point where this indeed becomes an issue; a sufficiently incompetent administration can generate problems even with the most robust and effective tools.

A related concern is that financial incentives could encourage employees to submit fraudulent claims, e.g. to “fabricate claims of wrongdoing for personal profit” (Howse & Daniels 1995, p.540, see also Rose 2014, p.1283). A similar concern is that: “Financial incentives might lead to more approaches from opportunists and uninformed parties passing on speculative rumors or public information. The reputation of innocent parties could be unfairly damaged as a result” (PRA & FiCA 2014, see also Vega 2012, p.510). There is also the fear that opportunistic whistleblowers will force “corporations into financial settlements in order to avoid the adverse reputational and related effects caused by highly public, albeit ill-founded, accusations” (Howse & Daniels 1995, p.526/27).

Although evidence on this is hard to find, judging from the reports of agencies, fraudulent and malicious has not been a significant issue. This is probably because fraudulent reporting is a crime, and a whistleblower who report fraudulent information exposes him or herself to a legal fight with the falsely accused employer and to sanctions against perjury and defamation. Indeed, in the case of the IRS, the information is submitted under penalty of perjury (Internal Revenue Code, 26 U.S.C. §7623 (b)(6)(C)), which is also the case of the SEC if the whistleblower is represented by an attorney (Exchange Act, U.S.C 78u-6(h)). In the case of the FCA, should the whistleblower lie to the court, he risks felony charges punishable by up to five years in jail for perjury, and the possibly of being convicted of other crimes related
to lying under oath. Further, the FCA has a reverse fee-shift for obviously frivolous claims (Engstrom 2016, p.10).

Whether fraudulent claims are a concern for the efficacy of a whistleblower reward program depends to a large extent on the precision of the court system. Buccirossi et al. (2017) analyze this concern within a formal economic model. They show that fraudulent reports are entirely irrelevant for countries with sufficiently precise/competent court systems, provided strong sanctions against perjury, defamation and lying under oath are there to balance the incentives generated by large bounties. Where the judicial system makes a lot of mistakes, instead, this may not be sufficient for the scheme to have crime deterrence effects, which may make it preferable not to introduce large rewards for whistleblowers.

Conclusions

Some suggest that the European hesitation over improving whistleblower protection and considering rewards may have partially historical roots, as both Nazi Germany and Soviet Russia relied heavily on citizens reporting on one another (Givati 2016, p.26.). But the lack of voices speaking out against what the Nazi’s were doing should suggest the opposite, and it is not clear how these parallels should be drawn when we are talking about rewarding whistleblowers in the financial offices of private corporations.

It is also the case that most valuable information to law enforcement is often in the hands of higher-ups in the organization, those who have more to lose in the case of whistleblowing (Engstrom 2016), and for whom protections would be an insufficient compensation relative to their current position and salary. The blunt tool that is horizontal protection for whistleblowers who report violations of EU law could be coupled with precise tools such as rewards for violations of specific EU laws whose undermining can be particularly detrimental to financial stability or the environment.

If European countries and their regulatory and law enforcement institutions are not capable of having an open and honest debate, competently based on the available evidence from rigorous research and from previous experiences in other countries, then they would hardly be able to competently design and properly administer a system of rewards for whistleblowers. As argued in Buccirossi et al. (2017), in countries with weak institutions high powered tools like whistleblower rewards should better be avoided, as in the hand of incompetent law makers and corrupt regulators they would likely produce more damage than good.
Whistleblower Protections but no Rewards: EU Commission Proposes a New Directive

References


Whistleblower Protections but no Rewards: EU Commission Proposes a New Directive


Financial Times. 2018a. “Maltese journalist Caruana Galizia was assassinated, says her son”, available at: https://www.ft.com/content/d410b136-b34b-11e7-a398-73d59db9e399


The Washington Post. 2018. “Police believe a journalist was killed for reporting on fraud in the heart of Europe”, available at: https://www.washingtonpost.com/news/worldviews/wp/2018/02/26/police-believe-a-journalist-was-killed-for-reporting-on-fraud-in-the-heart-of-europe/?noredirect=on&utm_term=.cac1bdef7f00


The Washington Post. 2018. “Police believe a journalist was killed for reporting on fraud in the heart of Europe”, available at: https://www.washingtonpost.com/news/worldviews/wp/2018/02/26/police-believe-a-journalist-was-killed-for-reporting-on-fraud-in-the-heart-of-europe/?noredirect=on&utm_term=.cac1bdef7f00


Theo Nyreröd
Theo.nyrerod@hotmail.com
Theo Nyrööd is a philosophy M.A, who has worked on whistleblower rewards since 2014.

Giancarlo Spagnolo
Stockholm Institute of Transition Economics (SITE)
Giancarlo.Spagnolo@hhs.se
www.hhs.se/site

Giancarlo Spagnolo is Professor of Economics at University of Rome II and Senior Researcher at the Stockholm School of Economics, both since 2006. He is also a research fellow of CEPR, London; ENCORE, Amsterdam; scientific advisor of LEAR, Rome; and a recurrent visitor of EIEF, Rome. He holds a Ph.D. from the Stockholm School of Economics, and was Assistant Professor at the University of Mannheim, Senior Economist at the Research Division of the Sveriges Riksbank, and founder and head of the Research Unit of the Italian Public Procurement Agency (Consip SpA).

He is an internationally recognized authority on Antitrust, Public Procurement and Anti-corruption issues, and has been consulting on these topics for national and international institutions, including the World Bank, the European Parliament, the European Commission (DG Comp, DG EcFin and DG Markt) and several Antitrust and Procurement Authorities.

freepolicybriefs.com

The Forum for Research on Eastern Europe and Emerging Economies is a network of academic experts on economic issues in Eastern Europe and the former Soviet Union at BEROC (Minsk), BICEPS (Riga), CEFIR (Moscow), CenEA (Szczecin), KEI (Kiev) and SITE (Stockholm). The weekly FREE Network Policy Brief Series provides research-based analyses of economic policy issues relevant to Eastern Europe and emerging markets.