

# Rewarding Corporate Whistleblowers: Will this Improve Canadian Capital Markets?

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# Motivation for a session on whistleblowing

Anecdotes suggest institutions to uncover fraud have failed

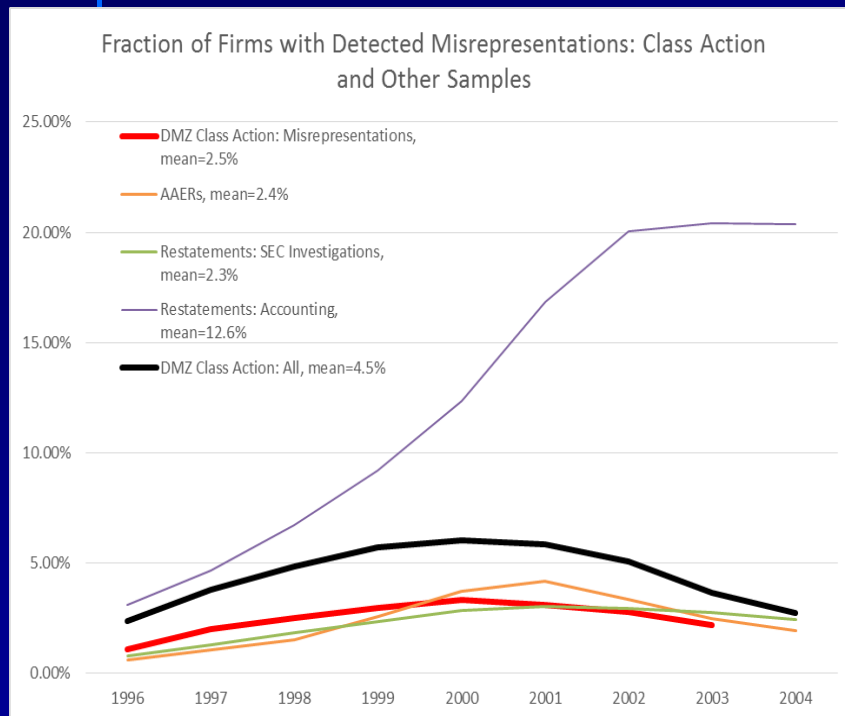


Would Shareholders have been better off if fraud was detected earlier?

Would Canadian capital markets provide a lower cost of capital if such frauds were fewer, and less severe?

# Detecting fraud more important if fraud is a big problem – is it?

## DETECTED FRAUD



## ICEBERG OF UNDETECTED FRAUD

- After Arthur Anderson forced auditor rotation, 3 x more frauds discovered in former Anderson clients. Not an Anderson issue, a signal of undetected fraud
- → up to 1 OF 7 FIRMS WITH ONGOING FRAUD

1 OF 25 FIRMS HAS FRAUD

# Improved fraud detection capabilities an asset but not one that comes without design

Having a system to identify fraud earlier:

- Reduces the extent of the fraud
- Reduces the reputational damage if a fraud does occur
- Helps lower cost of capital for all those seeking to raise funds – IPOs, SEOs

But a hard problem

- Incentives to bring bad news to light are generally not strong
- Insiders (who may be problem) police the system
- Reforms may have more costs than benefits

# Questions we asked in 'Who Blows the Whistle on Corporate Fraud?' (2010)

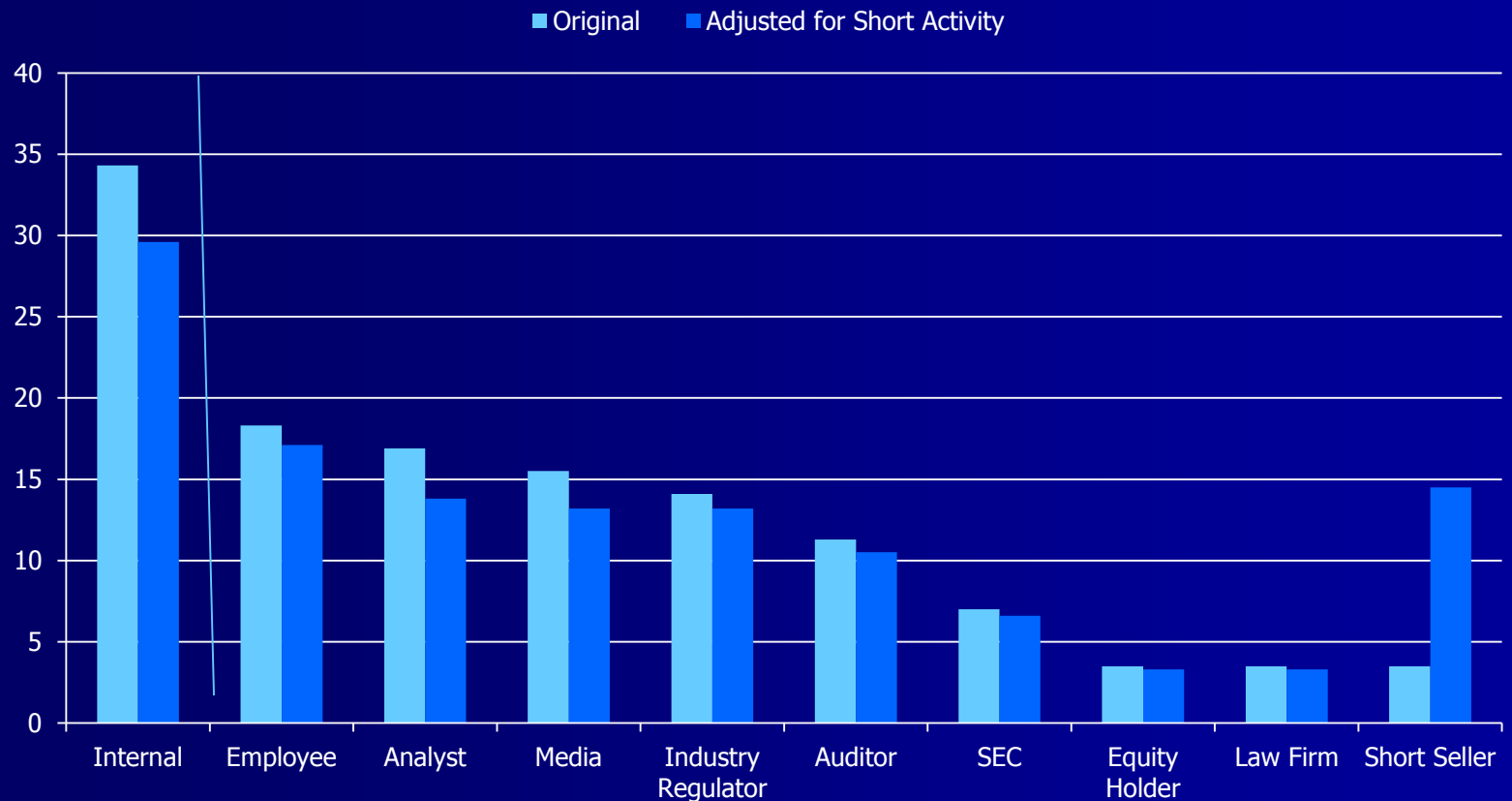
- Who actually blows the whistle?
- Why are these actors whistleblowers?
- What are their comparative advantages?
- Can the important whistleblowers' incentives be improved?



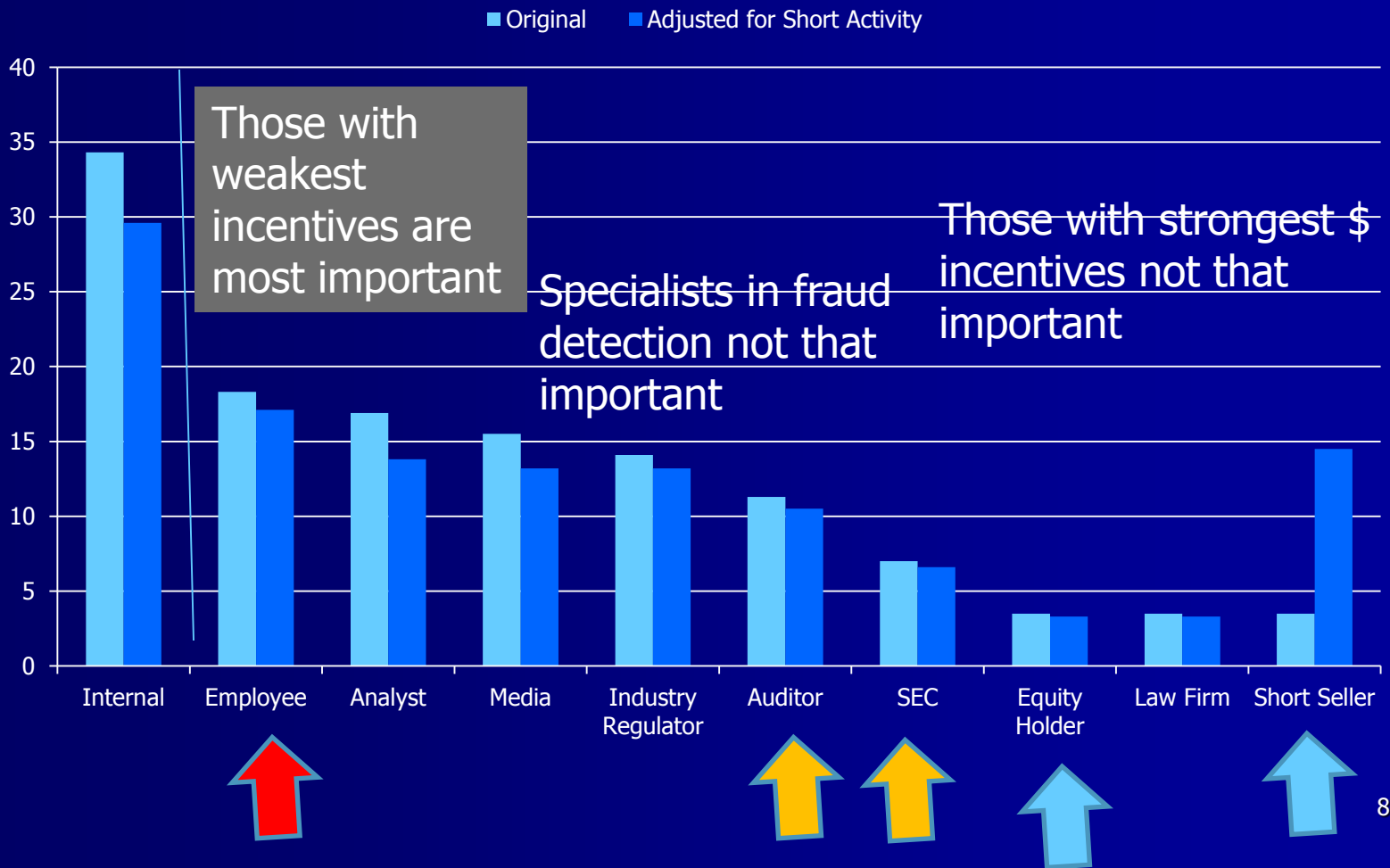
# Who did we expect would be catching frauds?

- Those with the greatest financial incentives to monitor (variable versus fixed claims)
  - Investors (equity and debt) and short sellers have variable claims and greatest incentive.
- Those with greatest reputational incentives
  - e.g. financial and other regulators, analysts, auditors, media, class action law firms
- Those with the greatest *access to information*
  - Easier to blow whistle if have information

# Distribution of whistleblowers in US traded firms with frauds 96-04



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# What to make of this 'village of detectors'

- Financial incentives, reputational incentives and access to information all play a role
- Relative unimportance of many mechanisms emphasized in the literature
  - Missing :Stock exchange regulators, Commercial banks, Underwriters, private security litigation
  - Important role by actors normally neglected: Employees, Media, Non financial-market regulators

# Incentives to act? –Look at outcomes for those who acted – generally poor

- Analyst: no benefit in career
- Journalists: no obvious benefit in terms of career and books
- Auditors: conditional on a fraud more likely to lose the job if they reveal it
- Employees:
  - In 45 % of the cases, the employee blowing the whistle does not identify herself
  - In 82% of cases with named employees, the individual alleges that they were fired, quit under duress, or had significantly altered responsibilities
- Blowing the whistle can have real costs !

# Is there specialization? Use multinomial logit, look at fraud types and detector types

	Analysis	Auditors	Clients, Equity Holders	Employees	Regulators	Media & Law	Short Sellers
Financial Misrepresent	<b>1.84*</b> (1.09)	0.532 (1.24)	-0.719 (0.74)	-0.942 (0.62)	-0.452 (0.70)	1.17 (0.92)	-0.494 (0.68)
Illegal Activities; Non-Compliance	2.05 (1.64)	1.85 (1.63)	1.01 (1.38)	1.40 (0.98)	<b>2.31**</b> (1.04)	1.26 (1.40)	0.128 (1.35)
Self-Dealing; Insider Trading	<b>2.71**</b> (1.20)	1.19 (1.31)	1.06 (0.83)	0.051 (0.80)	0.988 (0.82)	<b>2.13**</b> (1.00)	0.767 (0.83)
Accounting Restatement	-0.646 (0.54)	<b>2.06**</b> (0.91)	0.297 (0.62)	0.468 (0.51)	<b>0.833*</b> (0.49)	-0.600 (0.58)	-0.314 (0.56)
Ended Post SOx	0.180 (0.67)	<b>1.36**</b> (0.65)	-1.27 (1.01)	-0.733 (0.78)	0.669 (0.58)	<b>-1.46*</b> (0.77)	-0.248 (0.72)
Duration (years)	-0.193 (0.28)	-0.047 (0.26)	0.110 (0.22)	<b>0.493**</b> (0.24)	0.047 (0.20)	<b>0.447**</b> (0.22)	0.099 (0.22)
Assets \$B (prior year)	-5.78 (7.05)	<b>5.21*</b> (2.75)	3.30 (4.12)	<b>-19.96*</b> (10.24)	-3.12 (4.74)	0.842 (2.47)	-7.66 (9.77)
Constant	-2.27** (1.10)	-4.18*** (1.21)	-1.84*** (0.69)	-1.28** (0.59)	-1.70*** (0.62)	-2.32*** (0.84)	-0.770 (0.60)
Observations	216	216	216	216	216	216	216
Pseudo R-Square	0.0990						

# Do Incentives Impact Whistle blowing by those who have info? Evidence from healthcare

- In healthcare employees have \$ incentives from *qui tam* legislation in US. (one of few industries)
- Do \$ incentives increase likelihood to blow whistle?
  - Yes: From 14% to 47%, dif signif ( $p=.02$ )

⇒ Incentives work

- Do they create too many frivolous suits?
  - No. Percentage frivolous
    - 37% healthcare
    - 55% non healthcare

⇒ Potential gains from giving those with information more incentives → subsequent changes in US in Dodd-Frank give us chance to learn more

# Multi-pronged way to improve fraud detection

Missing piece – help the market to work by increasing incentives for those with information → \$ bounties seem to work

food for thought for firms - what incentives for bringing bad info to light?

food for thought for regulators

Likely more impactful to shape incentives for those with info than to focus more on those with incentives but lack info (e.g. regulators)

# Unanswered ? in study

1. How big do \$ have to be to affect behavior?  
– US qui-tam has 10-30% with no cap
2. Bigger bang for the buck with enhancing downside – anti-retaliatory provisions?
3. Do more positive incentives create issuer cost – frivolous allegations that take time and money and undermine internal processes?

# Nature of Corporate Fraud - Impropriety

Impropriety	%
Engagement in Self-Dealing, Insider trading	21%
Engagement in Other Illegal Activities	9%
Misrepresentation on Financial Statements/Breach of Controls	52%
Failure to Disclose Operational Problems	18%

# Can test if hypothesized incentives influence whistleblowing patterns - (conditional logit )

	Equal Weighted Distribution (1)	Marginal Effects
Access to Information	-0.428*** (0.120)	<b>-0.032</b> Low to high=.096
\$ Incentives [Dummy]	1.258*** (0.284)	<b>0.176</b>
Reputation Incentives [Dummy]	0.932*** (0.279)	<b>0.112</b>
Fama Reputation [Dummy]	.050 (.190)	
Observations	1,520	
Pseudo R-Squared	0.031	




# Importance of actors beyond Fama reinforced when look 'to whom' whistle is blown

- Who provides credibility, diffusion of information, and protection for whistleblowers?
  - Short sellers and analysts need credibility
    - > media is "to whom" actor in 37% and 62% of cases respectively.
  - Employees blow the whistle to a wider range of actors including non-financial regulators (35%), lawyers (23%), the SEC (11%), the media (11%)

# Further exploring the data – is there specialization? Use multinomial logit, look at fraud types and detector types

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Observations	216	216	216	216	216	216	216
Pseudo R-Square	0.0990						

# Importance of access to information declines with larger frauds

	Equal Weighted Distribution (1)		Value Weighted Distribution (2)
Access to Information	-0.428*** (0.120)		-0.187 (0.195)
\$ Incentives [Dummy]	1.258*** (0.284)		1.300*** (0.456)
Reputation Incentives [Dummy]	0.932*** (0.279)		0.947*** (0.378)
Fama Reputation [Dummy]	.050 (.190)		0.015 (.333)
Observations	1,520		1,520
Pseudo R-Squared	0.031		0.032