Whistle-blowers find more corporate fraud than regulators, study finds

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I bet cunning corporate pooh-bahs who have stolen from a company, ripped off shareholders or bilked the government fear most a visit from a Securities and Exchange Commission regulator.

If so, their worries may be misplaced. The SEC surprisingly is just a minor player on the fraud-busting front. Chances are, any corporate shenanigans coming to light will be from a trusted aide or embittered employee-turned-whistle-blower.

If not them, then from those pesky short sellers, who also have a knack for uncovering corporate malfeasance. And don't forget the analysts whom executives butter up and then cozy up to. A soon-to-be released study in The Journal of Finance titled "Who Blows the Whistle on Corporate Fraud?" found that in hundreds of corporate fraud cases employees, short sellers and analysts were the primary whistle-blowers.

"These players do not appear in traditional discussions of corporate governance, but the data suggest they should," said Adair Morse, assistant professor of finance at the University of Chicago's Booth School of Business and one of the authors of the report.

Morse and the other researchers analyzed 216 cases of corporate fraud from 1999 through 2004, including the Enron, WorldCom and HealthSouth cases. They found that employees were the whistle-blowers in 17 percent of the cases – the highest percentage of any of the players.

Short sellers ranked second, uncovering the fraud in 14.5 percent of the cases. Analysts were third, with 13.8 percent. The SEC detected only 6.6 percent.

Given what happens to employees when they bring fraud to light, it's surprising that any of them come forward.

"Their lives are damaged terribly," Morse said. "They often lose their jobs. They sometimes have to leave town because when frauds come to light there are usually layoffs."

One powerful motivator, however, is money. The Federal Civil False Claims Act states that when fraud is committed against the government, such as in Medicare fraud cases, the whistle-blowers are entitled to between 15 percent and 30 percent of the money recovered.

Because of that law, some 41 percent of the fraud cases in the health care industry are brought by employees, Morse said. So basically if you want employees to step up in fraud cases "you have to pay them to go into retirement."
Short sellers obviously have a huge monetary incentive to disseminate negative news to the market because they profit when stock prices drop. But to the extent that they uncover fraud, they are beneficial players in the system, Morse said, even though most executives despise them.

The monetary incentives for analysts are a bit more indirect but still very significant. Whistle-blowers in this field are much more likely to receive the prestigious "All American" analyst ranking given each year by the Institutional Investor magazine.

These top-ranked analysts are then courted and recruited by the big investment banks, and that means higher salaries for them, according to the study.

I asked Morse if she became discouraged and cynical slogging through all these corporate fraud cases.

She thought for a moment and then said: "No, not really. My goal was to level the playing field for investors so when they are putting their money away for retirement they trust the system."