



## Narrow Road Capital Submission to the Whistleblowing Review

### **Background**

Whistleblowing is a concept that most people have heard of but have little understanding of. Many people without direct experience believe that whistleblowers do not need legal protection or compensation. This is often founded on a belief that most people in management roles are honest and seek just outcomes, and that if misconduct was reported they would take action against the wrongdoers.

The reality of whistleblowing is that an individual is risking their employment, income and career by choosing to report misconduct. In many cases the whistleblower suffers far greater adverse consequences than the perpetrators of misconduct. To assist with the development of whistleblowing policy and legislation this submission begins with the basics of whistleblowing and some recent Australian and international examples. This is followed by discussion and recommendations on what whistleblowing protections and compensation should be implemented.

### **What is whistleblowing?**

Whistleblowing is the act of reporting misconduct. It is typically a junior employee reporting the misconduct to a more senior employee, the police, a regulator or the media. The misconduct could be criminal activity (e.g. tax evasion, fraud or environmental damage) or conduct that is unethical. The misconduct is likely to lead to financial or reputational damage for the company or government concerned.

### **Is whistleblowing policy important?**

In technical areas, such as taxation and financial services, it is almost impossible to prosecute criminal activities or to correct injustices without the assistance of expert insiders. Whistleblowing policy encourages and provides avenues for expert insiders to raise the alarm and to provide evidence of misconduct. Strong whistleblower protections and rewards will increase government revenue and reduce corporate misconduct.

### **Why does whistleblowing occur?**

Whistleblowing occurs because there has been misconduct and because no action has been taken. Large employers, both public and private sector, will inevitably have misconduct occur given the number of people they employ. They will typically have procedures for handling employee complaints and have policies that lay out what is appropriate and inappropriate conduct. If these processes function, misconduct is identified and dealt with quickly with perpetrators of misconduct identified and punished. However, for some employers the written policies and the culture of the workplace differ substantially with misconduct flourishing even though it goes against stated policies.

These different cultures underlie different responses to people who call out misconduct. Where good culture exists, those who call out misconduct are considered loyal employees who are seeking to protect the employer from long term financial or reputational loss. Where bad culture exists, whistleblowers are considered disloyal employees who are seeking to inflict short term financial or reputational loss on their employers. In situations where bad culture is widespread, reporting misconduct externally is the only way to bring about change.

### **What are the typical responses to whistleblowers by their employers?**

There are four typical responses that employees can receive to their efforts to have misconduct dealt with. They are:

Recognition/reward

Ignorance

Passive aggressive hostility



## Direct hostility

The most common response to whistleblowing is ignorance. Employers with bad culture do not care about misconduct and will typically ignore internal reports of it. Alternatively, there may be a cursory review where a pre-determined outcome of “no wrongdoing” or “no fault and no action” is recommended. In some cases, external legal and accounting firms are brought in to “investigate” a limited area with the wider issues ignored.

The next most common response to whistleblowing is to attack the whistleblower. This can be less obvious measures such as cutting off promotion and bonus possibilities, placing the employee under performance management or isolation from colleagues. In some cases, the employer responds with openly hostile actions including reduced duties or demotion, termination or threats to terminate employment. In the Comminsure and Wells Fargo cases highlighted below, evidence against whistleblowers was fabricated or exaggerated to justify their termination.

The least common response is that employees are positively recognised for raising misconduct. When there is positive recognition it is likely to be something of little value such as a certificate or letter of thanks, rather than a substantial financial reward. It is extremely rare for whistleblowers to financially benefit from reporting misconduct, with promotions or bonuses for helping a company address problems almost unheard of. Even in the US where there are regulatory rewards, the rate of rewards to complaints is less than 1%.

### **What motivates whistleblowers?**

In the vast majority of cases whistleblowers are people who have a strong sense of justice and fairness. Given there is (a) virtually no prospect of reward (b) a realistic prospect of punishment and (c) usually a need to repeatedly raise the issue to see action taken whistleblowers are typically people who are putting the best interests of others ahead of their own interests.

In rare cases, people seek to use whistleblowing as an attempt to protect themselves if they have committed misconduct. By making allegations of misconduct about others it can divert attention from their own misconduct. This is a grey area, as misconduct is often implicitly authorised and can be widespread in firms with bad cultures. For instance, the recent allegations of misconduct against a junior employee at Seven West Media involve expenses incurred as part of wider misconduct that involved the CEO.

### **Should whistleblowers be required to report their concerns internally first?**

One of the criticisms of the US system where whistleblowers are rewarded with a share of the fines levied are that employees should be required to raise their concerns through internal channels first. This is dangerously naïve.

Firstly, most whistleblowers have been repeatedly ignored or attacked for raising their concerns internally before going to the police, regulators or the media. Secondly, there are often statutory requirements to report misconduct to police or regulators. Delaying the lodgement of official complaints may result in evidence being lost. Thirdly, the culture may be so obviously rotten that making a complaint would at best be fruitless and at worst result in loss of employment. Fourthly, the responsibility of creating a process and culture that encourages internal reporting of misconduct is something a single junior employee cannot change. At some workplaces, there is no clear pathway to make complaints of misconduct other than speaking to a direct manager who may be involved in the misconduct. Fifthly, there is a substantial power imbalance between employers and employees. Employers may use their financial resources and access to legal advice to frustrate and intimidate whistleblowers.

## **Recent examples of whistleblowing**

The treatment of complaints and whistleblowers at Comminsure and Wells Fargo highlight the issues that whistleblowers face in reporting misconduct.

### **Comminsure**

The allegations regarding Comminsure are that it had a practice of denying legitimate claims from policyholders using outdated medical definitions. Files containing medical reports that showed that the rejected claims were legitimate were regularly disappearing. The chief medical officer raised the concerns internally, including with the executive responsible for the area, who reports directly to the CEO of CBA. After being terminated by Comminsure, the chief medical officer took his concerns to the media.

Following the media coverage and the commencement of an ASIC investigation, Comminsure reversed decisions and made payments to some claimants. Comminsure has chosen not to settle with the chief medical officer with litigation over wrongful termination continuing.

### **Wells Fargo**

Over a period of at least ten years over two million accounts and credit cards were established without client consent. Customers were billed for various fees on the unauthorised accounts. More than 5,000 staff were fired for involvement, with low level employees saying they were opening the accounts in order to hit unrealistic targets from management. Employees that refused to participate were fired for poor performance and whistleblowers were fired for calling out the misconduct. Numerous employees notified superiors, the internal misconduct hotline and even the CEO over many years with senior management ignoring the complaints. In some cases Wells Fargo has crippled the careers of whistleblowers by claiming they were fired for participating in the practices they reported. Litigation from former employees is likely to take years to resolve.

### **Lessons from these examples**

In both cases the employers had rotten cultures that encouraged blatant misconduct and attacked those who reported the misconduct through internal channels. External reporting was the only way for the misconduct to be addressed. As a result of external reporting customers that suffered loss are having their losses addressed. However, whistleblowers have paid a heavy price including the loss of employment and having their reputations sullied. An appropriate response would include the employers being forced to publicly apologise and pay compensation to their customers and to the whistleblowers. Compensation should include a punitive component to discourage other employers from similar behaviours and to reflect the hardship suffered. Whilst both of these examples may seem extreme, they are by no means rare.

## **Creating a culture supportive of whistleblowing**

The existing protections in Australia for whistleblowers have been shown to be hopelessly ineffective. If Australia wants to encourage whistleblowers it must offer potential whistleblowers four things:

- (1) an ability to remain anonymous;
- (2) protection from retaliation;
- (3) financial incentive for taking career risk in reporting criminal activity and misconduct; and
- (4) an expectation that their evidence will be taken seriously with serious punishment for wrongdoing.

Currently, none of these four are satisfied. Anonymous reports may not be allowed in some cases, in other cases whistleblowers have disclosed their identities to regulators who then reported them to their employer. Existing legal protection is piecemeal, covering some disclosures in some sectors in certain circumstances. Potential whistleblowers would need to obtain legal advice at their own expense to assess whether they are protected if they raise concerns.

Australia does not have incentive schemes for rewarding whistleblowers that report tax evasion or corporate misconduct. As a result, whistleblowers have no financial upside but often substantial downside.

Lastly, Australia has a very poor track record of prosecuting misconduct and tax evasion. ASIC has been levying fines of less than \$10 million on misconduct at major banks in situations where overseas regulators would be issuing fines in hundreds of millions or billions. The ATO is reported to have settled tax evasion cases for a fraction of the amount owed in matters involving large companies and companies that have doubtful solvency.

If Australia wants to encourage good business culture and the reporting of misconduct it must take action to rectify all four of these areas. The following sections make recommendations on practical measures that can be adopted. It is noted that there is substantial crossover between this review of whistleblower protections and the review due to begin shortly on the black economy. Enhancing whistleblower protections will encourage Australians to report tax evasion, particularly tax evasion by large corporations.

### **Protections for whistleblowers**

If an employee, contractor or service provider has raised and provided evidence of misconduct it should be illegal for an employer to retaliate. Employers that retaliate would be subject to punitive damages for loss of employment, income and/or reputational damage. The protection would apply once the employee has raised the complaint internally, with police or a regulator.

If the complaint is found to be false no protection would apply, but an employee would have the right to challenge such a finding through the fair work ombudsman or court processes. If the law is strong and compensation material, it is likely that law firms would be willing to take up egregious cases on a “no win no fee” basis thus providing a level of offset to the power imbalance between employers and employees.

### **Rewarding whistleblowers – corporate misconduct**

Australia has a terrible record in issuing court and regulatory financial penalties for workplace misconduct. This encourages misconduct as there is a low probability of negative financial consequences. It also means that there is virtually no pool of funds from which to reward to whistleblowers. This apathetic approach to enforcement needs to change if we want to see cultural change in business. By substantially lifting the penalties imposed and by imposing penalties as regular practice, business will be discouraged from allowing misconduct to occur and there will be funds available to financially reward whistleblowers.

### **Rewarding whistleblowers – tax evasion**

It is estimated that 10-30% of GDP in Australia is not being fully reported and taxed. Given the enormous revenue leakage small changes can be very cost effective. Tax evasion is stealing from fellow Australians, who are forced to pay higher taxes as a result. It is an act of greed and self-enrichment and should therefore be punished punitively. Tax

evasion is widespread, with cash in hand payments common amongst small businesses and individuals providing personal services. Large businesses and wealthy individuals are widely known to be using low tax jurisdictions to reduce their taxes, often exploiting transfer pricing provisions and intellectual property royalties.

The follow-on impacts from leaving tax evasion untouched goes beyond the direct impact of the burden of taxes being shifted. Widespread non-compliance punishes honest behaviour and creates a culture where bribery and corruption is rife. Greece is the most obvious Western example of what happens when cheating on taxes becomes a national practice, with basic services such as medical care now routinely requiring bribes to be accessed.

### **Small Business and Personal Tax Evasion**

Two relatively simple measures will dramatically decrease the level of taxes evaded at the smaller end of the economy. Firstly, electronic record keeping and the availability of electronic methods of payment need to be mandatory. Each time a sale is made it should be a legal requirement that it is recorded electronically on the spot, with a receipt able to be issued. Wages should be paid to bank accounts, with cash payments to employees outlawed.

The availability of electronic methods of payment should also be mandatory. Most service businesses already issue invoices and accept payments directly to their bank accounts and therefore no change is needed. For retailers and trades people, a desktop or handheld EFTPOS terminal could be the most efficient method of receiving electronic payments. The arguments that cash is a cheaper and more convenient way to transact are rebuffed by businesses having the ability to pass on credit card surcharges. Proponents of cash transactions frequently ignore the handling costs and security costs that cash transactions incur.

Once electronic methods of payment are mandatory, the job of monitoring and enforcing tax compliance becomes far easier. ATO employees and the general public can keep copies of their receipts and these can be used to cross check against the records of the business. If a sample of transactions shows that some are not declared as part of GST or income tax reporting, then it is likely the business is evading tax and should be subject to a full audit.

The second way to greatly reduce tax evasion at the smaller end of the economy is via the creation of a national tax lottery and suspicious activity reporting system. The ATO should have a well-advertised online and phone service where citizens can report suspicious activities, such as offers to reduce the price for cash payment or where receipts or electronic methods of payment were not available. Hoping that Australians will voluntarily report suspicious activities without any incentive is naïve. However, with the incentive of a tax lottery, many Australians are likely to be willing to take a few minutes to report suspicious activities and help build an enormous database of tax intelligence.

Each month, a lottery with a substantial prize pool (for instance \$20 million per month) would be nationally televised. Each report of suspicious behaviour would entitle a person to one entry in the lottery. Prizes could be both large and small, with perhaps 10 winners of \$1 million each and 1,000 winners of \$10,000. As a result of creating a tax lottery the rate of reporting of non-compliant activity will skyrocket and a perception will be created that any dodgy transaction could result in a business or individual being subject to investigation. Whilst \$20 million per month may sound material, it is immaterial compared to the tens of billions of dollars of taxes being avoided. A national tax lottery would also be a far quicker and cheaper way to gather information than increasing staff at the ATO.

### **Large Business Tax Evasion**

Tax evasion methods utilised by large businesses are often complex and may involve multiple jurisdictions. Gathering evidence to substantiate complex tax evasion frequently requires whistleblowers with insider information, such as employees, bankers, accountants and lawyers. While the protection offered by well thought out whistleblower

legislation is nice in theory, it frequently fails to prevent employees being fired, demoted or having their responsibilities curtailed as retribution for reporting dubious practices. Employees who report white collar crime are frequently placing their careers at risk, with the likelihood of being unemployable in their current industry once their efforts to correct wrong doing have been exposed.

The solution to both the complexity and career risk issues is best resolved by a revenue sharing arrangement. In the US, the tax service (IRS) and the securities regulator (SEC) pay up to 30% of the additional revenue collected to whistleblower. This is an enormous incentive to report tax evasion and financial crime. It creates major headlines when large fines and penalties are issued as well as when large payments are made to those who provided evidence. This incentivises both reporting of tax evasion and financial crimes and also serves as a major discouragement for those considering committing such crimes. Employees whose careers are impacted can receive substantial compensation whilst governments benefit by collecting a greater share of the taxes owed.

### **Penalties for Tax Evasion**

Given the widespread nature of tax avoidance in Australia, existing penalties are not severe enough and are not enforced sufficiently often to deter tax evasion. Tax evasion is undertaken to enrich the individual or the owners of the business and penalties should be focused on directly attacking that motivation rather than the threat of imprisonment. Tax evaders should not only be required to pay what they owe plus interest and legal/enforcement costs, that number should be multiplied depending on the behaviour involved in the tax evasion activity.

**Accidental Evasion:** In situations where there is a simple error in calculation and no malintent a penalty that includes interest and legal/enforcement costs is sufficient.

**Negligent Evasion:** When an error has been made that a reasonable person would not have made or would have taken steps to avoid, the penalty should be double that of accidental evasion.

**Wilful Evasion:** Where taxes are being deliberately evaded, such as consistently failing to declare all income or incorrectly using offshore jurisdictions to lower taxes then the penalty should be four times that of accidental evasion.

### **Conclusion**

The reality of whistleblowing is that an individual is risking their employment, income and career by choosing to report misconduct. Whistleblowers almost never receive a material benefit for taking these risks. Rather, Australia has a terrible record for treatment of whistleblowers, in many cases the whistleblower suffers far greater adverse consequences than the perpetrators of misconduct. When whistleblowers are not attacked for reporting misconduct they are often ignored with bad corporate culture allowing misconduct to continue and flourish.

Australia needs both legislative protection and financial rewards for whistleblowers. If an employee has raised and provided evidence of misconduct it should be illegal for an employer to retaliate. There needs to be a substantial increase in penalties levied on corporations that commit misconduct, both to discourage the misconduct and to create a pool of funds that is available to reward whistleblowers. Australia should mirror the US practice of sharing up to 30% of fines/penalties with those who blow the whistle on misconduct. Australia should also create a tax lottery to discourage tax evasion by individuals and small businesses and encourage the reporting of suspicious behaviour.



## **End of Submission**

Written by Jonathan Rochford for Narrow Road Capital on 26 January 2017. Narrow Road Capital appreciates the opportunity to make a submission, feedback is welcome and can be sent to [info@narrowroadcapital.com](mailto:info@narrowroadcapital.com)