Statement for Hearing on
Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions
Before the House Financial Services Committee
Subcommittee on Capital Markets & Government Sponsored Enterprises
by
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Mr. Chairman and members of the subcommittee, I am pleased to be here today to share my views on the whistleblower provisions of the Dodd-Frank Act. I am appearing here today on behalf of Deloitte LLP ("Deloitte"), one of the largest accounting and professional services firms, as well as, more broadly, a member of the public company auditing profession.

First, I would like to emphasize that, because we value the integrity of financial reporting and are committed to investor protection through the provision of high quality audits, we support efforts that help further the existence of strong controls to deter and to detect wrongdoing. We also respect the important role that a robust system of enforcement plays in maintaining public and investor confidence in the financial markets. My comments today are intended to support implementation of a whistleblower program in a way that will help support and maintain, rather than undermine, the robust systems in place at most companies, which Congress and the Securities and Exchange Commission ("SEC" or "Commission") have appropriately fostered in recent years.

Second, we agree with the Act's exclusion from the SEC whistleblower financial reward program accounting firm personnel reporting on suspected violations by companies they audit. Providing a financial reward for such reporting would be contrary to the requirements of Section 10A of the Securities Exchange Act of 1934, which sets forth specific steps that outside auditors must follow when suspected illegal acts are identified during the course of an audit, including the requirement to report their findings directly to management, and in some cases to the audit committee or the SEC. Accounting firms also may be engaged to perform a range of services for

non-audit clients; for virtually all of these services, the firm and its personnel owe professional duties of confidentiality to the clients. We would, therefore, support further expansion of the statutory exclusion. For example, Rule 301 of the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct requires firms to keep client information confidential. State licensing rules for accounting firm professionals may impose additional duties of confidentiality.[1] Yet, notwithstanding these requirements, personnel in accounting firms who are providing services to clients could be tempted by the whistleblower financial reward program incentives to breach their professional obligations of confidentiality and integrity. We believe that the most appropriate way to avoid these risks is to broaden the exclusion for accountants and accounting firms that was included in the SEC's proposed rule.[2] Expansion of the exclusion for accounting firms is further supported by considerations related to the utility of internal compliance procedures discussed immediately below, which apply to accounting firms just as they do to public companies.

Third, and most relevant to the purpose of today's hearing, I will address the potential impact of the SEC's proposed rule on the efficacy of public companies' internal compliance procedures and the risk that investors could be harmed if reporting companies are unaware that a whistleblower has come forward. In this regard, we are concerned that the rules proposed by the SEC could create a monetary incentive for whistleblowers to bypass companies' established and effective internal reporting procedures. While the SEC's proposed rules include a 90-day grace period to prevent individuals from being penalized for first reporting their concerns through internal channels, there is no financial incentive for would-be whistleblowers to do so. In fact, despite SEC reassurances, whistleblowers may be concerned that in order to meet the requirement to provide "original information" in their report, they must be the first to file certain information, and waiting up to 90 days to inform the SEC could lessen their chances of receiving

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[1] *See*, *e.g.*, 21 N.C. Admin. Code 08N.0205 (2004) ("A CPA shall not disclose any confidential information obtained in the course of employment or a professional engagement except with the consent of the employer or client."); Code of Professional Conduct of the New York State Society of Certified Public Accountants ET Section 301 ("A member in public practice shall not disclose any confidential client information without the specific consent of the client.").

[2] *Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934* U.S. Securities and Exchange Commission Proposing Release, 75 Fed. Reg. at 70,489, 70,496.

a whistleblower reward because others may by then have filed reports containing the same information.

A whistleblower may also choose not to report internally because he or she believes that the company could then rectify the problem, and therefore be subject to lesser or no monetary sanctions upon which an award would be paid. From a whistleblower's perspective, therefore, internal reporting may *lessen* the likelihood of receiving a monetary award and/or reduce the potential size of the award. Thus, while the SEC may believe that its proposed rules do not provide a disincentive to internal reporting, the perceptions of the public may be quite different, leading to unintended consequences.

We also believe that by inadvertently discouraging the use of internal procedures the proposed rules may raise concerns about the design effectiveness of an issuer's internal controls over financial reporting (ICFR). If the effectiveness of companies' internal systems are allowed to erode, there could be a rise in the incidence of financial reports that include incorrect reports about the effectiveness of ICFR as well as inaccurate financial information that would have been corrected had management been alerted of the problem through the timely use of internal procedures.

Therefore, we believe that the whistleblower program should be implemented in such a way as to establish a constructive balance between strengthening the operation of effective internal compliance programs, and encouraging timely whistleblowing to the SEC. We believe that this could be achieved by a requirement, as a condition of eligibility to receive a monetary award, that whistleblowers report their concerns fully and in good faith through company-sponsored internal compliance systems before reporting to the SEC; alternatively, at a minimum, we believe concurrent reporting to the SEC and internally should be required.

Potential Impact on the Accuracy of Financial Reporting

A rule that rewards whistleblowers who bypass internal compliance procedures will not necessarily result in more accurate financial statements—and may in fact result in the unintended

consequence of *less* accurate financial statements. Internal reporting gives the company an opportunity to correct problems before they impact the financial statements that are included in reports filed with the Commission or in financial results that are publicly announced before filing. When suspected wrongdoing is reported internally, management, under the oversight of the audit committee and with appropriate assistance of outside auditors, often can move quickly to investigate, prevent a violation from occurring, or mitigate the impact of an error. This may include, on a timelier basis, preventing any misleading disclosure to investors, removing culpable individuals from positions of responsibility, adopting other measures designed to prevent future violations, disciplining employees who had prior knowledge of the wrongdoing but failed to intercede, and making any necessary and appropriate disclosures in SEC reports or to the SEC or other regulatory authorities.

If whistleblowers report their information directly only to the SEC, however, the opportunity for company management, audit committees and independent auditors to foster accurate financial reporting may be delayed or even lost because allegations are not promptly communicated to companies as they become known.

For example, if an employee of a company sees a problem late in the fourth quarter and reports his or her concerns to the company internally, the company would be expected to address those concerns before it issues its year-end financial statements. But if that same whistleblower bypasses internal channels and reports his or her concerns only to the SEC, there would be a risk that the report will not be reviewed by the SEC staff—or brought to the attention of company management—before year-end financial results are announced or financial statements are released. As a result, the company later may need to restate those financials upon which investors had already relied. In this situation, the proposed rules would not serve the interests of anyone in the capital market system, least of all the investors the rules are intended to protect.

Even if the SEC's intent is to notify companies of whistleblower allegations promptly, there is a risk that its efficiency will diminish due to the expected dramatic increase in tips from whistleblowers seeking large financial awards, as the SEC is required to assume the burden of providing notice to companies and possibly conducting investigations previously addressed

directly by companies. These strains on regulatory resources could, despite the SEC's best intentions, delay communications to companies about reports of wrongdoing. Again, such delays could result in the unintended consequence of undermining accurate financial reporting, which is not in the best interest of the SEC, the investing public, companies or the auditing profession.

Because of the important role internal compliance systems can play in helping to ensure that investors receive accurate financial information from the company, we believe that whistleblowers should be encouraged to turn first to their companies' internal reporting procedures when they have concerns over possible wrongdoing. Existing frameworks, such as regulations promulgated under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and standards established by the Institute of Internal Auditors, should be allowed to continue to operate as intended. Section 301 of Sarbanes-Oxley, for example, directs companies' audit committees to establish procedures for receiving and processing complaints and confidential, anonymous tips regarding "accounting, internal accounting controls, or auditing matters." Many companies now require their employees to report actual or suspected illegal acts or violations of a corporate code of conduct through internal channels.

While we recognize that there could be circumstances where a potential whistleblower believes that the company's internal program is ineffective or fears retaliation, the Dodd-Frank Act already has taken that into consideration by including anti-retaliation provisions. Moreover, the SEC's proposed rules allowing potential whistleblowers essentially to preserve their place in line with the SEC if they first use their internal systems also serve to alleviate such concerns. But the 90-day grace period is not an incentive for employees to report internally. In the absence of a requirement or an incentive to report internally, we believe that employees may opt to report exclusively to the SEC so as to minimize the risk that the company will correct the purported misconduct before a report is filed or an announcement is made.

Therefore, on balance, we believe that the potential risks to the financial reporting system of allowing a whistleblower to bypass internal compliance programs are greater than the possible

effect of discouraging some reporting by requiring reporting through company systems first, or at least concurrently.

Potential Impact on the Evaluation of Internal Control over Financial Reporting

The monetary incentive to bypass internal reporting procedures also may impact assessments of companies' internal control over financial reporting, which are required by Sarbanes-Oxley. Companies' whistleblower hotlines and other means of confidential reporting, designed to detect and deter securities fraud and other violations, are considered "entity-level" controls and thus among the very few controls that can be effective in reducing the risk that management is overriding other internal controls.[3] The SEC itself has emphasized the importance of these controls, noting management's duty to evaluate "whether it has controls in place to address the entity-level and other pervasive elements of ICFR" that are deemed "necessary to an effective system of internal control," including "controls over management override."[4]

Most companies put such controls into place in a legal and regulatory environment that encouraged the internal detection and resolution of potential accounting problems. If the new whistleblower program were to encourage employees to bypass these existing entity-level controls, the fundamental assumptions upon which those controls were designed could be affected. Because of the potential shift in employee motivations, management and external auditors may no longer be able to conclude that controls that were once effective in detecting and deterring wrongdoing remain so. Thus the design of the controls themselves could henceforth be deemed flawed, through no fault of the company and outside its ability to repair. This result could be avoided if the whistleblower program ensured that whistleblowers use internal procedures rather than only reporting their concerns to the SEC.

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[3] *See* AICPA, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* 7 (2005) ("A key defense against management override of internal controls is a whistleblowing process that typically incorporates a telephone hotline.").

[4] *Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, 17 C.F.R. Part 241.

Conclusion

In light of the concerns discussed above, we believe that the SEC's whistleblower program should require, as a condition of eligibility to receive a monetary award, that whistleblowers first report their concerns through company-sponsored complaint and reporting procedures. Such a requirement would strengthen existing company reporting procedures by better ensuring timely reporting of violations to companies and auditors. In addition, it would allow the continuing operation of effective internal controls, including effective controls that were put in place and strengthened as a result of Sarbanes-Oxley. Such a requirement would also harmonize with other governmental regulations and policies that emphasize the value of internal company reporting, including the Department of Justice,[5] the Federal Sentencing Guidelines,[6] and the SEC's own cooperation rules.[7]

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[5] DOJ policy favors corporate self-policing by advising federal prosecutors, when evaluating whether to indict a business organization, to consider such factors as "the corporation's timely and voluntary disclosure of wrongdoing;" "the existence and effectiveness of the corporation's pre-existing compliance program;" and "the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies." United States Attorneys' Manual, Ch. 9-28.300 (2008). Implicit in each of the identified factors is a need for companies to have effective internal reporting and compliance procedures. The "effectiveness" of internal compliance procedures presumes that employees are willing to use them. And pre-indictment "remedial actions" are most easily demonstrated by organizations capable of detecting wrongdoing and voluntarily taking prompt corrective measures.

[6] At the criminal sentencing stage, the Guidelines call for courts to consider the existence of an effective compliance and ethics program when determining such factors as the organization's culpability score and its conditions of probation. An effective compliance and ethics program must be "designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct." U.S. Sentencing Guidelines Manual § 8B2.1(a)(2) (2010). By a wide margin, tips are the single source most responsible for detecting fraud in the workplace. Association of Certified Fraud Examiners, *Report to the Nations on Occupational Fraud and Abuse* 20 (2010). Thus, to be effective, a corporate compliance program should include whistleblower reporting processes that employees are willing and able to use to report fraud and other wrongdoing. Moreover, if whistleblowers are not required to report internally before reporting to the SEC, they may also lose the benefit of Section 8C2.5, which allows for the reduction of a company's culpability score for self-reporting a violation "prior to an imminent threat of disclosure or government investigation."

[7] SEC guidance sets forth criteria it will evaluate in considering whether, and how much, to credit a cooperating company's "self-policing, self-reporting, remediation and cooperation"—the criteria ask, among other things: (i) How was the misconduct detected and who uncovered it? (ii) How long after discovery of the misconduct did it take to implement an effective response? and (iii) What steps did the company take upon learning of the misconduct? *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and*

[Footnote continued on next page]

In fact, requiring internal reporting by employees as a condition for eligibility could encourage more appropriate behavior by companies and their employees. Such a requirement would not only serve to remind employees of their responsibility to speak up when they see potential wrongdoing within their companies, but also would serve to emphasize companies' obligations to address internal reports promptly. In cases where internal reporting is not effective and the whistleblower then reports to the SEC, the SEC would have to opportunity to emphasize the company's responsibility to follow up on internal reports, by basing enforcement actions not only on the original wrongdoing but also for any failure to take appropriate action once put on notice by a whistleblower.

If the SEC determines that it will not make internal reporting a requirement for eligibility to receive a whistleblower award, we believe that, at a minimum, it should require the concurrent submission of internal and external reports. We believe that sequential reporting is preferable, however, as it would allow companies to demonstrate their commitment to integrity in financial reporting and for accounting firms would enhance the likelihood that the Section 10A process will operate as intended.

Finally, while we appreciate that the SEC has indicated its willingness to consider the existence and extent of a whistleblower's internal reporting as one of several "permissible considerations" in making an award determination, we do not believe this standard—which does not even require such consideration by the SEC—will be strong enough to countervail the motivation to report to the SEC first.

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I thank you for allowing me to make a statement here today. I would be happy to answer any questions you may have.

[Footnote continued from previous page]
Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Rel. No. 1470 (Oct. 23, 2001).

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

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3. Business Address and telephone number:	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Robert Kueppers	

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