Written Testimony

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Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

"Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions"

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Introduction

My name is Darla C. Stuckey and I am currently Senior Vice President – Policy & Advocacy, for the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,100 members who serve more than 2,000 companies. Our members are responsible for supporting the work of corporate boards of directors and their committees and the executive management of their companies regarding corporate governance and disclosure. At our companies we seek to develop corporate governance policies and practices that support our boards in the important work and that serve the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. The majority of Society members are attorneys, although our members also include compliance officers and non-attorney governance professionals. More than half of our members are from small and mid-cap companies.

The Society is honored to give testimony before this Committee.

Background

The Subcommittee has asked for the Society's views on the whistleblower bounty provisions of the Dodd-Frank Act (the "Act") and possible legislative proposals to deal with the negative consequences of those provisions. Section 922(a) of the Act provides that the SEC "shall pay an award" to whistleblowers cash rewards of between 10% and 30% of any monetary sanctions exceeding $1 million that either the SEC or the US Attorney General, or any other self regulatory organization or state attorney general recovers as a result of the whistleblower's assistance. Our comments below are similar to those provided to the SEC in its comment period. In addition they address the draft legislation by Representative Grimm to amend the whistleblower incentive and protection provisions of the Securities and Exchange Act of 1934 and the Commodity Exchange Act ("draft Grimm legislation").

Corporate compliance programs serve several important functions. They provide a source of invaluable information to a company to enable it to detect and help prevent violations of law, are used to educate employees with respect to codes of conduct and legal and compliance matters, and are important components of remediation actions. Compliance programs are integral to the early investigation and remediation of possible misconduct by employees and others. These critical functions may be undermined by the whistleblower provisions in the Act. In fact, the whistleblower provisions could discourage an employee who becomes aware of a potential violation from speaking up to prevent a violation from occurring and, instead, only report it to the Commission after the company has actually incurred the violation. The employee would be motivated to do this in the hopes that, by ensuring that once the company has in fact violated the law, the employee can blow the whistle and receive an award. Rather than preventing a violation from occurring, the whistleblower provisions could, in fact, provide significant monetary incentives for employees to turn a blind eye to such violations when they first come to the employee's attention.

The modifications we suggested to the SEC are intended to strike the proper balance in preserving the purposes of effective corporate compliance programs while also fulfilling the mandate of the Dodd-Frank Act to "maximize the submission of high-quality tips and to enhance the utility of the information reported to the Commission." We believe the modifications included in the draft Grimm legislation will accomplish these goals.

I. In Order to be Eligible for a Bounty, a Whistleblower Must First Use the Company's Internal Compliance Program

Corporate tip lines (or hot lines) are an integral part of compliance programs. They function as valuable mechanisms for revealing and remedying violations of law, including securities law violations. These corporate compliance programs should be the first line for reporting violations (and potential violations). Accordingly, persons seeking to be eligible for a whistleblower bounty should be required to first report the information to the company, so long as the company has an effective corporate compliance program.

The draft Grimm legislation would require internal reporting to the company by a whistleblower as a condition of eligibility for an award. See Section 1(a)(2). The Society supports this provision.

Most responsible public companies have spent a significant amount of time and money implementing compliance and hot line policies and procedures and these companies continue to devote valuable resources to monitoring and updating these procedures. These programs have been established over the years to comply with the requirements of (i) the Federal Sentencing Guidelines related to "Effective Compliance and Ethics Program"; (ii) the requirements of Section 17A-3 and 17A-4 of the Securities Exchange Act of 1934 related to books and record keeping; and (iii) Section 301 of the Sarbanes-Oxley Act ("SOX")(adopted as Rule 10A-3 in the Securities Exchange Act of 1934)--which requires companies to establish tip line procedures for anonymous reporting relating to accounting, internal accounting controls, and auditing matters. The Society believes the processes and procedures in place to comply with SOX can be readily

modified and expanded to include the anonymous reporting of potential securities law violations.

The Society recognizes that not all companies have effective compliance programs. In certain circumstances, it may be appropriate for an individual to report first to the Commission. Such circumstances would include: (i) if the company does not have any reporting process or procedure in place that protects anonymous or confidential reporting; or (ii) if the company's audit committee has not adopted procedures for the handling of reports relating to securities violations (which procedures include the audit committee receiving information about such reports).

The draft Grimm legislation recognizes that in cases where a whistleblower is not afforded an anonymous internal reporting hotline or anti-whistleblower retaliation provisions, it may be necessary for the employee to report directly to the SEC. Section 1(a)(1) provides an exception from the requirement for internal reporting if a whistleblower alleges (and the SEC determines) that the employer lacks either 1) an anti-retaliation policy or 2) a system of anonymous reporting, or 3) if the SEC determines that internal reporting is not viable for the whistleblower due to alleged misconduct at the "highest level of management" or "bad faith" on the employers part. The Society supports this exception as an appropriate balance and as an incentive for companies to maintain effective compliance programs.

II. If a Company Has a Compliant Tip Line, the Company Should Have 120 Days to Investigate, Remediate and Report

Once notified by a whistleblower through the company's internal compliance processes that there may be a securities law violation, the company should have a 120 day period to investigate, remediate and report back to the tipper. If the tipper is not satisfied with the report from the company, the tipper may commence the SEC process, with the date of first reporting being the date the person first reported under the company's compliant corporate tip line program.

We believe there are several benefits to both companies and the Commission in permitting companies this 120 day investigative period:

First, by having the employee report first to the company and giving the company an opportunity to investigate the matter, responsible companies will have the opportunity to stop wrongdoing promptly and take appropriate remedial action quickly--and without the need for the Commission to use its limited resources to (i) evaluate the merit of the tip and (ii) communicate it to the company and (iii) conduct the investigation. In circumstances where the Commission first receives the tip (as currently contemplated would occur under the Whistleblower provisions) and then notifies the company of such fact, there could be unnecessary delay in the company learning of the violation, and therefore delay in its ability to initiate any remediation actions. As noted above, the whistleblower provisions could have the unintended result of encouraging employees to withhold information from companies until after a violation of law has occurred, thus resulting in undue harm to companies and their shareholders.

Further we believe most employees will be under the impression that having once raised an issue by calling a hot line, they have satisfied their obligations under a company's code of conduct to reported suspected violations of law. If that first call goes to the Commission, and if the alleged wrongdoing does not involve a securities violation (for example, a personnel matter), we question whether the Commission will have the staff and resources to report all such tips to companies. If not every call reported to the Commission is reported to the company, companies will not learn crucial information they need whether or not such information would be of interest to the Commission. Thus, the whistleblower provisions put a wedge between the company and employees who would otherwise raise their concerns--large and small--through company hot lines.

Data from one Society member health care company indicates that of the 726 compliance and ethics reports received through its "hotline" 50% were related to human resource issues and another 25% were related to customer privacy. A very small minority of issues raised end up being securities law violations. Yet, the program yields information crucial to the company for other purposes. Similarly, another member company (a Fortune 100 retailer), had 1,659 ethics reports in FY 2010, and of those 70% were related to human resource issues. Less than 1% would be of the nature that would be investigated as possible serious violations, including securities law violations. Again, the information learned from the hotline programs is crucial to the company's ability to discover theft and other customer privacy breaches. Finally, a third member (multi-line insurance company) reports that it received 75 reports to its hotline in 2010, more than double 2009, as a result of extensive training, communications, presentations and prompt, fair responses to the reports. Of the 75 reports received, more than 60% were "personnel related." Only 5 or 10 in any year are matters involving potential fraud, serious misconduct or serious potential regulatory violations, or any matter involving senior leaders, but every matter is investigated, and the company strictly enforces its tough non-retaliation policy, with the result that less than 40% of the reports are made anonymously.

Second, if allowed a reasonable, but limited, amount of time to investigate the alleged violation, companies will be able to weed out matters unrelated to potential securities law violations. For example, it has been estimated that more than 50% of claims on a typical corporate tip line relate solely to human resources matters.[1] As noted above, we believe that by requiring companies to undertake the necessary investigation of the complaint in the first instance, the Commission will be spared processing a large volume of poor quality submissions or submissions that are unrelated to securities law violations. This may be particularly relevant given the potentially significant increase in the number of tips, complaints, and referrals anticipated to be made as a result of the bounty.

Third, once the 120 day period is over, the whistleblower can report to the Commission if he or she believes it is appropriate to do so. Once notified, the Commission can conduct its own investigation as it determines, including evaluating how well and responsibly the company responded to the employee's complaint. As a result, the 120 day period will not detract from the Commission's own investigative efforts.

[1] According to the 2009 Corporate Governance and Compliance Hotline Benchmarking Report, 50% of tips received on corporate hotlines in 2008 pertained to "personnel management."

The draft Grimm legislation provides that in order to be eligible for an award, a whistleblower "shall…report to the Commission not later than 180 days after reporting the information to the employer." The Society supports this provision of the legislation.

Moreover, the draft Grimm legislation in Section 1(f)(1)(A) would require the SEC to notify any company before commencing an enforcement action "unless the Commission determines in the course of a preliminary investigation of the alleged misconduct, not exceeding 30 days, that such notification would jeopardize necessary investigative measures and impede the gathering of relevant facts based on evidence that the alleged misconduct . . . involved the complicity of the highest level management" or "bad faith" by the company. The Society supports this provision in the case where the company has not been notified of the whistleblower tip to the SEC as a result of an allegation that the company has no anonymous reporting mechanism or anti-retaliation policies or that the highest level of management was involved. The Society also supports the treatment of a company that acts in good faith following such notification as having self reported and in accordance with the Commission's policy on cooperation, as set forth in Section 1(f)(1)(A)(ii).

III. Companies Must Be Able to Enforce Established Codes of Conduct

Many corporate compliance hot line programs and policies generally require employees to internally report any potential violations of law. In fact, it is a violation of most companies' codes of conduct for an employee NOT to report violations of policy. It is important that the whistleblower provisions work in tandem with, and not in contravention of, these processes and procedures. The Society believes that unless there is an express requirement in the Rules that an employee be required to report first through the company's compliance and tip reporting programs (absent evidence that his or her efforts would be futile (as further discussed below)), such programs will be undermined. If this were to occur, the positive benefits, such as promoting a culture of compliance at companies, will be weakened, and the internal controls of a company would be significantly diminished. We believe that rather than this result, the Commission should take this opportunity to implement Rules that foster, encourage and support companies in developing and maintaining effective compliance and tip reporting processes and procedures.

In addition, the Society strongly supports anti-retaliation protections for employees and recognizes such provisions are an important component of effective, successful compliance programs. Without having the protection and security provided by anti-retaliation provisions, employees may not be appropriately motivated to report wrongdoing to companies. However, as presently drafted, the whistleblower provisions may shield employees from proper termination or other disciplinary actions and prevent employers from exercising legitimate rights. For example, it may be appropriate for a company to terminate the employment of a person convicted of a criminal violation, or who has engaged in unethical behavior or has materially breached the company's code of conduct. Not permitting a company to take appropriate action with respect to an

employee who has engaged in improper conduct would send an inappropriate message to the rest of the company's workforce.

The draft Grimm legislation clarifies that a company has authority to enforce existing policies that require employees to report violations and potential violations internally. Section 1(a)(2)(e) "Rule of Construction Relating to Other Workplace Policies" would allow companies to enforce "any established employment agreements, workplace policies or codes of conduct against a whistleblower, and any adverse action taken against a whistleblower for any violation of such agreements, policies, or codes shall not constitute retaliation for purposes of this paragraph provided such agreements, policies, or codes are enforced consistently with respect to other employees who are not whistleblowers." This provision would maintain a company's ability to take the necessary action against employees who fail to report internal violations. The Society supports this provision.

IV. Whistleblowers Who Participate in Wrongdoing Should Not Be Awarded a Bounty

The whistleblower provisions should encourage both companies and their employees to do the right thing in deterring, and remediating, violations of laws. However, the provisions, by permitting awards to be granted to persons who participated in the violation, would reward wrong-doers. The Society believes individuals who actively participated or facilitated the violation (even if such person did not "substantially direct, plan or initiate" the misconduct) should not be awarded a whistleblower's bounty. Accordingly, not only should amounts that may be imposed in enforcement actions be excluded from the calculation of the $1 million threshold, but such employees should not be entitled to awards at all.

The draft Grimm legislation does precisely this—it excludes any whistleblower that "is found civilly liable, or is otherwise determined by the Commission to have committed, facilitated, participated in, or otherwise been complicit in misconduct related to" a violation. Section 1(c). The Society supports this provision.

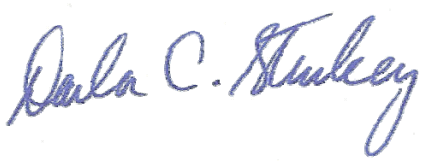
V. Elimination of the Minimum Award Requirement

The draft Grimm legislation in Section 1(b) eliminates the minimum award requirement from the Act to give the SEC flexibility to grant no monetary award. The Society supports this provision since it would allow for bounties smaller than 10% in cases where the recovery is very large and the award or potential award could create perverse incentives for employees. We believe the SEC should have the discretion to award any amount up to 30% given the facts and circumstances of each case.

Conclusion

The Society is mindful that no compliance program is perfect, and that whistleblower programs do perform an important role in helping law enforcement agencies investigate and correct violations of law. Whistleblower programs, however, should be designed to reinforce the integrity of compliance programs, and help encourage employees not only to identify violations but also to assist their companies in taking preventative as well as corrective action. Companies desire to investigate every single complaint that is submitted and uninvestigated complaints filed with the SEC could fall through the cracks, undermining the integrity of all compliance programs. The whistleblower provisions of Dodd-Frank, coupled with the SEC's proposed rules will undercut the carefully developed culture of compliance that so many companies try to foster as good for business and good for stakeholders. We respectfully support the draft Grimm legislation, which we believe will: 1) avoid negative unintended consequences of undermining existing compliance programs, 2) reinforce the protection given to whistleblowers of anonymous reporting and anti-retaliation policies, and 3) still give the SEC powerful tools for enforcing the securities laws by maximizing the number of high quality tips and useful information relating to possible violations of those laws.

Respectfully submitted,



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