LEGISLATIVE PROPOSALS TO ADDRESS THE NEGATIVE CONSEQUENCES OF THE DODD-FRANK WHISTLEBLOWER PROVISIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

MAY 11, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–29

U.S. GOVERNMENT PRINTING OFFICE

66–867 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO "QUICO" CANSECO, Texas
STEVE STIVERS, Ohio

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

LARRY C. LAVENDER, *Chief of Staff*

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

SCOTT GARRETT, New Jersey, *Chairman*

DAVID SCHWEIKERT, Arizona, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
JUDY BIGGERT, Illinois
JEB HENSARLING, Texas
RANDY NEUGEBAUER, Texas
JOHN CAMPBELL, California
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
NAN A. S. HAYWORTH, New York
ROBERT HURT, Virginia
MICHAEL G. GRIMM, New York
STEVE STIVERS, Ohio

MAXINE WATERS, California, *Ranking Member*
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
RUBÉN HINOJOSA, Texas
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
CAROLYN B. MALONEY, New York
GWEN MOORE, Wisconsin
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
AL GREEN, Texas
KEITH ELLISON, Minnesota

CONTENTS

LEGISLATIVE PROPOSALS TO ADDRESS THE NEGATIVE CONSEQUENCES OF THE DODD-FRANK WHISTLEBLOWER PROVISIONS

Wednesday, May 11, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 3:24 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Biggert, Posey, Hayworth, Hurt, Grimm, Stivers; Waters, Ackerman, Sherman, Maloney, and Green.

Chairman GARRETT. Good afternoon. The Capital Markets Subcommittee will come to order.

Thank you to the panel for waiting through our votes and what have you that we had before. We will begin today with our opening statements.

I will yield myself 3 minutes. And then, after opening statements, we will hear from the panel.

So, first of all, I want to thank the panel of witnesses for joining us all today to offer their thoughts and input on the whistleblower provisions of the Dodd-Frank Act, as well as the SEC's proposed rulemaking to implement some of those provisions.

It is appropriate that we convene this hearing today to have a discussion about the whistleblower provisions, appropriate in a better-late-than-never kind of way.

What would have been more appropriate is if this subcommittee, and actually the full House Financial Services Committee, had prior to this a full and robust discussion about the potential adjustments to the SEC whistleblower program. And if they had done that before the provisions were signed into law.

Unfortunately, too much of the Dodd-Frank Act was implemented in a way that we have here today: rushed to meet a political deadline; passed to check off a long-standing agenda of a certain constituency, rather than to address issues that actually contributed to the cause of the financial crisis; and not enough of a thoughtful analysis on some of the unintended consequences that might arise from certain policies in that bill.

So, the goal of providing an environment where whistleblowers can be most effective in helping to right the wrongs and where they have proper safeguards is a laudable one. The details of writing into law the proper incentives and rules to create such an environment, however, are very important.

We must be careful not to do more harm than good. It is always the rule.

Several of our witnesses here today, as well as scores of others who have participated in the comment letter process to the SEC, have raised concerns about the unintended consequences of the Dodd-Frank whistleblower rules.

Foremost among those concerns are the following:

First, will the incentive structure created by the Dodd-Frank provisions exacerbate violations by encouraging them to fester and become more serious problems over time?

Second, does the legislation and the proposed rulemaking allow those complicit in violations to not only—this is important—escape punishment, but potentially receive massive rewards in spite of their own malfeasance?

Third, if internal compliance programs are bypassed, isn't good corporate citizenship discouraged, and won't there be greater likelihood that companies will have less accurate financial statements and that companies will need to restate those financials upon which investors had already made reliance upon?

So, I am pleased that one of our freshmen here, Congressman Michael Grimm, has put forward a discussion draft of legislative proposals meant to address some of these concerns. Having this proposal in front of the subcommittee today will basically enhance the discussion and lead to a more positive outcome to the efforts of this Congress and to the SEC and to their whistleblower issues.

So once again, I would say thank you to the witnesses for the testimony we are going to receive, and I look forward to a full discussion on this issue.

And with that, I yield to the ranking member of the subcommittee.

Ms. WATERS. Thank you, Mr. Chairman, for holding this hearing.

Under the Dodd-Frank Act, Congress recognized that robust whistleblower protection is critical to preventing another financial crisis.

Prior to Dodd-Frank, the inducements for whistleblowers to step forward were inadequate when balanced against the tremendous countervailing social and economic disincentives.

Contrary to some of my colleagues on the opposite side of the aisle, I don't believe that whistleblowers are eager to run to the SEC and put their jobs, their 401(k)s, and sometimes even their friendships on the line. Significant evidence suggests that whistleblowers are often fired, quit under duress, or are demoted.

Additionally, whistleblowers are often blacklisted from working in the industry and experience severe social ostracism and personal hardship.

The bounties and systems were set up on the Dodd-Frank legislature precisely to combat these tremendous disincentives. And it is important to note that we did not set up these systems merely to provide payout to whistleblowers for the sake they were examined. In fact, we set up these systems to help empower the SEC.

Wall Street's problem would be to recover money owed to taxpayers.

Additionally, this bill would further weaken Dodd-Frank by making bounties paid by the SEC to whistleblowers discretionary rather than mandatory. I think that would amount to a step backward.

Between 1988 and 2000, the SEC had the authority to pay bounties under the Insider Trading and Securities Fraud Act and paid just $160,000 to 5 whistleblowers over that entire period. And ironically, I should note that one of the criticisms of the whistleblower award provisions in Dodd-Frank is that it will cause the SEC to be overwhelmed with debts from individuals trying to collect big rewards.

I would have great sympathy for this argument if the same folks who are making it were also trying to cut the funding the Commission needs to do its job.

I would also say that I am deeply concerned with corporate crimes being treated less seriously than street crimes. For instance, when in comes to street crime, investigators are required to first alert the subject of the investigation. Why should corporate crime be held to a lower standard?

Lastly, I would point out that yesterday, Senator Charles Grassley of Iowa issued a press release saying that the SEC's proposed rule of whistle-blowing is too weak. He is deeply concerned that House Republicans will try to weaken Dodd-Frank further in this legislative draft.

Thank you, Mr. Chairman.

I yield back the balance of my time.

Chairman GARRETT. And the gentlelady yields back.

The gentleman from California?

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman GARRETT. For 2 minutes.

Mr. ROYCE. Thank you.

We have had many failures at the SEC over the years. And despite hearing from people like Harry Markopolos about what he called the "overlawyered culture," the investigative ineptitude that was part of the culture at the SEC, despite this, last year we had a Dodd-Frank bill that rewarded the SEC with additional authority without looking at the fundamental problems within that agency.

And for nearly a decade—I am just thinking about the conversations we had here with Mr. Markopolos, actually over a decade—he tried to bring the Madoff case to the attention of the SEC, but he was repeatedly turned away. Clearly, something needs to change.

And while not nearly enough to solve the SEC's problems, the Office of the Whistleblower was simply a small step developed, by the way, by Mr. Markopolos, pushed by us here in an effort to hold the SEC more accountable. It is unfortunate that a broader effort to reform this agency was not undertaken, but I hope that Congress can take up this cause of reforming the SEC.

Now, the focus of this hearing is with respect to the other provisions within the whistleblower section of Dodd-Frank, most notably, the whistleblower reward program.

Because of the skewed incentives, greater wrongdoing and less timely reporting by whistleblowers may be the end result of the way that thing is set up. So I commend Mr. Grimm and the chairman here for their work to correct this provision and make it efficient and workable.

And I look forward to today's hearing.

I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentleman from New York for 2 minutes.

Mr. ACKERMAN. I don't know a lot of things about a lot of things. Maybe it is just because I am from New York.

Chairman GARRETT. That is true.

Mr. ACKERMAN. But what I do know is that if you are going to turn on the mob, you shouldn't first tell the mob.

Chairman GARRETT. And the gentleman yields back the remainder of his time.

The other gentleman from New York for 2 minutes.

Mr. GRIMM. First of all, I want to thank Chairman Garrett for holding this hearing, and thank our witnesses for testifying about ways to improve the whistleblower provisions of Dodd-Frank.

In response to accounting scandals, early in the last decade, Congress passed the Sarbanes-Oxley Act of 2002. The Act required, among other things, a robust internal reporting system for whistleblowers to anonymously report suspected misconduct occurring in their company.

These systems were set up at considerable cost. Internal reporting systems serve the valuable purpose of assisting the firm in detecting fraud early and putting a stop to it before it can spiral out of control.

The whistleblower provisions in the Dodd-Frank Act put these internal reporting systems in jeopardy of becoming obsolete.

By creating a system where whistleblowers can get a guaranteed reward by bypassing internal reporting systems and going directly to the SEC, the Dodd-Frank Act disincentivizes employees from reporting suspected fraud internally. This could lead to long delays in fraud detection that will result in the cost of fraud increasing and depleting shareholder value.

While we all recognize the important role whistleblowers can play in helping to protect investors from fraud, we must ensure that we do not allow the pendulum to swing too far, that laws and regulations inhibit the ability of the honest firms to quickly weed out a dishonest employee.

That is why I present the draft legislation for consideration today that I believe will bring balance back to the process of fraud detection.

I look forward to hearing the witnesses' comments on this important topic and I yield back the balance of my time.

Thank you.

Chairman GARRETT. And with that, we now can turn to our panel. Each member of the panel will have 5 minutes. Their complete statements have been made a part of the record and we appreciate the panelists' indulgence for having to wait a little bit.

Mr. Kueppers, for 5 minutes?

STATEMENT OF ROBERT J. KUEPPERS, DEPUTY CHIEF EXECUTIVE OFFICER, DELOITTE LLP

Mr. KUEPPERS. Thank you, Mr. Chairman.

Chairman GARRETT. And as always, pull your microphone as close as you can so it doesn't mess up your papers.

Mr. KUEPPERS. Okay. Thank you.

Chairman GARRETT. And you are all set.

Mr. KUEPPERS. Chairman Garrett, Ranking Member Waters, 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 on behalf of Deloitte LLP, one of the largest accounting and professional services firms, as well as, more broadly, a member of the public company auditing profession.

I have 35 years experience in the auditing profession, all with Deloitte or its predecessors, with two breaks in service: one time when I worked at the SEC; and another time when I served as CFO of an SEC reporting company.

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 to help ensure strong controls are in place, both to deter and to detect any 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 support implementation of a whistleblower program in a way that will help maintain, rather than circumvent, the robust systems in place at most public companies.

Congress and the SEC have appropriately fostered these systems in recent years, principally, as a result of Section 301 of Sarbanes-Oxley almost 10 years ago.

I will address the potential impact of the proposed whistleblower rules on the efficacy of public companies' internal compliance procedures. There is a risk that investors could be harmed if reporting companies are unaware that a whistleblower has come forward.

We are concerned that the rules proposed by the SEC could create a monetary incentive for whistleblowers to bypass companies established in effect of internal compliance mechanisms.

A rule that rewards whistleblowers who disregard internal compliance procedures might result in the unintended consequences of less accurate financial statements.

In this proposed rule, the SEC appropriately seeks to reassure whistleblowers that they will not lose their first-in-line status if they report to the company. While that is helpful, we believe that these measures will not be sufficient. And, if whistleblowers report their information directly and only to the SEC, the opportunity for management, audit committees, and external auditors to ensure accurate financial reporting may be delayed or even lost unless allocations are promptly communicated to companies as they become known.

Let me give you an example. Consider a situation where an employee sees a problem late in the fourth quarter of the year but chooses to go around internal channels and report his or her concerns only to the SEC. That creates a risk that the report would not be timely reviewed by the SEC staff or even brought to the attention of company management before year-end results are announced or before financial statements are released. As a result, the company may have to restate those errant financials after investors have already relied upon them.

In this example, the proposed rules would not serve the interest of the very investors that the rules are intended to protect.

Even if the SEC's intent is to notify companies of whistleblower allegations promptly, the potential increase in volume of reports may make choosing that objective difficult for the SEC staff.

I note that if a whistleblower does fear retaliation, the Dodd-Frank Act has already taken that into consideration by including very strong anti-retaliation provisions. Companys' whistleblower hotlines and another means of confidential reporting are designed to detect and deter securities fraud and other violations.

Such controls are considered what we call entity-level controls and are among the very few controls that can be effective in reducing the risk that management could override these other internal controls.

So if the new whistleblower program resulted in a shift, that is if employees no longer reported internally, management and external auditors may not be able to conclude that such controls are effective.

In light of these concerns, 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.

If the SEC determines that it will not make internal reporting a requirement for eligibility, we think that at a minimum, it should require what I will call concurrence of mission to the company and to the SEC.

And finally, we appreciate the fact that the SEC has indicated its willingness to consider the existence and expense of a whistleblower's internal reporting as one of several permissible considerations in making an award. However, we don't believe that the standard which does not even require that the SEC do this will be strong enough to countervail the motivation through reports of the SEC first.

Thank you for allowing me to make my statement here today.

[The prepared statement of Mr. Kueppers can be found on page 42 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

Ms. Narine?

STATEMENT OF MARCIA NARINE, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Ms. NARINE. Good afternoon, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Marcia Narine, and I am here on behalf of the U.S. Chamber of Commerce.

Until May 1, 2011, I served as the vice president of global compliance and business standards, deputy general counsel, and chief privacy officer of Ryder, a Fortune 500 global transportation and supply chain management solutions company serving 28,000 employees worldwide. Prior to that role, I spent almost 18 months as the group director of human resources for Ryder's supply chain solutions division. I began my career at Ryder in 1999.

Before joining Ryder, I worked at two law firms, and prior to that I worked for Supreme Court New Jersey Justice Garibaldi.

I left Ryder to pursue my career as an academic, where I plan to write on corporate governance and compliance issues.

And the basis of my testimony stems in large part from my experience at Ryder establishing its global compliance program under the direction of its board, CEO, and two general counsels.

I have also deposed and prepared a number of witnesses, spoken to people who consider themselves to be whistleblowers, and developed training programs and policies.

The views expressed are entirely my own and should not be attributed to any of my former employers.

There are at least five ways in which this legislation will adversely affect compliance programs.

First, the bill creates a presumption that all companies operate at the lowest possible level of ethical and illegal behavior and provides every incentive for the whistleblower to bypass existing compliance programs.

Treating all companies like criminals and assuming that we will all retaliate and that we will all destroy documents or shred documents if a whistleblower brings us a tip is wrong and unfair.

Under the current legislation, employees can go straight to the SEC to report their suspicions without even alleging that the existing company reporting mechanism is not a viable, functioning, credible or legitimate option.

Law-abiding companies which have spent years and millions of dollars investing in compliance programs and building strong ethical cultures since the Federal sentencing guidelines were enacted are being penalized because the SEC failed to do its job and failed to pay attention to the whistleblower who repeatedly brought information to them regarding—the sentencing guidelines have steps for an effective compliance program. That is what boards of directors look at when they assess compliance programs under their responsibilities.

I have oversight over compliance programs. And as a compliance officer, my role is to conduct risk assessments, develop policies, travel the world conducting training, interviewing employees, and interviewing our agents to make sure that our liability is not going to be affected, and raising awareness.

When I first started traveling the world, we were told in many countries that no employee would ever call a hotline. They prefer to go to regulators.

So after years when we started getting calls in the hotlines from Brazil, China, and Asia, we started to know that our compliance program was working. That is an effective compliance program.

Programs like Dodd-Frank which tell people you don't need to call the hotline erodes the hard work that companies have been doing.

Not every company does this or companies that follow the sentencing guidelines. This is the kind of work that we do every day. Dodd-Frank is assuming that no company does this.

Those companies that retaliate against employees or shred documents need to be punished because those are the companies that we use as examples to tell our executive employees you will go to jail, you are penalized under Sarbanes-Oxley, you are penalized under the law if you retaliate against employees or if you shred documents.

Those are the examples that we point to, but you should not assume that all companies are bad and all companies break the law.

And the 2010 revisions of the sentencing guidelines provide important clarifications and important direction for companies which Dodd-Frank now turns on its head. The 2010 sentencing guidelines tell companies that you will continue to get credit from the Department of Justice sentencing judges if you voluntarily disclose to the government after you find out yourself internally that there has been malfeasance and wrongdoing. What the SEC is doing with Dodd-Frank is saying, "Don't bother to use internal compliance program; come directly to us."

So how will companies be able to follow the guidance under the 2010 revisions in the sentencing guidelines if the internal people don't have the incentive to come to us?

And the irresponsible or smaller companies that aren't doing the new compliance programs will have no incentive to do so because they will assume that the whistleblowers will go external anyway.

The SEC has indicated that they do not plan to automatically share information with the company. Publicly traded companies and the SEC have this same goal to protect the shareholder. If the SEC wants to protect the shareholder, the presumption should be, the whistleblower should report internally first, but if not, the SEC informs the company at the same time so that the company and the SEC can work together to get to the bottom of the issue.

There are—or capable individuals have the ability to get the balance sheet. This means that if an agent or someone is terminated or fired because they have done something wrong, they actually have the ability to collect on the bounty. This is bizarre—although that cannot be intended by the legislation as written.

The anti-retaliation provisions aren't clear so if someone is a whistleblower, under the law as written, if they commit an act of workplace violence, they steal from the company, they don't show up to work, it is not true that under a consistently followed clearly written policy, that whistleblower can never be fired. Of course, they should not be fired for coming forward and bringing forth wrongdoings, but if they commit a violation of company policy, they should be fired.

So, again, there are a number of issues, a number of tweaks of the law.

We are not saying that a whistleblower who has no viable option, no viable legitimate complaint mechanism within the company should not be able to get a bounty. That is not what we are saying.

So to be clear, if there is clear malfeasance at the top of the organization, if there is no credible reporting mechanism, if there is no general counsel, internal auditor, or board of directors that the whistleblower can go to, they should be able to go directly to the SEC and collect their bounty.

But if there is a viable reporting mechanism that is functioning, that is using the sentencing guideline, that a board of directors has oversight, we believe that the whistleblower should go internally first, and that if they go to the SEC, the SEC should let the company know so that the company can work in good faith to ferret out the problem and remedy it.

Thank you for your time.

[The prepared statement of Ms. Narine can be found on page 50 of the appendix.]

Chairman GARRETT. Thank you for your testimony.

Mr. Daly?

STATEMENT OF KEN DALY, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS (NACD)

Mr. DALY. Good afternoon.

Thank you, Mr. Garrett, and members of the subcommittee for giving us this opportunity.

I am Ken Daly, president and chief executive officer of the National Association of Corporate Directors.

The NACD, with more than 11,000 members, is the membership organization of America's boards of directors.

We believe that capitalism is premised on decency, honesty, and trust. And consequently, it is no surprise that we support and encourage internal systems aimed at enhancing business functions.

In 2002, Sarbanes-Oxley encouraged effective internal compliance systems with the key provisions of required whistleblower systems and protocol, up-the-ladder reporting for attorneys, and prohibiting companies from retaliating against whistleblowers. These systems were built at great cost, reportedly millions of dollars.

And much has been learned over the past decade about how these systems work and how these systems don't work.

Today, we believe these systems are working. We have several concerns about the Dodd-Frank whistleblower legislation and the implementing rules.

One of our primary concerns is that Dodd-Frank whistleblower bounties do not encourage the use of these systems, as has been pointed out by many other folks. Arguably, the perverse incentive systems actually conspired a cause of delay in fixing problems.

We have three additional concerns.

First, the definition of independent knowledge. We think it shouldn't exclude not only external auditors but also government employees, attorneys, internal auditors, and other professionals like those assisting in audits and those assisting directors as envisioned by Sarbanes-Oxley.

Second, companies should be allowed time to cure reported violations prior to government enforcement action. A reasonable time should be a minimum of 90 days.

Third, employers should have the ability to use existing disciplinary measures to respond to employees who circumvent company compliance systems or make false allegations against a company.

We believe there are significant unintended consequences as already noted today in this incentive program and the more important ones are, as already noted, the existing whistleblower systems that were recently established at substantial cost will probably not be used.

During a time when expectations of directors and the complexity of business is greater than ever, the records may be in fact disincentive for using outside resources to gain additional perspective on corporate issues. Sarbanes-Oxley was really meant to encourage the use of such resources.

By setting up the SEC as a central repository and processor of claims, thousands if not tens of thousands of claims both valid and otherwise will result in a near and possible test we are trying to separate the important matter.

Finally, corporate culture depends upon shared values from the top down. In our view, a wildcard has been inserted in the culture. It changes the emphasis from problems solving—the culture of American business—to getting paid for problem identification.

The proposed Grimm bill helps correct some but not all of these issues.

We are particularly pleased with those matters requiring internal reporting and in following up with reporting to the SEC no later than 180 days, the preventing of awards to whistleblowers who at certain exceptions do not first report internally, removing the minimum reward requirement of 10 percent of monetary sanctions collected, and finally, clarifying the provisions or retaliations against whistleblowers, providing employers with the ability to remove employees who violate a established employment agreements, workplace policies and codes of conduct.

However well-intentioned, we question a need for the entire Dodd-Frank whistleblower incentive program. We understand there are strong opinions for and against the inclusion of incentives, but there has been insufficient study in our view to determine if cash incentives and a centralized repository of claims are needed or if the existing systems are working well.

We propose to delay the effectiveness of Dodd-Frank whistleblower incentive provisions for 1 year. This would allow time for a comprehensive study of the effectiveness of existing whistleblower processes pursuant to Sarbanes-Oxley.

Thank you very much for your time.

[The prepared statement of Mr. Daly can be found on page 32 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Professor Rapp? You have to push the little button and pull the plastic.

You got it.

STATEMENT OF GEOFFREY CHRISTOPHER RAPP, PROFESSOR OF LAW, UNIVERSITY OF TOLEDO COLLEGE OF LAW

Mr. RAPP. Good afternoon, Chairman Garrett, Ranking Member Waters, and members of the subcommittee.

Thank you for the opportunity to discuss the proposed legislation modifying the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Whistle-blowing is the single most effective method of detecting corporate and financial fraud. In recognition of this fact, the Sarbanes-Oxley Act of 2002 for the first time created a uniform Federal protection for financial fraud whistleblowers.

The central idea was to motivate employees to blow the whistle by protecting them from retaliation in the workplace.

Unfortunately, Sarbanes-Oxley failed to offer any sort of financial incentive for whistleblowers who bring fraud to light.

Section 922 of the Dodd-Frank Act answered the glaring need for a bounty provision for financial fraud whistleblowers.

In short, under Dodd-Frank, whistleblowers who voluntarily provide original information on securities fraud violations would be entitled to 10 to 30 percent of the sanctions obtained by the Securities and Exchange Commission in a successful enforcement action.

The legislation under discussion in today's hearing would modify the Dodd-Frank approach.

First, the proposed legislation would require that employee whistleblowers raise their concerns internally before going to the SEC. Whistleblowers failing to do so would be denied a bounty unless they demonstrate that their employer lacks an internal reporting process or a policy prohibiting retaliation or demonstrate that the fraud involved high-level managers or bad faith.

The question of whether whistleblowers should be required to report internally is one that the SEC considered in detail in connection with its proposed rules. The SEC concluded in its proposed rules that an internal reporting requirement was unnecessary.

The main argument that has been advanced in favor of such a requirement is that Dodd-Frank would damage existing internal reporting structures adapted by corporations after the passage of Sarbanes-Oxley.

In response to this argument, the SEC made several observations.

First, it noted that not all employers have robust and well-documented internal reporting procedures. Moreover, the SEC expressed its view that even without imposing a requirement of internal reporting, internal reporting structures are unlikely to be bypassed.

The SEC noted that in most cases, upon receiving a whistleblower tip, its staff would contact the corporation and describe the allegations, giving the firm the chance to investigate the matter itself. The SEC did not expect that Dodd-Frank's structure would minimize the importance of effective company processes for addressing allegations of wrongful conduct.

In addition, even without a hard requirement of internal reporting, many whistleblowers will likely report internally anyway. Most whistleblowers see themselves as loyal employees and they often blow the whistle out of a desire to help their firms.

The proposed requirement for internal reporting would complicate both the process and the expected benefit of whistle-blowing for a potential tipster.

A potential whistleblower would have to make a judgment call about whether the high level management or bad faith exceptions apply before contacting the SEC or else risk losing her eligibility for a bounty. This added uncertainty would dull the incentives Dodd-Frank seeks to use to put more cops on the beat.

A second aspect of the proposed legislation would eliminate the mandatory nature of Dodd-Frank bounties. Again, this proposal would likely dull the incentives Dodd-Frank was meant to foster.

The primary concern that would arise if bounties were purely discretionary is whether the SEC would in fact award bounties on a regular basis. The SEC was given a purely discretionary authority to pay bounties by the Insider Trading and Securities Fraud Enforcement Act of 1988.

Between 1988 and 2010, the Commission reportedly paid just $160,000 to only 5 whistleblowers. Similarly, when the payment of bounties in the tax fraud setting by the Internal Revenue Service was purely discretionary prior to the Tax Relief and Health Care Act of 206, the IRS had a rather dismal record of rewarding whistleblowers.

The reformed IRS program serves as a model for the Dodd-Frank provision and made bounties mandatory at a certain level of disputed tax liability.

In addition, the Dodd-Frank Act already involves a fair amount of discretion. The SEC can deny bounties to whistleblowers whose information is not original, who do not provide such information voluntarily, or who fall in to one of the categories excluded from claiming of bounty.

Making bounties discretionary in all cases as the proposed legislation would do simply increases the likelihood that the Commission will direct its energies to other priorities rather than respond to and reward whistleblower tips.

Thank you, and I would be happy to answer any questions you may have.

[The prepared statement of Professor Rapp can be found on page 57 of the appendix.]

Chairman GARRETT. Thank you Professor. And I thank the entire panel.

So, at this time, I yield myself 5 minutes for questions.

Ms. Narine, one of your opening comments was the fact that—you said that the language in Dodd-Frank paints all businesses as criminal going into it. I am not quoting you exactly.

But I absolutely heard my colleague from New York when he said, "You do not tell the mob when you are doing an investigation." And that is exactly the case. Not all corporations are the mob; they are not all engaged in illegal conduct. I got your point that we are doing a broad brush approach with this language with the legislation.

Ms. NARINE. That is correct.

Chairman GARRETT. And I can probably even step back further here.

And as we go into this discussion on this one particular piece of Dodd-Frank, and I know we have heard this from the other side already, a comment that we are trying to undo from the good language that is in that legislation that anytime we try to make any changes of what we would call improvements to it—we were trying to totally undo a rollback in all, what have you, the Dodd-Frank legislation—that basically has been the rhetoric that we have heard no matter what we have had in this committee so far to date.

We try to improve upon something, a 2,300 page bill where we have not had a full and complete discussion and disclosures and look at the unintended consequences and where we are charge with being—trying to repel legislation.

And actually, you can comment on this, that is really not what is—done here with the gentleman from New York, Mr. Grimm's legislation, is it not? What we are trying to do is trying to take both the existing whistleblower laws and the requirements that we had first under SOX basically that are already in place—on that and then what came through Dodd-Frank and basically making it in a way that it actually gets to the end result which is what they try to improve corporate culture and to try to rectify, to end those bad conducts that are going on within a particular company.

Mr. KUEPPERS. I think that is fairly stated.

One way to think about it, Mr. Chairman is there is some tension between protecting whistleblowers which I think is very important and whistleblowers themselves play an important role in protecting the broader group of investors.

So, there are tradeoffs here. And my own experience is that I happen to have had the pleasure and benefit of working with clients who are quite well established in investigating any wrongdoing that might come to their attention.

And I think Mr. Grimm's draft legislation—the part that I focused on was this notion that you have to report first to the SEC because I believe, whether it is first or concurrently, then the company has the ability to have knowledge to get to the bottom of what the issue is.

And, of course, if they don't do so there should be some severe consequences for that company.

Chairman GARRETT. Right.

And so, there is language in Dodd-Frank, I think it is a 90-day period of time in which they can go to their—go to the corporation and say, I see such and such go on. If they all are outside of that then, professor, I understand there, you are beginning to listen to a couple of areas where then you would as the whistleblower fail to comply with the provisions and say you fail to be able to be compensated by the SEC. Is that correct?

Mr. RAPP. Both the statute and the proposed rules do provide certain conditions that a whistleblower must meet in order to be eligible for a bounty.

Chairman GARRETT. Is there something in Dodd-Frank that says that is one of the conditions that could put you outside of receiving compensation? Is there something in Dodd-Frank that would say that a whistleblower who has engaged himself in malfeasance would be prohibited from collecting?

Where is that? Is that in Dodd-Frank?

Mr. RAPP. I would have to look back at the statute.

Chairman GARRETT. Okay.

Even better yet, how about within the proposed rule from the SEC?

Mr. DALY. I believe, Mr. Chairman, that there is nothing that would stop that person from being rewarded.

Chairman GARRETT. Yes.

So, if that is the case, there is nothing in Dodd-Frank and there is nothing in the rule, I appreciate the fact that they tried to set some parameters within how many days you have—90 days, 3 months—to comply.

That seems to be a glaring problem, why the sponsor of the underlying legislation and also the SEC did not grab on that to say that if you have someone engaged in illegal activity, they may have been the one who actually started it, but now it is a year down the road and I realized this thing has spun out of control or something like that and now it is the time to rein it in.

But under the way that it is currently written and under the rules, Mr. Daly, that individual is not prohibited by statute or the proposed rule from the receiving end of this—

Mr. DALY. That is correct.

Chairman GARRETT. —Dodd-Frank. Yes.

Professor, is that just a glitch in the legislation that should probably have been addressed in some way, shape or form?

Mr. RAPP. My own view is that it is very unlikely that such a person would be deemed eligible for a bounty because of the other structures that are built into the proposed rules.

Chairman GARRETT. And what would they be based on—what are the other structures in it that would prevent them from getting it?

I am going to say my time is up. So I close on this.

Mr. RAPP. I believe the proposed rules do cover something about individuals who are convicted in connection with a fraud.

Chairman GARRETT. Yes.

Mr. RAPP. In addition to common law obligations that such an employee would have to their employer—

Chairman GARRETT. Right.

Mr. RAPP. —would likely make them liable to the employer for any damages—

Chairman GARRETT. So basically, they have to have a conviction on—in essence, but if the person is not convicted by it then they could still—thank you.

The gentlelady from California.

Ms. WATERS. Thank you very much.

To Professor Rapp, my colleagues on the other side of the aisle seem to think that now that Dodd-Frank is law, employees of financial companies will be racing to the SEC to blow the whistle hoping to win the lottery with a claim.

Based on your research on whistle-blowing programs then, incentives historically, is this an accurate expectation? And can you elaborate on what your research says about the disincentives whistleblowers face when considering whether or not to step forward?

Mr. RAPP. In response to the first question, I think it is unlikely that whistleblowers will race to the SEC in search of a bounty. The way that the bounty provision in Dodd-Frank is structured, a whistleblower is only entitled to a bounty if their information leads to a successful enforcement action producing over $1 million in monetary sanctions.

And the bottom line is that the SEC often pursues enforcement actions that do not produce that minimum threshold as required for the Dodd-Frank bounty provision to be triggered.

Between 1978 and 2002, by one study, the SEC imposed monetary penalties in only 8 percent of the enforcement actions that it pursued. And in those where monetary sanctions were imposed, the median sanction was below $1 million.

What that means is that in less than 10 percent of the SEC enforcement actions, only half of the time would the whistleblower potentially be eligible for a bounty.

So I don't think that it is likely to lead to a rush to the SEC because only in the most serious instances of fraud would a bounty actually be triggered.

As far as the disincentives to whistle-blowing, I think that the fear of retaliation is obviously the foremost one that has been covered in the media.

Various studies have found that between 80 and 90 percent of whistleblowers are either fired, demoted, or forced to quit under duress. In addition, in one study, more than 60 percent reported being blacklisted by their industry. But I think the social costs of whistle-blowing are often the most significant.

A whistleblower will inevitably become distant from friends and colleagues. And these water-cooler effects, the social effects, I think, can provide a strong disincentive, a disincentive which bounty programs are meant to overcome.

Ms. WATERS. Thank you.

To be clear, I would like more clarity on one provision of the Grimm draft discussion that perhaps won't get a lot of attention but could have a chilling effect on the ability of legitimate whistleblowers to step forward.

The Grimm draft legislation will prohibit whistleblowers from paying their counsel via contingency fee arrangement. Can you explain to me the practical impact of this provision? Would an average employee be able to afford counsel if no contingency fees were allowed? What would be the impact of this provision on the SEC's ability to screen and develop potential cases?

Mr. RAPP. I think that aspect of the proposal would virtually guarantee that no whistleblowers were represented by talented counsel in the application for an SEC bounty. And I think that would be particularly problematic in light of two aspects of the Dodd-Frank statute.

First, it authorizes whistleblowers to report anonymously to the SEC and requires that they be represented by counsel if pursuing anonymous submission.

And the alternative to a contingency fee, whistleblowers will be paying attorney's hourly rates. Bearing in mind that many of these people will have been terminated and not have any income, paying hundreds of dollars an hour is simply unrealistic and I can't see that happening.

The Dodd-Frank statute also has an appellate right where a whistleblower who is denied a bounty can appeal to the U.S. Court of Appeals.

I don't think talented lawyers are likely to take on such time-consuming representation without the prospect of a contingency fee. The fact is, contingency fees are regular part of practice in other areas of Federal bounty reward programs and there is no evidence of widespread abuse of contingency fees.

Ms. WATERS. Do you know any place else in the law where contingency fees are absolutely denied to someone seeking legal assistance?

Mr. RAPP. My understanding of the American Bar Association's Model Rules of Professional Responsibility is that they are denied in criminal defense matters but that wouldn't seem to be a very strong parallel.

The ABA model rules on contingency fees require that like all attorney fees, they be reasonable at three points in time: when they are agreed to; when they are charged; and when they are collected. So, if an attorney signs a contingency fee arrangement for a Dodd-Frank whistleblower, but doesn't end up doing any work on the matter and a bounty is paid, that fee would have to be renegotiated.

Ms. WATERS. But, would you conclude that it is a disincentive? For someone that information—important information that would benefit the taxpayers and would like to share that, if they could not get an attorney based on contingency fees, that would be a disincentive that this person probably would not come out of their own pocket to hire an attorney to do this?

Mr. RAPP. The idea of paying an attorney tens of thousands or more in attorney's fees to pursue a bounty would to me be unrealistic for most whistleblowers.

Ms. WATERS. Thank you very much.

I yield back.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

And actually, the ranking member just started a whole line of thoughts in my head.

My understanding is that a—we call it a bounty, is now mandatory within the Dodd-Frank. Am I correct about that?

Ms. NARINE. That is correct.

Mr. SCHWEIKERT. What is the law of unintended consequences here? Are we heading down the path where I have just created the whole new legal industry that I do my best even to collect data or put up things on the boards or e-mail, saying, "Have you been fired, have you been removed from your position, would you like to get back at your former organization? Excuse me, would you like to catch your former organization?"

It is always my concern. Look, I am new here, but I keep looking at pieces of legislation, and people keep saying, "We didn't mean for that to happen." And there seems to be this repeated cascading effect around here of the law of unintended consequences.

And I heard the professor's comments which I appreciate. Is it pronounced "Narine?"

Ms. NARINE. "Narine."

Mr. SCHWEIKERT. Narine.

Ms. NARINE. I can address that. I actually—a few weeks ago I sat on a panel addressing whistleblowers. And so, in the audience, what would be your response? Would you ask a—when they walk in the door if they had used the company's internal reporting requirement? If there was a viable compliance option, would you ask them to use them?

He said, "I might or I might not, but that is really not my problem. My role is to maximize their award because I am going to use my other contingency plan." That was actually his response: "It is not my role to make sure that they use their internal reporting response."

And there is—that is his job and that is how he sees his role.

Mr. SCHWEIKERT. Mr. Chairman, and this is also for anyone who wants to answer, but wouldn't you be now queuing up a scenario where I am dismantled or I see something that I don't understand, whatever the reason be.

And that the threat is, we are going to go on to the step of filing at the SEC unless we receive certain compensation? Or is it, you hire a legal counsel and immediately go?

I am thinking through the number of steps here. This has almost become a new legal paper practice.

Ms. NARINE. The follow-up question I have, I posted a series of questions. I said, what if your whistleblower is wrong? Because, in many instances, companies rely on people to come forward internally. Sometimes your whistleblower in good faith believes he or she has information.

They may not have the complete story. They could be wrong. And once the company says, "Here is the actual situation," they realize, "You know, something, I was wrong. I am sorry. I am glad you cleared that up." And then they are wrong and they go away.

But sometimes they are right and you say, "I am glad you brought that information. We have now remedied the issue." You won't know that if they don't come internally.

I raised that issue with the—and, again, he said, "That is not my issue. I go to the SEC and I take care of my client."

And I said, "Would there be a situation where you come to the company first and say, 'I am coming to you first, how about a settlement before I go to the SEC'?"

He said, "I could see that happening."

Mr. SCHWEIKERT. Okay. So we are—

Ms. NARINE. So could there be—is that an extortion issue if I wouldn't call it that? I am coming in to settle with the—of the company before going to the SEC.

So these are the kinds of things that companies would have to deal with which again is that the best interest of a shareholder? I am not sure.

Mr. SCHWEIKERT. Okay. Ms. Narine, we try not to use the extortion word but functionally—so it is not only just at the company level or at the bureaucracy level. There may be that midpoint.

I need to also get myself educated a little bit. This is for all publicly held companies? Any types? So not just financial companies. It is all publicly held companies?

Is it also for other types of organizations out there that have to share a relationships and up and down the chain?

No?

Ms. NARINE. We are not trading on the exchange.

Mr. SCHWEIKERT. They would know. I do not believe it.

Would it be for pension plans?

Mr. DALY. Probably not, but there is one side of this that I think you should not miss. You don't have to be an employee in this particular company to file a claim against some other company.

Mr. SCHWEIKERT. But—okay. I want to close on that. And I have like 26 seconds.

And it wouldn't be for a very large charity. This is only for a publicly held company?

Mr. DALY. Correct.

Mr. SCHWEIKERT. Not just financial companies, all publicly held companies?

Mr. DALY. All publicly held companies.

Mr. SCHWEIKERT. And from—my other thing—and you have just heard a touch on it. And it didn't have to be an employee in that organization or—I could be the filer of any publicly, filing the complaint on any publicly held—

Mr. SCHWEIKERT. —company?

Ms. NARINE. You could be a filer. A client officer at Ryder—I learned that we had an agent in Bangladesh who was bringing people unauthorized which could expose Ryder to—practice at that liability.

I terminated that agent. That agent could call the Department of Justice and the SEC and say, "For 10 years I have been bribing people—and that person conceivably under the law—

Mr. SCHWEIKERT. —and thank you for being so gracious. I know we are going over time, but the other side, towards Mr. Daly. Does it have to be—it was part of that organization? Could it be, for instance, the housekeeper who overheard something?

Mr. DALY. It could be literally anyone.

Mr. SCHWEIKERT. So, back to my scenario again. If you had a new legal profession, you could just shop for professional—

Mr. DALY. Possibly.

Mr. SCHWEIKERT. All right.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman's time has expired.

The gentleman from New York.

Mr. ACKERMAN. Thank you very much, Mr. Chairman.

It seems to me we have a tremendous difference in point of view based on philosophy and based on whose interest we are interested in protecting. It is not surprising to me that all three expert witnesses who agree with each other represent corporate interests who have a need to be protected against people who might want to expose them to things that they are doing wrong.

We have one witness who doesn't necessarily have a vested interest and I appreciate his point of view because—not just because I agree with it, but I think it makes more sense.

Whose interest do we represent? Who are we trying to protect? Are we trying to protect corporate interest because on investors, because of people who are putting up their money or are we trying to protect the system and innocent people?

If there is one thing that—if not worse than, but it is bad as blaming the victim, it is blaming the witness and trying to discourage people who are witnesses from coming forward.

Nobody is saying that everybody in the corporate world is part of the mob, but there are people in the corporate world as there are else who do things that are wrong. And there is nothing wrong with having encouragement and disincentive from people who call them on that in every walk of life.

And if you are interested in protecting the public, you call them whistleblowers. If you are part of the system that needs protection against being exposed, you call them snitches, whether it is a corporation that is doing something wrong or a criminal venture that is doing something wrong.

The point I was trying to make before is that you really don't go to the bad guys to report the bad guys hoping that they are going to change their ways because there is a price to be paid for that.

The incentives and disincentives seem to work. It works for the FBI. They were offered a $27 million reward for legitimate evidence to find Bin Laden. Now, there were a lot of people who knew who Bin Laden was and where he was and they didn't get the reward.

I know probably a lot of innocent people who retired six-foot, seven footer to some basketball team who looked like Bin Laden who were looked at but nothing ever happened, but they still have to reward Mr. Moore.

In major cities, mine included, they have a cops program. If you report that you are a witness and saw somebody killing a cop, you would go and report it to the police and there is a minimum $10,000 reward if you are right. If you are wrong, nothing happens.

Decision as far as invention of incentives and disincentives and rewards goes all the way back to when religion was invented or God created heaven and hell. It doesn't mean everybody is evil but the FBI said that the IRS has a system where you turn someone in for income tax fraud whether it is the individual or corporate, you get 10 percent of what they can recoup. It doesn't mean every taxpayer is a cheat. We have a program where if you see something, say something. We want people to participate and to report.

I don't think we should reduce whistleblowers to the status of bounty hunters and I would be shocked if there weren't a large number, if not a majority of people who work for corporations who think the corporation is violating their own rules or some standards who doesn't report it to somebody within the corporation seeking no reward.

And maybe like the essence that Mr. Kueppers, in Deloitte where you have considerable experience, other people who come and say, "Hey, I think we are doing this wrong. We shouldn't be doing this. This is wrong to violate the company rules."

Mr. KUEPPERS. Yes, indeed. In fact, in my experience with clients, this is not an everyday occurrence. But I have experienced several pretty serious situations where somebody in the organization called the financial management of the company and comes forward. They are uncomfortable and it goes up the chain and—

Mr. ACKERMAN. I would suspect that.

Mr. KUEPPERS. Yes.

Mr. ACKERMAN. And I think that is a good thing, but there are people who legitimately say—I am not pointing the finger at your company—but I am sure that there are people in other companies who think that people are deliberately doing things wrong.

I am not as worried about the lure of unintended consequences as I am about the deliberate intended consequences of actions that some people do, that people know if they blow the whistle will turn them in, that they are going to—and I would think that is a legitimate concern, and to try to penalize those people, to try to discourage them, to try to cause not to report to a legitimate authority, it is something that we really have to view through dispassionate eye.

And as policymakers, those of us on this side of the table should be looking at this as to how to protect not just our company and investors, not just one guy or gal who may be a shakedown artist within a company, I am sure we can find one or two of those as well, but we have to be seriously talking about protecting the public, Mr. Chairman. I know I have not—but I wanted to make that statement.

Chairman GARRETT. I appreciate that. And the gentleman yields back.

Mr. Hurt, you are recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I thank you all for appearing this afternoon on this important subject.

And yes, my comments would begin with saying, I think that one of the important hallmarks of our civil justice system is ensuring fairness and ensuring accountability and offering a way in which the government allows for the enforcement of contracts and making sure that the people in the marketplace act honestly.

It is my view that most do, and that those who represent shareholders, those are the corporate—the people who are elected to be the corporate structure certainly have a purer interest in seeing and taking care of shareholders, certainly a greater interest than even the SEC or any government entity.

And I guess it strikes me that coming to Washington, you find again and again examples where the Federal Government seems to believe that it knows better how to take care of its customers or its employees than those who have the greatest interest and that is in running a successful business for the shareholders, and I can't help but be struck by that as we have listened to this testimony and consider what I think is a good bill.

But my question—my first question—and I would ask that all of the witnesses maybe address this, but my question is with respect to uncovering illegal activity within the corporate structure, I would think there is a big difference between having an organization that is corrupt throughout or in a significant way at the higher end of the management versus having one rogue employee.

It seems to me as a pretty big difference in terms—and it has some implications here, and I was wondering if not having that much of a background in this area, if each of you could maybe just address that issue, how are you able to quantify or qualify the number of times that you have just a rogue employee who needs to be stopped immediately? And when you stop them early, it saves shareholders' money, saves the company money as opposed to these larger conspiracies that may require a longer time of investigation. Perhaps you can just speak to that.

Mr. KUEPPERS. Sure, let me start, Congressman.

I have on several occasions witnessed client situations where one or two handfuls of people were engaged in improper behavior. Uncovering that, you would hope there is a function of the regular sort of management processes but there is not.

For example, as outside auditors, if we uncover it, it is our duty to take that to management and to insist that they investigate and take action. If they don't, we go to the audit committee. If they don't act, we go to the board. If they don't act, we go to the SEC under Section 10A of the Exchange Act.

I take those responsibilities very seriously because I have never—the reason I have so many of these 10A reports must not be working, we don't get these reports.

The threat of going to the SEC, and I have done it twice, is pretty much all it takes for people to get serious about solving the problem and doing it quickly.

Mr. HURT. Thank you.

Ms. NARINE. I think—and just to be very clear about some things there, from a corporate perspective, if the management team is corrupt, no one would expect the employee to use anything within the corporation. That doesn't make sense.

The fear of reporting anything, whether it is, "My manager is mean to me, please investigate," or "The CEO is stealing the pension funds," it is very real. There is a rational normal fear of reporting anything and the compliance officers are sensitive to that. So it is not an insensitivity to that issue. But every company whether you have 100 employees or 28,000 employees, you are going to have some rogue employees somewhere.

So for those kinds of things, you would hope that if there is a viable functioning compliance program, you use that. If you believe that there is a corruption that is coming from the top or that the independent auditor is really not independent or the board member is in bed with a CEO and you really can't trust them, there is no way and no reason that anybody would expect you because that is not legitimate, that is not a legitimate function and compliance program.

In the seven steps, the sentencing guidelines set out are very clear as to what it is. And the revised guidelines in 2010, the first thing that they recommend is that the compliance officer report to the board, and if not reporting directly to the board, have access to the board of directors, but there is a level of independence because they recognize that those kinds of issues can come up.

So again, if there is no way, if the person legitimately believed, it will have to be right, that they legitimately believe that there is no way, not just rumor, speculation, "I think if I go, I am going to be retaliated against."

If they have a legitimate reason to believe no one is going to reasonably believe that they shouldn't go directly to the SEC and collect their bounty of that is due to them.

So there is a difference between, "I think I am going to be retaliated against," and I am dealing with one rogue employee versus, "It is dirty at the top and I shouldn't have to go."

Mr. HURT. All right. Thank you.

Mr. DALY. I can report that in a prior life before I arrived at the NACD, I audited dozens and dozens of companies. And I cannot re-member one instance where I would report that the entire company, to your point, was corrupt from the top down.

Essentially, what happens is you have rogue employees. You have someone who does something nefarious for an evaluation or for a bonus or for something of that nature.

I think to the chairman's point at the beginning, at the top of this discussion today, I think we are wrestling with the issue of whether additional assistance is required and whether to have Sarbanes Oxley as originally envisioned work.

Unfortunately, I don't think that there has been sufficient work to make the decision with that. That is to my point that I think we want to delay this for a while until we have an opportunity to determine whether or not the systems are working. If in fact the systems are not working, then they should be corrected. If in fact the systems are working, then I suspect we should allow them to continue.

And I can tell you from spending lots of times with lots of audit committees and my current role with the NACD, there is consistent talk, robust discussion about how the systems work, what kind of issues are being found and what the companies are doing about it. So this is very much on the minds of corporate America.

Chairman GARRETT. Thank you.

The gentleman from California.

Mr. SHERMAN. I see that there are two controversies here. One is whether the whistleblower gets a bonus, the other one is would the SEC keep the investigation confidential at certain stages.

Ms. Narine, do you have any objection to a whistleblower who helps society and comes forward and blows the whistle and takes those risks, getting a bonus or payment? Is there something the matter with that?

Ms. NARINE. No.

Mr. SHERMAN. Now, the next issue is how confidential the whole investigation is. Mr. Kueppers, what would be the advantage if when the SEC opens a file, they also notify the auditor of the company under question?

Mr. KUEPPERS. I think there would be an advantage to notifying the auditor and we would obviously put that information directly to the board or the audit committee of the company plus the resources to perform their own investigation.

Today, most problems with financial reporting, indeed with the SEC, violations of SEC law investigated by the companies who spent the money, the resources, do whatever needs to be done and they report immediately back to the SEC.

Mr. SHERMAN. So there is really no way to notify the auditor without notifying the company as well?

Mr. KUEPPERS. That is the optimal—

Mr. SHERMAN. In other words, if the auditor—if there was a situation in which it was not best to notify the company, then it is probably not best to notify the auditors as well?

Mr. KUEPPERS. It would—out of necessity because we couldn't investigate without the cooperation of the company—

Mr. SHERMAN. Okay.

Mr. KUEPPERS. —it probably wouldn't achieve much.

Mr. SHERMAN. Section 301 of Sarbanes Oxley requires the independent audit committee at every public company to establish a system for managing whistleblower concerns related to accounting and auditing. Section 806 of Sarbanes Oxley provides protections for the whistleblowers. Does any provision of Dodd-Frank undermine those two provisions of Sarbanes Oxley?

Mr. KUEPPERS. I think the tension here comes when—in applying or operationalizing the Dodd-Frank elements which is what the SEC is in the process of doing, the worry is that it would render the company systems under 301 of SOX in effect because people would bypass those systems and go to the SEC. So it is more in the—and sort of how it would work where the issue arise.

Mr. SHERMAN. So SOX envisions a company investigation, Dodd-Frank envisions a company not notified, SEC investigation, and those are two rival as anything that matter with having those two items be separate and both available or—

Mr. KUEPPERS. I am not sure what the intent of the statute was, but if the SEC is investigating itself through its enforcement division—

Mr. SHERMAN. Yes, the company is going to get notified there too.

Mr. KUEPPERS. Absolutely, because of the need to produce documents, witnesses, and so forth.

Mr. SHERMAN. Professor Rapp, is there any reason for the SEC to not share with the company the fact that there has been a complaint filed, perhaps not identifying who filed it and if they are investigating a particular matter? And how would they possibly investigate without the company knowing?

Mr. RAPP. Their usual practice of reporting to the SEC, and I don't speak for the Commission, but I see what they have announced publicly, their usual practice would be to contact the corporation.

It might not make sense to do that in the early stages of investigation insider trading, for example. And the Dodd-Frank bounty scheme subsumes the insider trading bounties that were formerly part of the law if we were concerned that a wrongdoer facing significant criminal sanction might destroy a document, you might try to get preliminary safety case together before you reach out in that way.

Mr. SHERMAN. I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from New York.

Mr. GRIMM. Thank you, Mr. Chairman.

I want to take a step back because you just mentioned the destroying documents. Here is the reality. Sometimes it is just so frustrating because what sounds great and looks good and it is an honest, fair theory to have, doesn't marry up with reality.

When the SEC does these investigations, who do you think they contact? They contact the company because that is how they get all their information, and it may not be that day but it is very, very soon thereafter, so does the FBI. That is how it works. That is how it has always worked. That is how it is always going to work.

So this idea that you just go to the SEC and the company is not going to find out, it is simply not based in the way things are done and there is the distortion of what really happened.

The idea that someone is going to destroy documents, that is why since 2004, the penalty for doing such a thing is up to 20 years in prison, and that is a big hammer and that is why the vast majority of players out there are not going to destroy documents, and that is better than anything we could be talking about today, is that 20 years of imprisonment is a lot more of disincentive than Dodd-Frank is going to address. So I think that is already handled.

But I wanted to just strongly disagree with my colleague from New York that it has left in—this idea that the whistleblower that we are protecting is the public and that corporate America is not.

That is a fundamental problem that we have of ideology. These corporations, a lot of the plumbers and all the different unions and teachers and every other person in America, they are invested in these companies. Their pensions are invested in these companies.

Corporate America is providing all the jobs that we all talked about creating. Who do you think is creating these jobs? This is where America works. This is where America invests. These corporations are the heart and soul of our public.

So to think that pitting corporations against the public is just—is this demonization that has to stop. The idea that we want these companies to succeed not at the expense of a whistleblower, that is just drawing the divide that is not there.

The reality is that Congress created Sarbanes Oxley, and asked all of these corporations to spend a lot of time and effort to get it right, and they are right in doing so and corporate America did that.

And now, a few years later, we want to come back when they are just about finished and say, “Oops, it is not necessary.” Because the idea that you can go straight to the SEC and not have to go to any internal controls really does obviate the need for those internal controls.

If I owned a big corporation, I would no longer spend hundreds of thousands and millions of dollars on my internal controls knowing that you can just go to the SEC anyway. And I think that is very, very important.

My colleague from New York also mentioned the way FBI awards work. Let me tell you, I can tell you for a fact people came in all day with bogus information seeking a reward, and what did it do, it tied up agents on wild goose chases for days, for weeks, for months.

Our SEC is already overburdened. They cannot afford to have people coming in, in the hope that they are going to get an award because they have an attorney out there who just went for the CLE class. The new CLE class has been telling everyone, “Hey, this new rule is coming out. We can help you build your legal business.”

So it is going to be another legal frenzy and yes, it can lead to frivolous lawsuits, but more importantly, it is not just the frivolous lawsuits. It is the SEC being bogged down with all these claims while the burning—is not being worked at.

And lastly, again, it is just a dose of reality. Think about this. I discover a Ponzi scheme and I am an employee and I go to the

SEC. Guess what? The SEC, they have 200 allegations of Ponzi schemes, 300 allegations of illegal insider trading, 400 pump and dump schemes, and so on and so forth.

Do you really think the SEC is going to look at my Ponzi scheme allegation today or tomorrow? Maybe not for 8 months. So what do we tell the public who is being scammed for 8 months until the SEC gets to it?

When, if we went through the internal controls and compliance of the company, they would stop that then and there that day. That employee who was doing all these schemes would have been looked at and cut off from trading right there.

So the SEC cannot handle everything. They certainly can't handle it as efficiently as the company there. I do believe that we should not penalize in any way the whistleblower and they should be protected if they blow the whistle but not at the cost of obviating what Sarbanes Oxley did, all the controls we have in place now and the unrealistic expectation that is not based in reality that the company is not going to find out about the investigation anyway. That is just a—sorry, I didn't get to ask you a question. I had to address all the misinformation out there.

I yield back with time that I don't have left.

Chairman GARRETT. Thank you very much.

Mr. Green?

Mr. GREEN. Thank you. I may not need all of my time and I will be honored to yield, so you may ask a question. I thank the witnesses for appearing. And I would like to move quickly to the area of legal fees—contingency fees for legal representation.

There was something known as "voir dire" or "voir dire" depending on where you are from. It is a French term and it means to speak the truth. For our purposes, this will become the truth telling portion. It always has been but for us moving forward.

And in "voir dire" or "voir dire," we tend to have people who are responding raise their hands so please don't be offended by my asking that you raise your hand.

Do you believe that a person who is a millionaire who desires to report as a whistleblower should be allowed to hire a lawyer to represent himself or herself? If you do believe that this is appropriate, kindly raise your hand.

Thank you. Let the record reflect that all of the witnesses have raised their hands.

For my edification, should a person who is poor, who cannot afford a lawyer, not be permitted to have a similar opportunity? That would lead in a contingency fee such that a poor person, not an indigent but a person who is not of need, why would this person not have the same opportunity to have legal counsel that the millionaire had?

What is wrong with a contingency fee for people who cannot afford legal counsel? That is a rhetorical question. My suspicion is that most of you would think that it would be fair to allow this, but my suspicions are not always correct, so let me just ask.

Is it fair for a poor person to have legal counsel just as a millionaire will have legal counsel? If you think it is fair for the poor person to have legal counsel, would you kindly extend a hand into the air?

Thank you. Let the record reflect that all persons believed that poor people are entitled to legal counsel.

Now, contingency contracts allow poor people to acquire that which they cannot afford contingent upon a lawyer taking a certain amount of risk and moving forward to aid and assist a person who has an agreement. Anybody kindly raise your hand because that is a basic premise that I think we have to build upon.

If this is the case, why would we not allow a contingency fee for people who cannot afford a lawyer who have a legitimate complaint? Before you respond, I need to say this. No one assumes corporate executives are dishonest. As a matter of fact, they are honest, honorable people. Shareholders are honest, honorable people. People who blow whistles are honest, honorable people—some make mistakes, some do not.

Some corporate executives are able to do some things that are inappropriate and unlawful, and they are the person that we are talking about.

So the question of these jobs and who creates the jobs, I am coming back to my point, but to the questions of jobs, your friend, yes, corporations may be the vehicle. But if the consumer—if the consumer spending that calls as a job to be there. So while we want to thank the corporations for what they do and the businesses, let's not forget that the consumers play a vital role in this process.

Now, back to where I was. I have to get back commercially. Who among you believe that a person who cannot afford counsel should not have the opportunity to have counsel by way of a contingency fee? If so, raise your hand please.

Let the record reflect that no hands were raised and that this panel believes that a contingency fee arrangement appears to be appropriate.

And to my friend, I have some time left. I would allow you to ask a question if you so choose.

Nothing left?

Chairman GARRETT. Nothing left.

Mr. GREEN. I owe you one.

Chairman GARRETT. There you go.

Mr. GREEN. Thank you. Thank you very much. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

Yes, I know a lot of folks have talked about the contingency fee arrangements and there have been a lot of discussions. Do any of the panelists have any concern about where our contingency fee might encourage the wrong behavior?

I know that at least one of the panelists talked about it earlier, but again, just to follow up on my colleague's question, is there any one on the panel who would have some concern about the behavior of—that an attorney would give their client or tell their client to do because of a contingency fee as opposed to just a discretionary award without a contingency fee?

Ms. NARINE. I am happy to address that. In my prepared remarks, I did not address the contingency issue directly because it is not a focus of my main area of concern.

Where I would have a concern, however, so for the record, I do believe that people should have the right and the ability to get counsel. My concern would be, again, protecting the interests of the shareholders, many of whom are company employees, from secretaries all the way up to the CEO. So those people have a vested interest in the company succeeding.

My concern would be whether the incentive of the larger contingency fee could cause the attorney consciously or subconsciously to want the award to be larger, which could thereby allow the alleged fraud to perpetuate longer so—

Mr. STIVERS. I would like to follow up on that with the couple other members of the panel.

Ms. NARINE. And so that would be the concern that—

Mr. STIVERS. Because that was what I assumed, that if I had a concern, it would be if there is a financial incentive based on the award as a contingency, how much the attorney is going to get.

The attorney is going to have every incentive to make the award as large as possible, therefore telling their client if they know something, "Well, let's wait a little bit because it is not quite big enough yet and we might not—you might now profit enough from it and we might not profit enough from it. Let's just give it a little while and see what happens."

Ms. NARINE. Exactly.

Mr. STIVERS. Yes, go ahead—

Mr. KUEPPERS. Congressman—

Mr. STIVERS. Yes.

Mr. KUEPPERS. —I, too, believe that a contingency arrangement per se is no problem particularly if the individual who needs counsel on the SEC rule cannot otherwise afford counsel of contingency from misrepresentation.

Here is my worry. If—just a word to work in a way that what actually create more claims as opposed to giving good counsel to those who already had legitimate claims, solicitation of large numbers of clients, I worry about the system getting clogged to the point where the real whistleblower, I will call it, is not heard because of the volume issue.

So soliciting large groups of people who have just been recently laid off and so forth. By outside counsel, I would worry about that because it is going to create a problem with getting the legitimate whistleblowers heard as they should be.

Mr. STIVERS. All right. And I guess my follow up to Professor Rapp—by the way, it is great to see you here from Ohio; I am from Columbus—is, how do we do exactly what Mr. Kueppers just talked about, encourage focus on the legitimate claims as opposed to just creating incentive for more volume which may or may not be legitimate and does a contingency fee really help us in that vein?

Mr. RAPP. The theory behind a contingency fee is that the lawyer takes some of the risks and should therefore get some of the reward. I don't see there being a major likelihood that attorneys will encourage clients to save up fraud. That same argument has been made about the Civil False Claims Act and there is no evidence that occurs in False Claims Act practice.

And the reason why I don't think it occurs there and why I don't think there will be a problem with Dodd-Frank is because bounties are only permitted to the original source in False Claims Act practice or whistleblower here to provide original information.

If you try to save up fraud hoping it will get bigger, there is a very good chance that some other individual who knows about the fraud will be the first to report it to the SEC and you will no longer be the original source or the person with the original information eligible for a bounty.

Mr. STIVERS. Okay. And I do want to follow up on Mr. Rapp's—I think it was third concern about—maybe it was your first concern about the percent of the—the difference in the mandatory award, I believe is 10 percent or a completely discretionary award.

It seems to me that a discretionary award would certainly would empower some folks but I guess my concern on the mandatory award is that it really doesn't seem to be appropriate based on—it should matter what the information is and how important it is, shouldn't it, as opposed to, you gave us information therefore you are entitled to 10 percent of the award regardless?

Mr. RAPP. I think that is absolutely right, and that is why the SEC rules only make the awards mandatory where the information provided by a whistleblower leads to a successful enforcement action.

So if someone calls the SEC and gives them information and the SEC starts digging and finds a legitimate instance of fraud that is separate from what the whistleblower brought to their attention, that whistleblower gets nothing because the information they have provided didn't directly lead to a successful enforcement action.

Mr. STIVERS. But you believe that a mandatory award as opposed to a discretionary award, I saw you talked about the IRS. It sounds like—it works better when people—and can you help me understand either psychology or profit motive behind that? Do you think people needs certainty on what the award is or—I just don't follow if there is a possibility of an award and it is 0 to 30 percent as opposed to between 10 and 30 percent. Why are they guaranteed 10 percent, that big of a deal?

Mr. RAPP. I think it just makes the cost benefit analysis for a potential whistleblower easier to run, so to speak.

Mr. STIVERS. Thank you, Mr. Chairman. I yield back my time.

Chairman GARRETT. The gentleman yields back.

The gentlelady looks like she—

Ms. WATERS. If you would grant me a minute to raise a question before you close the committee?

Chairman GARRETT. For a witness?

Ms. WATERS. No, to you.

Chairman GARRETT. Sure.

Ms. WATERS. It is not parliamentary.

Chairman GARRETT. Yes, okay.

Ms. WATERS. On the whistleblower question, I am trying to find out what the Financial Services Committee intended placing a request for whistleblowers to report to members of the financial services committee. Are you aware of that on your work site? What are you trying to do with this—

Chairman GARRETT. I am informed that is on the committee's Web site. There is a provision not with regard to what we are talking about here per se which is whistleblowers, but it is just a more general idea of waste, fraud and abuse and wasteful programs and for the public to come forward with those.

Ms. WATERS. So that means you do believe in whistleblowers?

Chairman GARRETT. Exactly. We do believe that there is a need for whistleblowers both in the corporate world, as we heard from this panel—I think all four of them would agree that there is a need for whistleblowers in the corporate world because there are bad actors, sometimes individual actors and sometimes more than one actor.

And we certainly know that there is a need for whistleblowers when it comes to government programs because there is certainly a need to point out waste, fraud and abuse in the Federal Government. So absolutely, we need to do so.

But on our Web site, we are not saying that there will be a payback to them specifically as far as the contingency fee and otherwise where they are saying as the American citizens to come forward that information and let us know, and I am sure you will join with us when those come forward to try to root out that waste, fraud, and abuse on the Federal level.

And with that—

Ms. WATERS. As you asked me to join with you, allow me to indicate that yes, I do absolutely support the whistleblowers. I am more concerned with the testimony from Mr. Rapp that talks about a lot of whistleblowers coming forward.

And as we have discussed Mr. Grimm's legislation here, we can see where there are disincentives to whistleblowers coming forward. So I would like to join with you to see what we can do to encourage whistleblowers, to compensate whistleblowers with fair compensation, and to make sure that as he has indicated, they have representation even if they don't have the money to have legal counsel or a counsel rather.

Chairman GARRETT. The gentlelady yields back. And I am glad that the lady agreed that there is a need to do what we are doing here today and that is to examine Dodd-Frank, to realize that there is a possibility for re-examining it to see how it could be made to work better.

The gentleman from New York has a draft—I don't think it is in final form yet. This is for draft discussion to try to address some of the concerns that the gentlelady from California has, how we can work to make sure that it does exactly what I think everyone in the room wants it to do—identify who the whistleblowers are, have an incentive for those cases that are appropriate cases to come forth. Not overwhelm the situation with fraudulent cases or cases without any merit, if you will, but for the rightful cases to come to the top of the list and make sure that the SEC can investigate those and also to do something else. He is no longer sitting in this chair, but the former chairman, Mr. Oxley, who was instrumental in passing the bill by his name, Sarbanes Oxley, to make sure that law also can be seen to provision as well to make sure that the internal controls and the corporations can be properly implemented, administered, and used as SOX—Sarbanes Oxley—was intended.

Some of which—for some of us who thought that it might have been unnecessary in other areas, but this is one area that I think we have an agreement on and that was right for addressing in SOX, and also in Dodd-Frank as far as to the extent of this.

I am looking forward to—

Ms. WATERS. Mr. Chairman, I have a unanimous consent request to insert into the record the project on government oversight on the Grimm discussion..

Chairman GARRETT. It is all yours—

Ms. WATERS. And—

Chairman GARRETT. —without objection.

Ms. WATERS. —we would like to—without objection, you are saying? Yes, I would like to enter the project on government oversight document into the record.

Chairman GARRETT. Okay.

And does Mr. Grimm have the copy? It might be something you want to just take a look at as well?

Okay, great.

And also, without objection, we will be entering into the record: a May 11th letter of the Association of Corporate Counsels; testimony of David Baris, executive director of the American Association of Bank Directors; the statement of the Investment Company Institute with regard to the hearing today; and written testimony of Darla C. Stuckey, senior vice president, policy & advocacy, for the Society of Corporate Secretaries and Governance Professionals.

And with that, again, as I did at the very beginning of the hearing, I thank this panel very much for their testimony, for their insights and their study on these issues as well and with that, your full testimony as indicated earlier will be made a part of the record.

The Chair notes that some members may have additional questions for these witnesse that they wish to submit in writing. The record will remain open for 30 days so members can submit written questions to these witnesses and place their responses in the record.

[Whereupon, at 4:55 p.m., the hearing was adjourned.]

A P P E N D I X

May 11, 2011

May 11, 2011

Testimony of
Ken Daly, President and CEO of NACD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Chairman Scott Garrett

Hearing on:
Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions

Chairman Garrett, Members of the Subcommittee, and fellow guests, thank you for the opportunity to speak with you this afternoon about whistleblowing—a critical issue for Corporate America.

I'm Ken Daly, president and CEO of the National Association of Corporate Directors, the membership organization for America's boards of directors. Our 11,000 members represent men and women who oversee millions of American jobs.

We applaud you for holding these hearings to discuss the **whistleblower bounty and protection provisions** of the Dodd-Frank Act. NACD has significant concerns about these provisions—and about the proposed implementing rule from the Securities and Exchange Commission (SEC). To help solve some of these issues, Rep. Michael Grimm (R-NY) has drafted a bill to amend Dodd-Frank (or more precisely the law that Dodd-Frank amended). We support the Grimm bill, which is consistent with our views.

The NACD Comment Letter Parallels the New Grimm Bill

We have submitted a comment letter (attached herewith) to the SEC with our concerns, as follows:

- Under the proposed SEC rule, a person possessing "independent knowledge" can report it directly to the SEC and collect a large bounty—in some cases worth many times the person's typical annual salary. This program could actually create a perverse incentive to let a problem grow and then report it, rather than to solve the problem in its earliest stages.

  NACD believes that such individuals should be required to report allegations or violations to the internal compliance system prior to submitting them to the SEC. We would therefore agree with the Grimm bill, which states "In order to be eligible for an award, a whistleblower shall "first report the information…to his or her employer before reporting such information to the Commission." (The Grimm bill does state that an employee may still report to the SEC prior to his employer if the company's whistleblowing system is deficient in some way, but this would be an exception in Corporate America today.)

- Furthermore, the rule does not clearly exclude all internal and external compliance personnel from being able to claim "independent knowledge."

  NACD believes that to avoid any dilution of professional integrity and effectiveness, the definition of "independent knowledge" should exclude anyone involved in compliance work—including but not limited to external auditors but also government employees, attorneys, other professionals, and internal auditors.

- *NACD believes the proposed rule should exclude from the definition of "independent knowledge" all communications with attorneys, even in cases where the privilege has been waived for any reason.* The concept of "privilege" has never been well defined. The rule should define some types of communication that under all circumstances and without exception should be included in the definition of privilege.

- *It must be made clear that individuals in an internal audit function, or those individuals working in the capacity of internal audit, are not deemed to have "independent knowledge."* Oftentimes, an employee in a different department or an organization may have temporary duties that aid the internal or external auditors. Such individuals should also be excluded from the bounty system.

- Also, under the proposed rule, the time frame for corporate cure prior to government action would be 90 days. *NACD believes that this grace period for corporate reporting should be three to six months.*

- *Finally, the proposed rule leaves no recourse to a company if an employee circumvents the compliance system or makes false allegations against a company. Employers should have the ability to use existing disciplinary measures to respond to employees who make false claims.* We would also support the added clarifications of the Grimm bill, which provides employers with an ability to remove employees who violate established employment agreements, workplace policies, or codes of conduct.

Additional Observations Concerning "Independent Knowledge"

Corporations and their directors today operate in a complex global economy, with risks of greater magnitude and unpredictability than ever before. At the same time, directors face heightened expectations from shareholders, regulators, and the general public. Consequently, directors need and are seeking more advice from outside advisors, including advice on compliance matters.

By creating a perverse incentive for reporting allegations directly to the government rather than to the company, the Dodd-Frank legislation makes directors less inclined to ask for outside perspectives. This reduces the information flow to the board at precisely a time when the board needs it most.

Legislative Proposal from NACD

As mentioned earlier, NACD believes that the proposed Grimm bill has merit. We acknowledge that Grimm's bill requires a study conducted by the U.S. Comptroller General to determine whether the whistleblower incentive program has had an impact on shareholder value. We agree that this study should move forward if Grimm's bill is passed. However, we believe a study should also be conducted to ascertain the effectiveness of the whistleblower systems put in place at substantial costs pursuant to Sarbanes-Oxley.

Congress should consider asking the SEC to delay taking any action on the Dodd-Frank whistleblowing bounty and protection program until there is a thorough study of current whistleblowing programs. It is worth emphasizing that the Sarbanes-Oxley Act, passed in 2002, ***already mandates a whistleblowing system*** (Section 301) with up-the-ladder reporting for attorneys (Section 307). Sarbanes-Oxley says companies may not retaliate against whisteblowers (Section 806). These provisions, after a decade, have taken hold in Corporate America. Let us see if they are working as intended. I believe they are.

Thank you for your attention.

Submitted by Ken Daly on behalf of the National Association of Corporate Directors.

NACD
NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

December 17, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-33-10, Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

Dear Ms. Murphy:

Ethics and compliance rank highly among the characteristics needed in today's corporations, and a proper system for internal whistleblowing is vital to those causes. Since 1977, the National Association of Corporate Directors (NACD), a nonprofit educational organization, has provided corporate directors with resources to help them maintain the most ethical tone at the top, as well as effective compliance systems. We convene, educate, and inform 10,000+ members on many issues, including ethics and compliance.

NACD is grateful for this opportunity to comment on the SEC's Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934. These whistleblower provisions provide an incentive for persons having "independent knowledge" of possible corporate wrongdoing to report directly to the SEC. In NACD's opinion, the legislators who enacted the original provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) did not weigh the consequences the provisions could have on the ethical and compliance-based cultures of corporations. A strong corporate culture is one of the best tools a company has for combating fraud. We are writing this letter in order to bring about a more workable regulatory solution.

NACD is primarily concerned with the chilling effect that these proposed rules may have on current internal compliance systems already in place, thanks in part to existing regulatory and professional requirements. Attorney conduct rules in Section 307 of the Sarbanes-Oxley Act (Sarbanes-Oxley), as well as current ethics rules of the American Bar Association (Model Rule 1.13(b)), require attorneys to report suspected legal violations "up the ladder." Furthermore, additional rules under Sarbanes-Oxley (Sections 301 and 406) require that public companies have hotlines for reporting accounting concerns as well as codes of ethics supported by "prompt internal reporting to an appropriate person or persons identified in the code of violations of the code." The new whistleblowing rules should build on these requirements for internal reporting. The rules should include a requirement for all employees to report to immediate supervisors prior to submitting complaints to the SEC. At a minimum, a requirement for reporting up the ladder would ensure that attorneys adhere to their Section 307 rules and professional ethics by informing corporate supervisors. More broadly, early reporting up the ladder will have the effect of useful pre-screening of complaints. Whistleblowing systems often elicit complaints about management matters best addressed by internal human resources professionals. Such matters are not appropriate for SEC investigations conducted at taxpayer expense.

We recognize that the SEC's proposed rules attempt to promote the use of internal systems by granting higher monetary rewards to whistleblowers who first report their complaints to the company, and by giving companies some time to address problems internally, before the SEC investigation begins. We also acknowledge that the rules set forth seven exceptions to the "independent knowledge" definition intended to promote the use of internal systems. These exceptions, however, do not go far enough to ensure the full use of internal systems. With certain restrictions, any individual should be able to report suspected legal violations through an internal whistleblower system that includes the ability to report to the SEC. Therefore, the rules should require individuals to make use of corporate compliance systems prior to submitting any allegations to the SEC.

We also have strong reservations about the incentive system for whistleblowers. The proposed rule establishes a large "bounty" for information that leads to enforcement actions by the SEC. This bounty may incentivize individuals to avoid internal compliance systems and deal directly with the SEC. We understand the SEC's need to learn of violations that are not being detected and addressed within the company; however, the rules as currently proposed may bypass the company's ability to address these internally as they arise. In this letter, we hope to help the SEC reshape the rule to maintain robust compliance systems while still pursuing the intent of the Dodd-Frank mandate. We ask the SEC to consider the following commentary responding to specific questions asked in the proposal.

NACD Commentary

Request for Comment #6:
Should the rule [in defining "independent knowledge"] preclude submissions from all government employees?

NACD strongly believes that the proposed definition of "independent knowledge" should exclude government employees. The government and its agencies, as regulatory bodies, are already charged with discovering fraud and other damaging activities. Awarding bounties for government responsibilities undermines the very purpose of the government and its laws, including the Dodd-Frank Act. Rather, the rule should be aimed at stopping potential fraud before government agencies are required to act.

Request for Comment #9
Is it appropriate to exclude from the definition of "independent knowledge" or "independent analysis" information that is obtained through a communication that is protected by the attorney-client privilege?

NACD believes the proposed rule should exclude from the definition of "independent knowledge" all communications with attorneys, even in cases where the privilege has *been waived for any reason.* The proposed whistleblower rule excludes from the definition of "independent knowledge" a communication that is "subject to the attorney-client privilege." However, the concept of "privilege" has never been well defined. The rule should define some types of communication that under all circumstances and without exception should be included in the definition of privilege.

Request for Comment #11
Should the exclusion for "independent knowledge" or "independent analysis" go beyond attorneys and auditors, and include other professionals who may obtain information about potential securities violations in the course of their work for clients?

The "independent knowledge" definition should also exclude professionals hired by the board of directors, such as consultants or attorneys. The responsibilities of public company boards have expanded in recent years as the challenges of the business environment and the burden of regulations have grown. In response, NACD and others have recommended that boards of directors hire outside consultants for independent advice on areas such as compensation, audit, strategy, crisis, and risk. In the course of their work, these outside consultants are given access to company information that may be sensitive or reveal potential wrongdoing by the corporation. For the benefit of candid advice and consultation, boards and outside consultants must establish trust. This trust would be undermined when outside consultants could be awarded a bounty with the submission of damaging information about the corporation. Therefore, individuals hired by the board for the purpose of advice and consultation should not be deemed to have "independent knowledge" for the purpose of receiving bounties and protection.

Request for Comment #13
Do the proposed exclusions for information obtained by a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity ... strike the proper balance? Should a "reasonable time" be defined in the rule?

It must also be made clear that individuals in an internal audit function, or those individuals working in the capacity of internal audit, are not deemed to have "independent knowledge." The rule should make it clear that anyone performing or supporting an internal audit function must be specifically excluded. Additionally, this exclusion must be extended to those individuals who may perform the functions of internal audit but whose job titles and responsibilities may differ. Oftentimes, an individual in a different department of an organization may have temporary duties that aid the internal auditors. Such individuals must also be excluded from the rule because they are given access to information that may lead to a whistleblower submission.

Exclusions should apply to all employees who provide information at the request of internal or external auditors. Currently, none of the exclusions specifically apply to company employees who interact with independent public accountants. As a result, company accountants providing information at the request of external auditors will still be considered to have "independent knowledge" and "independent analysis." It cannot be considered independent analysis if an auditor's request calls attention to a matter that should be reviewed. In this event, the company accountant would be incentivized to ignore other internal compliance processes and proceed directly to the SEC as a whistleblower.

Accountants serve as indispensible elements of the audit process; their knowledge and information contribute significantly to the integrity of the internal compliance function. Those individuals who compile information for auditors as part of the internal compliance function should be excluded so as to maintain strong internal compliance systems.

As for the "reasonable period of time," this could be three to six months—no less than 90 days and no more than 180 days. Only after this period would the SEC be permitted to take any enforcement actions. The period may be shortened to prevent material harm that is evident and immediate, or lengthened in some circumstances. In this manner, costly enforcement actions can be avoided if the company takes steps to resolve any wrongdoing first.

Request for Comment #16
Does the provision regarding the providing of information to a company's legal, compliance, or audit personnel appropriately accommodate the internal compliance process?

NACD believes that all individuals deemed to have "independent knowledge" must report allegations or violations to the internal compliance system prior to submitting them to the SEC. The proposed rule allows employees not covered under an "independent knowledge" exclusion to bypass the internal compliance functions. While the rule includes incentives for using the internal compliance function, such as a higher reward, the proposed rule incentivizes employees to be whistleblowers first and loyal employees second. We understand and agree that after a certain amount of time or inaction by the company in response to an allegation of wrongdoing, an employee should be able to approach the SEC with a whistleblower submission. However, there is little motivation or reason for a company to build an effective internal compliance system if the corporate employees are not expected to use it and can bypass it at anytime.

The proposed rule should require and encourage employees to use the internal compliance function prior to approaching the SEC. NACD recommends amending the rule to require an individual to first submit an allegation to internal compliance. After the initial report, the individual may submit the allegation to the SEC. The SEC would then contact the general counsel (GC) or chairman of the audit committee, and advise the GC or chairman to solve any issues or violations and report back within a reasonable period of time (see Request for Comment #13).

Request for Comment #17
Is the 90-day deadline for [reporting] to the Commission (after initially providing information about violations or potential violations to another authority or the employer's legal, compliance, or audit personnel) the appropriate timeframe?

Again, as described in the response to Request for Comment #13, NACD believes that the period for reporting should be between three and six months (90 to 180 days).

<u>Request for Comment #42</u>
Should the anti-retaliation protections ...be applied broadly to any person who provides information to the Commission concerning a potential violation of the securities laws?

NACD believes that employers should have the ability to use existing disciplinary measures to respond to employees who circumvent the compliance systems or make false allegations against a company. As the propose rule is currently written, it seems as if potential whistleblowers can enjoy retaliation protections whether or not they satisfy the conditions for an award. This opens the door for employees to submit fake allegations that may cause reputational harm to the company and/or unfairly embarrass corporate employees and leadership.

Conclusion

The SEC's goal of helping to enhance effective whistleblowing is to be commended. However, the problems with the Dodd-Frank whistleblowing provisions are so great that even the most enlightened rulemaking may not be able to correct them. The changes we have recommended above can help to foster more effective and workable whistleblower programs for the good of companies, shareholders, and all stakeholders.

Sincerely,

Barbara Franklin

Barbara Hackman Franklin
Chairman
NACD

Kenneth Daly
President and CEO
NACD

KENNETH DALY
National Association of Corporate Directors
1133 21st Street, NW, Suite 700
Washington, DC 20036
Office: 202-572-2085 – Cell: 215-518-0060
kdaly@NACDonline.org

Ken Daly is president and CEO of the National Association of Corporate Directors (NACD), the nation's largest organization devoted exclusively to serving the governance needs of corporate boards and individual board members.

Prior to joining NACD, Ken had a distinguished career as an independent audit partner at a large, international accounting firm, working closely with boards of directors and audit committees as the partner-in-charge of several different practices, including: the National Risk Management Practice, the National Sales Practice, and the Financial Services Practice for the Mid-Atlantic region. He also served as executive director of their Audit Committee Institute. While at the firm, some of his other accomplishments included:

- Serving as a member of the firm's senior management team for national audit and advisory services
- Serving as engagement audit partner focused on commercial banks, savings and loans, broker/dealers, and insurance companies
- Advising bank clients on SEC and other regulatory financial reporting requirements
- Extensive experience with audit committees and senior financial management qualifying him as an audit committee financial expert
- Developing the firm's risk-based audit approach for financial services companies
- Forming, developing and managing the firm's national risk management practice
- Developing, managing and serving as the lead instructor for the firm's mentoring program for "fast track" senior managers to become partners
- Assisting in practice reviews of large financial institutions

Ken is passionate about motivating boards to promote the highest professional standards. He is the architect of NACD's vision of being the Voice of the Director and its mission of Exemplary Board Leadership.

Ken's initiatives as CEO are credited with enhancing NACD's long-standing reputation as the authoritative voice on corporate governance policy and procedures. With over 11,000 members and 22 chapters in major cities, NACD is highly regarded as the thought-leader through its educational, informational and advisory services. In addition to providing leadership and vision to the organization, Ken serves as faculty for all NACD educational training concerning audit committees.

Ken is frequently called upon to speak and write about corporate compensation, risk oversight, audit committee standards, regulatory policies and other governance leading practices. He regularly appears in the media and has recently been quoted in the *Wall Street Journal*, *New York Times*, *Atlanta Journal-Constitution*, Reuters, AP Radio, and FoxNews Radio, among others. Ken is a member of the National Infrastructure Advisory Committee, and previously served on the audit committee of a large insurance company both as a member and chair. He has also been active in several philanthropic organizations where he served as a trustee.

Ken received his bachelor's degree in accounting from the University of Delaware and has attended an international partner program in Birkenstock, Switzerland, as well as the partner development program at the University of Pennsylvania's Wharton School. He is a CPA (inactive status) in Pennsylvania.

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
Robert J. Kueppers, Deputy CEO
Deloitte LLP

May 11, 2011

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

---

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.

---

[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]

---

[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.

* * *

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).

Statement
of the
U.S. Chamber
of Commerce

ON: **Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions**

TO: U.S. House Subcommittee on Capital Markets and Government Sponsored Enterprises

DATE: **May 11, 2011**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Good afternoon Chairman Bachus, Ranking Member Frank, and Members of the Committee. Thank you for the opportunity to submit views on the potential unintended impacts of the Dodd-Frank Whistleblower Provisions on corporate compliance programs.

My name is Marcia Narine, and I am here on behalf of the US Chamber of Commerce.

Until May 1, 2011, I served as the Vice President of Global Compliance and Business Standards, Deputy General Counsel and Chief Privacy Officer of Ryder, a *Fortune 500* global transportation and supply chain management solutions company with over 28,000 employees worldwide. Prior to that role, I spent almost eighteen months as the group director of human resources for Ryder's Supply Chain Solutions division. I began my career at Ryder in 1999 as senior counsel focusing on labor and employment.

Before joining Ryder, I was an associate attorney with Morgan, Lewis and Bockius' labor and employment practice. I have also worked as a commercial litigator with Cleary, Gottlieb, Steen and Hamilton working on securities fraud, among other matters, and as a law clerk to former Justice Marie Garibaldi of the Supreme Court of New Jersey. I earned my law degree from Harvard in 1992, and my bachelors degree in political science and psychology from Columbia in 1988. I left corporate life to pursue a career in academia and am currently researching and writing law review articles on compliance, governance, employment law, and international human rights and am a founding member of a foundation focusing on maternal and infant mortality and education in the Congo.

The basis of my testimony stems in large part from my experience at Ryder establishing its global compliance and ethics program under the direction of its two general counsels, its CEO and its board; my experiences as both in house and outside counsel training, deposing and preparing witnesses and employees; personally interviewing employees around the world who consider themselves "whistleblowers"; and speaking with other compliance professionals and conducting research to benchmark and continually improve our compliance program.

The views expressed are entirely my own and should not be attributed to any of my former employers although I do expect to draw on some of those experiences.

There are at least five ways in which this legislation will adversely affect compliance programs.

First, the bill creates a presumption that all companies operate at the lowest possible level of ethical and illegal behavior and provides every incentive for the whistleblower to bypass existing compliance programs. Employees can go straight to the SEC to report their suspicions without even alleging that the existing company reporting mechanism is not a viable, functioning, credible or legitimate option.

It appears as though responsible companies, which have spent millions of dollars and several years investing in compliance programs and building strong ethical corporate cultures since the Federal Sentencing Guidelines were enacted are being penalized because the SEC failed to pay attention to the whistleblower who repeatedly brought information to them about Bernard Madoff, who defrauded investors of $65 billion.

The Sentencing Guidelines are not mandatory but are used by the Department of Justice when making charging, non prosecution and deferred prosecution decisions when corporations commit crimes and by federal district judges when imposing sentences. In fact, the explosion in the number of compliance programs in the United States after 2004 is due in large part to the revision of the Guidelines. The Guidelines require a company to take seven steps[3] to ensure mitigation of fines and penalties for corporate crimes. Compliance officers base their programs on these steps and boards, which have an oversight duty under the law, use these standards to ensure that an effective compliance program exists.

The 2010 Revisions added important clarifications.[4] Ironically, the SEC's current position allowing whistleblowers to bypass the compliance program squarely contradicts the intent of the new guidelines because the revisions require companies to discover wrongdoing first and to voluntarily disclose to the government, which

[3]The 2004 Guidelines require a company to establish standards and procedures to reduce the likelihood of a violation of the law; assign oversight of compliance program to high level individuals such as a compliance and ethics officer; delegate substantial discretionary authority only to reputable individuals without a propensity to or history of violating the law; develop position-specific compliance training and communications; establish audit and monitoring process; publicize the anonymous reporting system and ensure that there is no retaliation; establish uniform disciplinary action, including against those who failed to detect a violation; take steps to prevent similar offenses and make changes to the compliance program if necessary.

[4] The 2010 revisions require a company to ensure that the Chief Compliance Officer reports to the Board or Audit Committee and if s/he reports to the General Counsel that the Compliance Officer has direct and unfettered access and reporting obligations to the Board or appropriate Board Committee; discover the problem inside the organization rather than outside; after conducting an investigation promptly voluntarily disclose the wrongdoing to the government; and ensure that compliance officer wasn't involved in the violation or willfully ignorant.

companies cannot do without the aid of employees willing to come forward internally. Companies rely on employees and other tipsters who come forward in good faith. In fact, in many instances, corroboration rates for anonymous tips can be higher than for those who provide names, so responsible companies have an incentive to provide a multipronged complaint structure where employees or others can come forward and bring tips.

The coverup is always worse than the crime. While there are companies that shred documents, retaliate against employees and commit crimes, both civil and criminal remedies and penalties already exist for that kind of behavior under both Sarbanes-Oxley and other laws and the government should enforce those. Dodd-Frank should not compound the problem. The irresponsible companies which don't have effective compliance programs or strong ethical cultures won't have any incentives at all to develop them now because they will simply assume that employees will report externally. This means that their shareholders and employees won't enjoy the benefits of a strong ethical compliance culture further risking the kind of financial fraud that Dodd-Frank was meant to prevent.

If the Committee wants to encourage responsible companies to continue to build strong programs and irresponsible companies to start, it should not dismantle the effective incentive structure of the Sentencing Guidelines. Instead, <u>for a whistleblower to receive the bounty, s/he should be required to use the internal mechanism first unless s/he alleges that there is no viable independent internal reporting mechanism such as a credible anonymous hotline or email system, independent internal or external auditor, board member or general counsel or that the entire executive team is involved in malfeasance.</u>

Second, the SEC has indicated that the agency does not plan to automatically share information with a company when it receives a tip from a whistleblower. As of today, the whistleblower investigation office has not yet been funded. Even if it were fully funded, the corporation has the best access to documentation and witnesses. While the whistleblower community and apparently the SEC cynically view this as a negative, this Committee should view this as a positive. Responsible companies and boards want to know sooner rather than later if something is wrong before the problem gets bigger. The Sentencing Guidelines provide credit and possibly nonprosecution for voluntary disclosure. Publicly-traded companies don't only have to worry about regulators- there are private rights of action, potential significant loss of share price, employee morale and reputational value if there are even allegations of fraud. Accordingly, it makes sense for a company to retain counsel and other investigators and experts, conduct a thorough investigation, notify outside auditors and the board, preserve documents and disclose to the government and regulators if appropriate. Under the legislation as written and under the SEC's current position, if a whistleblower discloses malfeasance to the SEC but not the company and the SEC does not inform the Company, the alleged wrongful conduct could continue unchecked.

The SEC and corporations have the same goals – protecting shareholder value. The SEC's posture on this issue may hurt, not help the shareholders, which include company employees, pension funds, institutional investors and individuals. <u>The presumption should be that the whistleblower reports internally first, but if not then the SEC informs the company immediately unless there is a legitimate reason not to do so. This allows for an immediate and thorough investigation.</u>

Third, the legislation as written has a loophole that could allow legal, compliance, audit, and other fiduciaries to collect the bounty although they are already professionally obligated to address these issues. While the whistleblower community believes that these fiduciaries are in the best position to report to the SEC on wrongdoing, as a former in house counsel and compliance officer, I believe that <u>those with a fiduciary duty should be excluded and have an "up before out" requirement to inform the general counsel, compliance officer or board of the substantive allegation or any inadequacy in the compliance program before reporting externally.</u>

Fourth, currently culpable individuals may also collect a bounty despite their participation in the conspiracy. This could lead to the bizarre result that an agent who is terminated after a company realizes that he has been committing unauthorized bribes for which the company could be liable could turn the company in to the SEC and DOJ for violations of the Foreign Corrupt Practices Act and could then conceivably collect a multimillion reward when the government fines the company. <u>Culpable individuals should not be able to collect a bounty.</u>

Finally, the proposal's anti-retaliation provisions are unclear. Generally, under normal circumstances employees should be disciplined or terminated if they violate clearly established, well documented, consistently followed company policies. However, the Dodd-Frank legislation as written is ambiguous as to whether legitimate, nondiscriminatory business reasons will suffice for taking adverse action against a whistleblower who steals from the company, sexually harasses an employee, fails to come to work or commits an illegal act such as workplace violence. <u>The legislation needs clarification to ensure that while no adverse employment action can be taken for making a good faith report under the Act, the Act should not affect a company's ability to take legitimate non-retaliatory action employment actions.</u>

Thank you again for the opportunity to present my views. These are important issues and the compliance and ethics community has spent many years doing good work to encourage employees, suppliers, customers and members of the general public to report known or suspected wrongdoing internally so that these matters can be investigated and remedied. Dodd-Frank Whistleblower Reform will not prevent the next financial crisis. But what may happen is that the legislation as written may erode some of the very good work that has been done over the past few years if some of the fixes that we have suggested are not adopted.

THE UNIVERSITY OF TOLEDO COLLEGE OF LAW

Written Statement of

Geoffrey Christopher Rapp
Professor of Law
University of Toledo College of Law

Before the

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

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

May 11, 2011

Good afternoon Mr. Chairman and distinguished members of the Subcommittee. Thank you for the opportunity to present to you my reactions to the proposed legislation modifying the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Whistleblowing is the single most effective method of detecting corporate and financial fraud. Employee disclosures are by far the most common source of fraud detection. One of the major impediments to the detection of fraud involves the cost of acquiring and gathering information indicating that a fraud has occurred. Insiders have the best access to such information and can discover fraud at a much lower cost when compared to outsiders including market actors and regulators. In addition to having access to the information relating to a fraudulent scheme, whistleblowers are often highly trained and sophisticated professionals with the technical expertise to understand the complex financial transactions at the core of many instances of securities and financial fraud.

In recognition of the important role that whistleblowers can play in the financial fraud setting, the Sarbanes-Oxley Act of 2002 for the first time created a uniform federal protection for financial fraud whistleblowers. Prior to the enactment of the Sarbanes-Oxley whistleblower protections, employees who blew the whistle were covered by a patchwork of state statutes and common law remedies, and true protection was sporadic if present at all. The central idea of the anti-retaliation provision in Sarbanes-Oxley was to motivate employees to blow the whistle by protecting them from retaliation in the workplace.

Unfortunately, the Sarbanes-Oxley provisions had a number of holes. The statute was procedurally complex, provided only limited damages in civil actions by whistleblowers, provided no right to a jury trial, and limited opportunities for terminated employees to participate in the early stages of an investigation. Enforcement of the Sarbanes-Oxley provisions fell to the Occupational Safety and Health Administration, which had some experience in administering other federal whistleblower provisions. Unfortunately, as the General Accounting Office concluded in a 2010 report, OSHA investigators often lacked the training to "understand complex securities and navigate complex legal issues in order to conduct an investigation"[1] of a Sarbanes-Oxley claim.

As a result, Sarbanes-Oxley provided the illusion of protection for financial fraud whistleblowers without providing a truly meaningful and robust method for ensuring such protection. Empirical research on whistleblowing since the passage of Sarbanes-Oxley has lent some confirmation to view that the statute was ineffective in motivating whistleblowers to bring fraud to light. Since the passage of Sarbanes-Oxley, the percentage of whistleblowers who were employees *fell* from 18% to 13%[2]; had the

---

[1] GENERAL ACCOUNTING OFFICE, WHISTLEBLOWER PROTECTION: SUSTAINED MANAGEMENT ATTENTION NEEDED TO ADDRESS LONG-STANDING PROGRAM WEAKNESSES, GAO 10-722 (August 2010), at 24.

[2] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2250 (2010).

statute provided truly robust protection, one would have expected an increase in the level of employee whistleblowing.

Most fundamentally, Sarbanes-Oxley failed to offer any sort of financial incentive for whistleblowers who bring fraud to light. Sarbanes-Oxley "screamed out"[3] for a whistleblower bounty scheme. If the aim of a policy is to encourage whistleblowing, bounty programs work. In industries subject to the federal False Claims Act, for instance, employee tips are responsible for 41% of fraud detection, as opposed to just 14% in other industries.[4]

The reason bounties work is that a whistleblower faces tremendous disincentives, which bounties can help offset. Most whistleblowers will be subject to some form of retaliation on the job. Various studies indicate that between 82%[5] and 90% [6]of whistleblowers are fired, quit under duress, or are demoted.. More than 60% of whistleblowers report having been blacklisted by other firms in their industry.[7] In addition to these economic costs, a whistleblower is likely to face severe social ostracism and experience personal hardship as she struggles to bring fraud to light. By adding the possibility of a bounty reform, policymakers can offset these potential costs and encourage individuals with information about fraud to blow the whistle rather than remain silent. Bounties are particularly effective because "successful" whistleblowing involves not just an initial decision to expose fraud, but persistence as that fraud is investigated.

Section 922 of the Dodd-Frank Act answered the glaring need for a bounty provision for financial fraud whistleblowers. In short, under Dodd-Frank, whistleblowers who voluntarily provide original information on securities fraud violations would be entitled to 10-30% of the sanctions obtained by the Securities and Exchange Commission in a successful enforcement action. Since the passage of the Act, the SEC has been hard at work in developing rules to govern its administration of the new bounty program. A proposed draft of those rules was released in November 2010. Since then, the SEC has received hundreds of comments – more than a thousand, in fact, if petitions are included – on its proposed rules. The final draft of those rules is expected to be released some time this summer.

The legislation under discussion in today's hearing would modify the Dodd-Frank approach, making what I view as three significant changes. First, the proposed

---

[3] Jarod Spencer Gonzalez, *A Pot of Gold at the End of the Rainbow. An Economic Incentives-Based Approach to OSHA Whistleblowing*, 14 EMP. RIGHTS & EMP. POL'Y J. 325, 346 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1538336.

[4] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2215 (2010).

[5] Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?*, 65 JOURNAL OF FINANCE 2213, 2216 (2010).

[6] Kim R. Sawyer et al., *The Necessary Illegitimacy of the Whistleblower*, 29 BUS. & PROF. ETHICS J. 85 (2010), at *4, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=917316.

[7] Kim R. Sawyer et al., *The Necessary Illegitimacy of the Whistleblower*, 29 BUS. & PROF. ETHICS J. 85 (2010), at *2, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=917316.

legislation would require that employee whistleblowers raise their concerns internally before going to the SEC. Whistleblowers failing to do so would be denied a bounty, unless they demonstrate that their employer lacks an internal reporting process or a policy prohibiting retaliation, or demonstrates that the fraud involved high-level managers or bad faith. On a related note, the proposed legislation would task the SEC to notify corporations of any investigation launched as a result of a whistleblower tip and give those firms an opportunity to take remedial action. Second, the proposed legislation would eliminate the mandatory nature of bounties present in the Dodd-Frank provision. Third, the proposed legislation would prohibit contingency fees for attorneys representing whistleblowers in connection with Dodd-Frank bounty claims.

The question of whether whistleblowers should be required to report internally is one that the SEC considered in detail in connection with its proposed rules. SEC staff members are the federal government's resident experts in financial regulation and corporate governance, and those experts came to the conclusion, in the Commission's proposed rules, that an internal reporting requirement was unnecessary. The main argument that has been advanced in favor of such a requirement is that Dodd-Frank would damage existing internal reporting structures adopted by corporations after the passage of Sarbanes-Oxley.

In response to this argument, the SEC made several observations. First, it noted that not all employers have robust and well documented internal reporting procedures. Moreover, the SEC expressed its view that even without imposing a requirement of internal reporting, internal reporting structures are unlikely to be bypassed. The SEC noted that in most cases, upon receiving a whistleblower tip, its staff would contact a corporation and describe the allegations, giving the firm the chance to investigate the matter itself. The SEC did not expect the Dodd-Frank structure, without an internal reporting requirement, to "minimize the importance of effective company processes for addressing allegations of wrongful conduct."[8]

In addition, even without a hard requirement of internal reporting, many whistleblowers will likely do so anyway. Most whistleblowers see themselves as loyal employees, and they often blow the whistle out of a desire to help their firms. Even without a formal requirement of internal reporting, most employees will likely use internal processes anyhow.

The proposed requirement for internal reporting would complicated both the process and the expected benefit of whistleblowing for a potential tipster. A potential whistleblower would have to make a judgment call about whether the high-level management and bad-faith exceptions applied before contacting the SEC, or else risk losing her eligibility for a bounty. This added uncertainty would dull the incentives Dodd-Frank seeks to use to "put more cops on the beat."

---

[8] SECURITIES EXCHANGE COMMISSION, PROPOSED RULES FOR IMPLEMENTING THE WHISTLEBLOWER PROVISIONS OF SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934, Nov. 3, 2010, at 35.

In addition, the requirement of internal reporting might delay effective intervention in cases of serious fraud. Since a potential whistleblower won't know for sure whether the exceptions would apply, she is likely to choose to report internally. A group of motivated fraudsters, however, might choose to retaliate and cover up fraud rather than take genuine remedial efforts. By comparison, a whistleblower who complains directly to the SEC will likely trigger the kind of contact the SEC described in its proposals rules, where a member of the Commission's enforcement staff contacts the firm. Such a call is far more likely to deter a cover-up. By imposing a hard requirement of internal reporting, the proposed legislation may delay a regulatory response to serious fraud. Since the financial markets today operate at an incredible velocity, any delay in bringing fraud to light can magnify the seriousness of fraud and the potential loss to the investing public.

In addition, the proposed internal reporting requirement would address only a portion of potential whistleblowers. In many instances, a whistleblower may contact the SEC not about fraud at her employer, but instead about fraud at a subsidiary corporation, a related entity, a client or a even a competitor. The proposed legislation complicates matters by forcing a whistleblower to decide who exactly is responsible for the fraud – their own employer, or someone else – before deciding whether internal reporting is required.

A second aspect of the proposed legislation would eliminate the "mandatory" nature of Dodd-Frank bounties, giving the SEC the authority to award either *no* bounty even in cases where a tip led to a successful enforcement action meeting the $1 million threshold, or a bounty below 10% of the sanction collected. Again, this proposal would likely dull the incentives Dodd-Frank was meant to foster. The original draft of the Administration's Investor Protection Act of 2009, which included whistleblower bounties, as well as the early Congressional drafts of bills that became Dodd-Frank, would have made the payment of bounties purely discretionary as suggested in the proposed legislation today. By my reading of the legislative history of Dodd-Frank, the decision to make such bounties mandatory was made in connection with a committee print submitted by Senator Dodd on March 15, 2010. That suggests the mandatory nature of bounties in Dodd-Frank reflected a deliberate decision.

The primary concern that would arise if bounties were purely discretionary is whether the SEC would in fact award bounties on a regular basis. The SEC was given a purely discretionary authority to pay bounties by the Insider Trading and Securities Fraud Act of 1988. Between 1988 and 2010, when the Dodd-Frank Act subsumed the insider trading whistleblower bounty program, the Commission reportedly paid just $160,000 to only five whistleblowers.[9] The SEC appeared at the time to have little interest in whistleblowers and there was no evidence that the anemic program had any effect in deterring insider trading. Similarly, when the payment of bounties in the tax fraud setting by the Internal Revenue Service was purely discretionary, prior to the Tax Relief and Health Care Act of 2006, the IRS had a rather dismal record of rewarding whistleblowers.

---

[9] Michael Mann et al. *Enforcement Initiatives*, 1867 PLI/CORP 479, at 487 (Feb. 16, 2011).

The reformed IRS program served as a model for the Dodd-Frank provision and made bounties mandatory at a certain level of disputed tax liability.

There is also some empirical evidence gathered in experimental settings suggesting that *small* bounty awards can be ineffective or even counterproductive. Where only small rewards are available, potential whistleblowers may be *less* likely to reveal fraud than where no bounties are available at all.[10] It may be that where a small bounty is available, that amount of money isn't enough to compensate a potential whistleblower for the perceived downsides of bringing fraud to light; at the same time, it may also lead a potential whistleblower to assume that someone else will blow the whistle in search of such an award. Eliminating the Dodd-Frank minimum 10% bounty floor for covered actions might actually lead to less whistleblowing, as tipsters become complacent and assume someone else will step forward.

In addition, the Dodd-Frank Act already involves a fair amount of discretion. The SEC can deny bounties to whistleblowers whose information is not "original", who do not provide such information "voluntarily," or who fall into one of the categories excluded from claiming a bounty. Moreover, all the SEC has to do to avoid paying a bounty under Dodd-Frank is settle an enforcement action for $999,999, below the $1 million in sanctions threshold imposed by the Act. Making bounties discretionary in all cases, as the proposed legislation would do, simply increases the likelihood that the Commission will direct its energies to other priorities rather than respond to and reward whistleblower tips.

A third aspect of the proposed legislation would prohibit contingency fee arrangements for attorneys representing whistleblowers seeking SEC bounties. This proposal would virtually guarantee that no whistleblowers were represented by talented attorneys in connection with the application for a bounty. No such prohibition on contingency fee arrangements exists in other federal bounty programs, such as the False Claims Act. Contingency fees are a regular part of False Claims Act practice and there are no indications of widespread abuse. The process for claiming a bounty will involve detailed submissions to the SEC, and having a talented lawyer is essential for a whistleblower in making such submissions. The SEC is also likely to prefer working with counsel to individual whistleblowers, since attorneys can help process the information in a whistleblower's possession in a readable and usable manner. This increases the likelihood that fraud will be quickly stopped and deterred. Moreover, under Dodd-Frank the decision not to pay an award may be appealed to the appropriate U.S. Court of Appeals. Very few attorneys would take on such time-consuming representation absent the possibility of a contingency fee. The whistleblowers in these cases simply can't afford to pay attorneys by the hour. They have usually been terminated or suspended. One story has circulated of a Sarbanes-Oxley whistleblower who, even though eventually successful in a retaliation claim, accumulated $100,000 in attorneys

[10] *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties and Protections for Reporting Illegality*, 87 TEX. L. REV. 1151, 1201 (2010).

fees and was forced to sell his family farm.[11] That kind of story could become the norm if contingency fees were prohibited.

In conclusion, let me add that I think the proposed changes in Dodd-Frank's whistleblower provisions would have a negative symbolic effect. In the 2005 Deficit Reduction Act, Congress created a strong financial incentive for states to adopt their own False Claims Acts with whistleblower bounty provisions. Where such laws were enacted, states would be entitled to a larger share of recovery in successful Medicaid fraud cases. As a result, a number of states have either adopted such laws or are currently considering doing so. In my own state, Ohio, Republican Attorney General Mike DeWine proposed in March an Ohio whistleblower bounty rewards statute, which is now under consideration in Columbus. Congress should continue to support strong whistleblower protection and reward programs, and the proposed legislation may result in mixed signals.

[11] Beverly H. Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change*, 44 AM. BUS. L. J. 1, 25 (2007).

○

Written Testimony

Darla C. Stuckey

Senior Vice President – Policy & Advocacy
Society of Corporate Secretaries and Governance Professionals

May 11, 2011

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"

May 11, 2011

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"

Written Testimony of Darla C. Stuckey – Senior Vice President - Policy & Advocacy, Society of Corporate Secretaries and Governance Professionals

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,

Darla C. Stuckey

Darla C. Stuckey

Society of Corporate Secretaries and Governance Professionals

[DISCUSSION DRAFT]

112TH CONGRESS
1ST SESSION

H. R. ____

To amend the whistleblower incentive and protection provisions of the Securities Exchange Act of 1934 and the Commodity Exchange Act to [to be provided]

IN THE HOUSE OF REPRESENTATIVES

Mr. GRIMM introduced the following bill; which was referred to the Committee on ____

A BILL

To amend the whistleblower incentive and protection provisions of the Securities Exchange Act of 1934 and the Commodity Exchange Act to [to be provided]

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934.

(a) EXCLUSION OF CERTAIN COMPLIANCE OFFICERS AND INTERNAL REPORTING AS A CONDITION OF AWARD.—Section 21F of the Securities Exchange Act of 1934 (15 U.S.C. 78u–6) is amended—

(1) in subsection (b), by redesignating paragraph (2) as paragraph (3) and inserting after paragraph (1) the following:

"(2) INTERNAL REPORTING REQUIRED.—In the case of a whistleblower who is an employee providing information relating to misconduct giving rise to the violation of the securities laws that was committed by his or her employer or another employee of the employer, to be eligible for an award under this section, the whistleblower, or any person obtaining reportable information from the whistleblower, shall—

"(A) first report the information described in paragraph (1) to his or her employer before reporting such information to the Commission; and

"(B) report such information to the Commission not later than 180 days after reporting the information to the employer."; and

(2) in subsection (c)(2)—

(A) in subparagraph (C), by striking "or" at the end; and

(B) by redesignating subparagraph (D) as subparagraph (F) and inserting after subparagraph (C) the following:

"(D) to any whistleblower who fails to first report the information described in subsection (b)(1) that is the basis for the award to his or her employer before reporting such information to the Commission, in the case where the misconduct giving rise to the violation of the securities laws was committed by such employer or an employee of the employer, unless the whistleblower alleges and the Commission determines that the employer lacks either a policy prohibiting retaliation for reporting potential misconduct or an internal reporting system allowing for anonymous reporting, or the Commission determines in a preliminary investigation not exceeding 30 days that internal reporting was not a viable option for the whistleblower based on—

"(i) evidence that the alleged misconduct was committed by or involved the complicity of the highest level of management; or

"(ii) other evidence of bad faith on the part of the employer;

"(E) to any whistleblower who has legal, compliance, or similar responsibilities for or on behalf of an entity and has a fiduciary or contractual obligation to investigate or respond to internal reports of misconduct or violations or to cause such entity to investigate or respond to the misconduct or violations, if the information learned by the whistleblower during the course of his or her duties was communicated to such a person with the reasonable expectation that such person would take appropriate steps to so respond; and".

(b) ELIMINATION OF MINIMUM AWARD REQUIREMENT.—Subsection (b)(1) of such section is amended—

(1) by striking "shall" and inserting "may"; and

(2) by striking "in an aggregate amount equal to—" and all that follows and inserting "an amount determined by the Commission but not more than 30 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions.".

(c) EXCLUSION OF WHISTLEBLOWERS FOUND CULPABLE.—Subsection (c)(2)(B) of such section is amended by inserting ", 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 such violation" after "violation".

(d) PROHIBITION ON CONTINGENCY FEES BY ATTORNEYS.—Subsection (d)(1) of such section is amended by adding at the end the following: "Counsel may not represent a whistleblower in such claims on a contingency fee basis.".

(e) RULE OF CONSTRUCTION RELATING TO OTHER WORKPLACE POLICIES.—Subsection (h)(1) of such section is amended by adding at the end the following:

"(D) RULE OF CONSTRUCTION.—Nothing in this paragraph shall be construed as prohibiting or restricting any employer from enforcing 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.".

(f) NOTIFICATION TO EMPLOYER.—Paragraph (2) of subsection (h) of such section is amended—

(1) in the paragraph heading, by striking "CONFIDENTIALITY" and inserting "NOTIFICATION TO EMPLOYER AND CONFIDENTIALITY";

(2) by redesignating subparagraph (A) through (D) as subparagraphs (B) through (E), respectively;

(3) by inserting a new subparagraph (A) as follows:

"(A) NOTIFICATION OF INVESTIGATION.—

"(i) NOTIFICATION REQUIRED.—Prior to commencing any enforcement action relating in whole or in part to any information reported to it by a whistleblower, the Commission shall notify any entity that is to be subject to such action of information received by the Commission from a whistleblower who is an employee of such entity to enable the entity to investigate the alleged misconduct and take remedial 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—

"(I) evidence that the alleged misconduct was committed by or involved the complicity of the highest level management of the entity; or

"(II) other evidence of bad faith on the part of the entity.

"(ii) GOOD FAITH.—Where an entity notified under clause (i) responds in good faith, which may include conducting an investigation, reporting results of such an investigation to the Commission, and taking appropriate corrective action, the Commission shall treat the entity as having self-reported the information and its actions in response to such notification shall be evaluated in accordance with the Commission's policy statement entitled 'Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Statement of the Relationship of Cooperation to Agency Enforcement Decisions'."; and

(4) in the heading of subparagraph (B) (as redesignated by paragraph (3)), by striking "IN GENERAL" and inserting "CONFIDENTIALITY".

SEC. 2. AMENDMENTS TO THE COMMODITY EXCHANGE ACT.

(a) EXCLUSION OF CERTAIN COMPLIANCE OFFICERS AND INTERNAL REPORTING AS A CONDITION OF AWARD.—Section 23 of the Commodity Exchange Act (7 U.S.C. 26) is amended—

(1) in subsection (b), by redesignating paragraph (2) as paragraph (3) and inserting after paragraph (1) the following:

"(2) INTERNAL REPORTING REQUIRED.—In the case of a whistleblower who is an employee providing information relating to misconduct giving rise to the violation of the securities laws that was committed by his or her employer or another employee of the employer, to be eligible for an award under this section, the whistleblower, or any person obtaining reportable information from the whistleblower, shall—

"(A) first reported the information described in paragraph (1) to his or her employer before reporting such information to the Commission; and

"(B) report such information to the Commission not later than 180 days after reporting the information to the employer."; and

(2) in subsection (c)(2)—

(A) in subparagraph (C), by striking "or" at the end; and

(B) by redesignating subparagraph (D) as subparagraph (F) and inserting after subparagraph (C) the following:

"(D) to any whistleblower who fails to first report the information described in subsection (b)(1) that is the basis for the award to his or her employer before reporting such information to the Commission, in the case where the misconduct giving rise to the violation of the securities laws was committed by such employer or an employee of the employer, unless the whistleblower alleges and the Commission determines that the employer lacks either a policy prohibiting retaliation for reporting potential misconduct or an internal reporting system allowing for anonymous reporting, or the Commission determines in a preliminary investigation not exceeding 30 days that internal reporting was not a viable option for the whistleblower based on—

"(i) evidence that the alleged misconduct was committed by or involved the complicity of the highest level of management; or

"(ii) other evidence of bad faith on the part of the employer;

"(E) to any whistleblower who has legal, compliance, or similar responsibilities for or on behalf of an entity and has a fiduciary or contractual obligation to investigate or respond to internal reports of misconduct or violations or to cause such entity to investigate or respond to the misconduct or violations, if the information learned by the whistleblower on the course of his or her duties was communicated to such a person with the reasonable expectation that such person would take appropriate steps to so respond; and".

(b) CAP ON AWARD IN CERTAIN CIRCUMSTANCES AND ELIMINATION OF MINIMUM AWARD REQUIREMENT.—Subsection (b)(1) of such section is amended—

(1) by striking "shall" and inserting "may"; and

(2) by striking "in an aggregate amount equal to—" and all that follows and inserting "in an amount determined by the Commission but not more than 30 percent, in total, of what has been collected

of the monetary sanctions imposed in the action or related actions.''.

(c) EXCLUSION OF WHISTLEBLOWERS FOUND CULPABLE.—Subsection (c)(2)(B) of such section is amended by inserting '', is found civilly liable, or is otherwise determined by the Commission to have committed, facilitated, participated in, or been complicit in misconduct related to such a violation'' after ''violation''.

(d) PROHIBITION ON CONTINGENCY FEES BY ATTORNEYS.—Subsection (d)(1) of such section is amended by adding at the end the following: ''Counsel may not represent a whistleblower in such claims on a contingency fee basis.''.

(e) RULE OF CONSTRUCTION RELATING TO OTHER WORKPLACE POLICIES.—Subsection (h)(1) of such section is amended by adding at the end the following:

''(D) RULE OF CONSTRUCTION.—Nothing in this paragraph shall be construed as prohibiting or restricting any employer from enforcing 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.''.

(f) NOTIFICATION TO EMPLOYER.—Paragraph (2) of subsection (h) of such section is amended—

(1) in the paragraph heading, by striking ''CONFIDENTIALITY'' and inserting ''NOTIFICATION TO EMPLOYER AND CONFIDENTIALITY'';

(2) by redesignating subparagraph (A) through (D) as subparagraphs (B) through (E), respectively;

(3) by inserting a new subparagraph (A) as follows:

''(A) NOTIFICATION TO EMPLOYER.—

''(i) NOTIFICATION REQUIRED.—Prior to commencing any enforcement action relating in whole or in part to any information reported to it by a whistleblower, the Commission shall promptly notify any entity that is to be subject to such enforcement of information received by the Commission from a whistleblower who is an employee of such entity to enable the entity to investigate the alleged misconduct and take remedial action, unless the Commission determines in the course of a preliminary investigation not exceeding 30 days of the alleged misconduct, that such notification would jeopardize necessary investigative measures and impede the gathering of relevant facts, based on—

"(I) evidence that the alleged misconduct was committed by or involved the complicity of the highest level management of the entity; or

"(II) other evidence of bad faith on the part of the entity.

"(ii) GOOD FAITH.—Where an entity notified under clause (i) responds in good faith, which may include conducting an investigation, reporting results of such an investigation to the Commission, and taking appropriate corrective action, the Commission shall treat the entity as having self-reported the information and its actions in response to such notification shall be evaluated accordingly."; and

(4) in the heading of subparagraph (B) (as redesignated by paragraph (3)), by striking "IN GENERAL" and inserting "CONFIDENTIALITY".

SEC. 3. STUDY.

The Comptroller General shall conduct a study to determine what impact, if any, the whistleblower incentives program established under section 21F of the Securities Exchange Act of 1934 (15 U.S.C. 78u–6) and section 23 of the Commodity Exchange Act (7 U.S.C. 26) has had on shareholder value. The Comptroller General shall transmit to Congress a report on the study not later than 18 months after the date of enactment of this Act

○