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.

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).

Request for Comment #42

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 Hackman Franklin
Chairman
NACD

Kenneth Daly
President and CEO
NACD

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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.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

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

1. Name:	2. Organization or organizations you are representing:
Kenneth Daly	National Association of Corporate Directors

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered 'yes' to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.

United States House of Representatives

Committee on Financial Services

"Truth in Testimony" Disclosure Form

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Kenneth Daly	National Association of Corporate Directors

3. Business Address and telephone number:

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