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December 16, 2010

Via Electronic Filing

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

RE: File Number S7-33-10 (Implementation of the Whistleblower Provisions, Section 21F of the Securities Exchange Act of 1934)

Dear Secretary Murphy:

The Cornell Securities Law Clinic ("the Clinic") welcomes the opportunity to comment on the Securities and Exchange Commission ("the Commission") Rule Proposal for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, File Number S7-33-10 ("Rule Proposal"). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") enacted by Congress on July 21, 2010, requires the Commission to implement a whistleblower program that directs the Commission to pay an award to eligible whistleblowers who voluntarily provide to the Commission original information about a violation of the federal securities laws and which leads to successful enforcement. [1] We generally support this Rule Proposal and offer this comment letter to address three principal questions that the Commission has raised:

- Whether the Rule Proposal frustrates internal fraud monitors;
- Whether the Commission should exempt awards to persons who have a pre-existing legal duty to report violations; and
- Evaluating the definition of "significant contribution."

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[1] *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter Dodd-Frank Act), page 1841, *available at* http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

1. Employees of Public Companies Who Are Whistleblowers Should be Required To Use Internal Fraud Monitors First

The Commission asks whether the Rule Proposal to exempt whistleblowers from using internal fraud monitors frustrates company compliance structures[2] and whether there is an alternative that fulfills Section 21F of the Dodd-Frank Act.[3] The Clinic addresses this question in the context of publicly held companies. As such, the Clinic believes the Rule Proposal does frustrate internal fraud monitors for public companies and that a better standard does exist.

In 2002, Congress passed the Company Accounting Reform and Investor Protection Act, generally known as the Sarbanes-Oxley Act.[4] Sarbanes-Oxley required public companies to institute internal fraud monitors as a way to encourage employees to come forward with accounting complaints.[5] As such, public companies now have a complaint system in place that alerts the audit committee of a company's board of directors of potential accounting abuses.

Employees of public companies should be required to use the company's internal fraud monitor, thereby allowing the firm to address and rectify the problem before having to alert the Commission. The benefit of this process is that it helps to minimize profit-motivated complaints, assists the Commission by controlling caseloads, and respects instituted compliance systems like an internal complaint system. Indeed, companies in the future will have no incentive to improve or institute their own corporate governance standards if they know government intervention will undermine established guidelines. By allowing employees to bypass a company's internal complaint system, employees have little incentive to file an internal complaint where they are unlikely to profit, when the alternative is to provide information to the Commission and potentially profit.

A better standard would be to allow whistleblowers to approach the Commission only after they have alerted the company to potential abuses and the company has failed to reasonably respond to those concerns. In this case, because the company's internal complaint system can be assumed to have failed, the employee should be encouraged to file a claim with the Commission. Alternatively, if the company does react to the tip but does so in name only (i.e. as a sham), the employee should also be encouraged to file a claim with the Commission. This approach fulfills the intent of Sarbanes-Oxley, respects instituted corporate governance systems, and realizes the

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[2] Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934; Proposed Rule, 75 Fed. Reg. 70488, 70496, *available at* http://www.sec.gov/rules/proposed/2010/34-63237fr.pdf (hereafter Rule Proposal).
[3] *Id.*
[4] *See* Company Accounting Reform and Investor Protection Act, *available at* http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf (hereafter Sarbanes-Oxley).
[5] Section 301(4) of Sarbanes-Oxley states: Each audit committee shall establish procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. *Supra* note 4 at 776.

requirements of the Dodd-Frank Act. Thus, employees of public companies should be required to use their company's internal fraud monitors before approaching the Commission.

2. The Commission Should Exempt Awards to Persons Who Have a <u>Pre-Existing Legal Duty to Report Violations</u>

The Commission states that it intends to exempt awards to parties who are contractually obligated to report securities violations to the Commission or other authorities; this exclusion is meant to preclude awards to persons who provide information pursuant to preexisting agreements that obligate them to assist Commission staff or other investigative authorities.[6] The Dodd-Frank Act denies an award to "any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to the requirements of section 10A of the Securities Exchange Act of 1934."[7] Thus, persons who obtain and disclose information as a result of an audit and who are subject to the requirements of Section 10A of the Exchange Act would not be considered to have voluntary come forward with the information.[8]

The Commission asks whether this definition is appropriate.[9] The Clinic agrees with the Commission that it should exempt awards to parties who have a pre-existing duty to report securities violations.[10] For purposes of clarity, however, the Clinic recommends that the Commission delineate which groups are covered under this exemption. As currently defined in the Rule Proposal, individuals subject to the requirements of Section 10A would be exempt from any award; this provision principally applies to the independent auditor.

The Clinic recommends that the Commission consider including in its definition of exempted parties those who must file periodic reports with the Commission under Sarbanes-Oxley, Section 302.[11] Section 302 reads, in part, that the principal executive officer and the principal financial officer, or persons performing similar functions, certify to the Commission that the company's financial statements are not misleading, does not contain any untrue statement of a material fact, and that, based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition of the company.[12] Thus, by certifying their company's financial

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[6] *See* Rule Proposal, *supra* 2 at 70491.
[7] *See* Dodd Frank Act, *supra* 1 at 1843.
[8] *See* Rule Proposal, *supra* 2 at 70493.
[9] *Id.* at 70491.
[10] Consistent with the Commission's position that whistleblowers should not be paid awards based on monetary sanctions arising from their own misconduct, the Clinic supports the Commission defining the term "whistleblower" to expressly state that it is an individual who provides information about potential violations of the securities laws "by another person." *See* Question 1 of the Rule Proposal, *supra* note 2 at 70489.
[11] Sarbanes-Oxley, Section 302, *supra* note 4 at 777.
[12] *Id.*

statements, senior managers make an explicit representation that there are no securities violations. The Commission should preclude awards to individuals like the principal executive officer and the chief financial officer.

Additionally, a company's independent auditor is supposed to alert senior management, the audit committee and the general board of directors of accounting anomalies under Section10A. For this reason, the Commission should consider defining all members of those groups as individuals who have a legal duty to report violations. Allowing high-ranking company officials, who have a pre-existing legal duty to disclose, to benefit from whistleblower status creates the adverse incentive for company officials to act against the best interests of the company. The aim should be to minimize these kinds of incentives. Thus, the Clinic supports the Commission in exempting awards to persons who have a pre-existing legal duty to report violations.

3. The Commission Should Reevaluate the Definition of Significant Contribution

Proposed Rule 21F-4(c) paragraph (1) creates a two prong test to determine whether information provided by a whistleblower about conduct not already under investigation would make the whistleblower eligible for an award. First, the information "caused the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning new or different conduct as part of a current examination or investigation." Two, the information must have "significantly contributed to the success of the action."

In order for information to be considered a "significant contribution," the information must be "connected to evidence that plays a significant role in successfully establishing the Commission's claim."[13] This requirement itself has two elements: 1) the claim for which the information is used must either end in a settlement or a judgment for the commission and 2) there is a causal relationship between the information provided and the settlement or judgment. While the first element is clear and reasonable, the second element is likely to unduly narrow the list of potential whistleblowers.

According to the Rule Proposal, in order to significantly contribute, information provided must be of such "high quality, reliability, and specificity" that it leads to the successful completion of the investigation and a settlement or judgment for the commission.[14] Examples given include evidence that strongly and directly supports a claim, or evidence that had a "critical role" in the discovery of further information that provide "important support" for a claim by the Commission.[15] In sum, the requirement is that the information, by itself, must either

[13] *See* Rule Proposal, *supra* 2, at 70497.
[14] *Id.*
[15] *Id.*

provide a basis for a claim or that further important information could not have been found through a reasonable investigation without it.

The Bernard Madoff incident highlights the potential problem with this provision. Madoff's Ponzi scheme was revealed when his sons reported to the SEC that their father had confessed that his business was "one big lie."[16] Assuming the sons were not involved in the scheme, it would be uncertain whether they would qualify as whistleblowers. The statement that the business is "one big lie" is not specific and, by itself, would not be sufficient to establish a claim. In fact, it would, at best, lead to the opening of an investigation that would eventually result in a successful enforcement action—information that the notice specifically excludes from the definition of "significant contribution." However, such a statement was undoubtedly critical in exposing the scheme, which had gone on unnoticed for decades. In more mundane cases, it is very likely that those who notice an initial oddity with a firm or corporation do not have specific claims or numbers to assert. In such cases, the lack of specificity should not, in itself, bar potential whistleblowers from an award as they play a critical role simply by pointing out the anomaly that would otherwise be overlooked.

The current explanation of "significant contribution" imposes a stringent requirement which would unduly narrow the potential pool of whistleblowers who would be incentivized by this new regulation. Moreover, the most likely candidates who would have information of such specific and incriminating nature would be those who are either involved in the illicit activity or those who already have some preexisting legal duty to monitor and report such activities—a category of persons that Proposed Rule 21F-4 paragraph 4 specifically excludes.

One possible way to balance the need to discourage insubstantial claims with the need to promote disclosure of illicit activities is to take into account (1) what information was reasonably available to the whistleblower at the time of filing, and (2) what reasonable steps could have been taken to verify the veracity of the claim or to gather further information. Applying these two considerations in evaluating the Madoff case, the sons would be arguably qualified for an award as their information was the only information reasonably available and, as it came from Madoff himself, additional steps to verify the information would not have been reasonably necessary.

The two considerations could also be used as additional criterion to consider in determining the amount of an award—perhaps decrease the percentage awarded for information that only leads to the opening of an investigation but is critical in uncovering the illegal conduct. In sum, a more liberal interpretation of what constitutes "significant contribution" would better embrace the spirit of the rule and further its purpose of exposing security regulation violations.

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[16] Jamie Heller & Joanna Chung, *Life After Madoff's 'Big Lie,'* WALL ST. J., Dec. 11, 2010, *available at*
http://online.wsj.com/article/SB10001424052748703727804576011451297639480.html.

Conclusion

The Clinic appreciates the opportunity to provide our comments to the Commission. The Clinic generally supports the Rule Proposal and offers the three suggestions detailed above.

Respectfully Submitted,

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