COMMENTS

of

THE WASHINGTON LEGAL FOUNDATION

to the

SECURITIES AND EXCHANGE COMMISSION

Concerning

PROPOSED RULES FOR IMPLEMENTING THE WHISTLEBLOWER PROVISIONS OF SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934
(FILE NO. S7-33-10; RELEASE NO. 34-63237)

IN RESPONSE TO THE COMMISSION'S INVITATION
TO SUBMIT WRITTEN COMMENTS

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December 17, 2010

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December 17, 2010

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

Re: Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

Ms. Murphy:

The Washington Legal Foundation (WLF) hereby submits these comments to Chairman Schapiro and the Commissioners in response to the request by the Securities and Exchange Commission (the "Commission") for input on proposed rules and forms for implementing the whistleblower provisions entitled "Securities Whistleblower Incentives and Protection," which are contained in Section 21F of the Securities and Exchange Act of 1934 ("Exchange Act"), as amended by Title IX of the Dodd-Frank Act.

I. *Interests of WLF*

The Washington Legal Foundation (WLF) is a non-profit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Founded 33 years ago, WLF regularly appears before federal and state courts and administrative agencies to promote economic liberty, free enterprise, and a limited and accountable government. WLF has a longstanding interest in the work of the SEC, especially as it relates to several of WLF's comprehensive goals. These include protecting the stock markets from manipulation; protecting employees, consumers, pensioners, and investors from stock losses caused by abusive securities and class action litigation practices; encouraging congressional and regulatory oversight of the conduct of the plaintiffs' bar with respect to the securities industry; and restoring investor confidence in the financial markets through regulatory and judicial reform measures. Additional background information on WLF is available on our website at *www.wlf.org*.

Over the years, WLF has filed several complaints with the SEC requesting formal investigation of instances where there appeared to be a manipulation of the price of a stock by short sellers who were collaborating with class action and plaintiffs' attorneys. On May 22,

2003, WLF testified before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services for the U.S. House of Representatives on "The Long and Short of Hedge Funds: Effects and Strategies for

Managing Market Risk: The Relationship Between Short Sellers and Trial Attorneys."

WLF has filed a number of comments with the SEC on matters of public interest. For example, on September 18, 2006, WLF filed comments in File No. S7-11-06: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting Under Sarbanes-Oxley. On January 26, 2006, WLF filed comments on SEC Release No. 53025 (Dec. 27, 2005) regarding the distribution of moneys placed into seven Fair Funds as a result of a settlement between the SEC and seven New York Stock Exchange specialist firms. WLF also filed comments with the SEC on February 26, 2007 in File No. S7-24-06: Management's Report on Internal Control Over Financial Reporting, 71 Fed. Reg. 77635 (Dec. 27, 2006). More recently, WLF filed comments on May 20, 2008 in File no. S7-08-08: SEC's Proposed "Naked" short Selling Anti-Fraud Rule, 73 Fed. Reg. 15376 (March 21, 2008).

WLF also litigates and appears as amicus curiae before federal courts in cases involving securities litigation. *See, e.g., Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010); *Merck & Co. v. Reynolds*, 129 S. Ct. 2432 (2009); *Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006); *Dura Pharm, Inc. v. Broudo*, 544 U.S. 336 (2005).

Similarly, WLF's Legal Studies Division has produced and distributed timely publications on securities regulations and the SEC. WLF's most recently published works in this area include: William G. Lawlor and Michael L. Kichline, *Federalizing Fiduciary Duties Through Shareholder Lawsuits: Three Reasons for Court Scrutiny* (WLF Working Paper, July 23, 2010); Tammy Albarran, *Court Reins In SEC's Expansive "Primary Liability" Theory* (WLF Legal Opinion Letter, June 18, 2010); and, Laura L. Flippin and Morgan J. Miller, *Double Teamed: Defending Parallel Investigations Under SEC's New Cooperation Initiative* (WLF Legal Backgrounder, April 23, 2010).

Comments of WLF

1. The Proposed Rules Will Discourage Employees From Participating In Internal Corporate Compliance Programs Required By Sarbanes-Oxley.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted on July 21, 2010, establishes a whistleblower program that requires the Commission to pay an award ranging from 10% to 30% of the sanctions collected to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of federal securities laws that leads to a successful enforcement action totaling over $1 million. Unfortunately, the Commission's proposed Rules threaten to undermine another important federal law, the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act ("Sarbanes-Oxley"), which was not replaced by Dodd-Frank and remains binding law.

Following the enactment of Sarbanes-Oxley, corporate firms went to great lengths and incurred considerable expense to develop and implement effective internal corporate compliance programs. WLF is concerned that the Commission's proposal does not do enough to preserve the important role that such internal corporate compliance programs serve. In view of the enormous financial incentives involved, it now appears likely that companies will only be notified by their employees of potential wrongdoing *after* the Commission learns of it. It would be both ironic and counterproductive if, as a result of the SEC's new whistleblower program, effective internal compliance programs were completely undermined.

WLF appreciates that the proposed Rules include provisions designed to "discourage" employees from bypassing their own company's internal compliance programs. For example, the Commission's proposed Rules would treat an employee as a whistleblower as of the date that employee first reports the information internally as long as the employee provides the same information to the SEC within 90 days. *See* Proposed Rule 21F-4(b)(7). But the fact remains that nothing in the Commission's suggested approach *requires* whistleblowers to first utilize internal complaint and reporting procedures before submitting whistleblower information to the Commission. Indeed, whistleblowers are evidently free to bypass their own internal compliance programs entirely, while their eligibility for vast monetary awards from the Commission remains unaffected. Likewise, the proposed Rules expressly permit a corporate employee to qualify for a whistleblower award even if the sole basis for the proffered information is obtained from the questions asked of the employee during an internal interview conducted in the course of the company's internal investigation of potential wrongdoing. *See* Proposed Rules, at 12 n.11. Such a circumvention of corporate compliance programs threatens to drastically limit the ability of responsible companies to (1) encourage internal reporting of wrongdoing by employees, (2) conduct effective internal investigations, (3) remediate any problems discovered, and (4) self-disclose, where appropriate, any findings to the Commission.

The Commission should work harder to harmonize the corporate compliance mechanisms established under Sarbanes-Oxley with the new whistleblower program established by Dodd-Frank. This is especially crucial since, under the proposed Rules, a whistleblower is entitled to an award even if he or she deliberately violates the company's own policies requiring them to notify the company about the violations. WLF urges the Commission to strongly consider providing disincentives for whistleblowers who fail to first report their information through effective internal compliance programs. Rather than reward employees with even higher percentage awards for merely following their firm's own robust compliance procedures, the Commission should consider significantly reducing awards for those whistleblowers who fail to report wrongdoing internally in the first instance.

2. Neither Dodd-Frank Nor The Commission's Proposed Rules Effectively Precludes Wrongdoers From Profiting From Their Own Misconduct.

Dodd-Frank and the Commission's proposed Rules implementing it obviously create powerful incentives for corporate employees and others to report to the Commission almost any conceivable violation of the securities laws, no matter how far-fetched, in the hopes of obtaining a multimillion-dollar award. Dodd-Frank rightly excludes certain people from eligibility for awards, including those with a pre-existing duty to report such information, as well as attorneys and public accountants who encounter such information in the course of representing whistleblower clients. Unfortunately, under the relevant statutory language, Dodd-Frank fails to effectively preclude wrongdoers from profiting from their own malfeasance. Rather, a culpable whistleblower becomes ineligible *only if criminally convicted* of a violation connected to the violation underlying the award. *See* Dodd-Frank Act § 922(c)(2)(B).

In other words, even a whistleblower found liable in a civil enforcement action by the Commission will be entitled to a lucrative bounty for reporting his violation unless it is also established in criminal court that he violated the law beyond a reasonable doubt. Conceivably, under such a rule, a foreign national able to avoid the jurisdiction of American courts could receive a bounty worth millions of dollars simply by reporting his or her own misconduct. Absent further clarification, WLF cannot support any scheme that allows culpable whistleblowers to profit from their own misdeeds. Presumably, Congress did not intend to reward persons for blowing the whistle on their own misconduct. More importantly, a company should never be forced to pay vast sums of money for corporate wrongdoing to the very employee(s) who engaged in it. At a bare minimum, WLF urges the Commission to strictly define the term "whistleblower" so as to be limited to an individual who provides information about potential violations of securities laws *by another person.*

3. The Commission Should Not Permit Payment of Attorney Contingency Fees From Whistleblower Bounties.

Section 922 of Dodd-Frank provides that any whistleblower who desires to remain anonymous must be represented by counsel. Many whistleblowers may also elect to engage counsel to help them navigate the whistleblower claims process for reasons unrelated to anonymity. For those whistleblowers lacking the financial resources to hire an attorney on an hourly fee basis, many will agree to compensate their attorney with a percentage portion of their award. In private securities litigation, a plaintiff's attorney can charge a contingency fee anywhere between 30 to 50 percent of the total amount recovered. Yet counsel for a whistleblower in a Section 922 complaint is unlikely to contribute materially to investigation, prosecution, and recovery of monetary sanctions. Under such circumstances, allowing such large contingency awards for plaintiff's attorneys runs contrary to the public interest.

The Commission's own estimates anticipate submission of at least 30,000 tips each year, with half of these leading to formal money claims for a minimum $100,000 award. WLF is concerned that public companies will be inundated with frivolous claims brought by attorneys representing a "high volume" of complainants in the hopes that one of them will be successful in a lucrative award from the sanctions recovered by the Commission. WLF urges the Commission to adopt a formal rule prohibiting an attorney representing a whistleblower from receiving a contingency fee based on any amount ultimately awarded to the whistleblower client. Such a rule is entirely consistent with other provisions of the Exchange Act that prohibits the payment of attorneys fees from Commission disgorgement funds unless ordered by a court upon motion by the Commission. *See* Section 21(d)(4).

Conclusion

For the foregoing reasons, WLF urges the Commission to take all steps necessary to reduce the regulatory burden on public companies of complying with the proposed Rules implementing the whistleblower provisions of Dodd-Frank. The Commission should do more to require participation in robust internal corporate compliance programs required by Sarbanes-Oxley. At the same time, the Commission should do everything in its power to preclude wrongdoers from profiting from their own misconduct as whistleblowers. And finally, the Commission's Rules should not allow the payment of attorney contingency fees from whistleblower bounties. WLF appreciates the opportunity to submit these comments and thanks the Commission for the opportunity to provide meaningful feedback.

Respectfully submitted,

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