Exposing Corruption Exploring Solutions
Project On Government Oversight

December 17, 2010

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Via email: rule-comments@sec.gov

Dear Ms. Murphy:

The Project On Government Oversight (POGO) provides the following public comment on the Securities and Exchange Commission's (SEC) "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934" (Release No. 34-63237, File No. S7-33-10).

As an independent watchdog that champions good government reforms, POGO has a keen interest in establishing safe and open channels for whistleblower disclosures, and we welcome the opportunity to comment on the SEC's proposed rule.

POGO believes the SEC's mission to protect investors and regulate financial markets will be greatly advanced by incentivizing whistleblowers to come forward with tips, and by protecting those whistleblowers from retaliation. However, we are concerned that the SEC's proposed rules might be overly deferential to internal corporate compliance programs. As a result, the rules contain provisions that could jeopardize the ability of whistleblowers to make anonymous disclosures to the government without fear of retaliation, and include many traps that would disqualify credible whistleblowers and limit the flow of potentially valuable information to the SEC.

POGO would like to respond to several specific questions posed by the SEC in its proposed rules, and to offer other suggestions for strengthening the whistleblower award program.

BACKGROUND

Whistleblowers play an essential role in exposing corporate misconduct. A recent survey conducted by the Association of Certified Fraud Examiners found that nearly half of occupational fraud cases were uncovered by a tip or complaint from an employee, customer, vendor, or other source. In the case of detecting fraud perpetrated by owners

and executives, tips played an even more important role.[1] Another recent study found that whistleblowers played a bigger role than external auditors, government regulators, self-regulatory organizations, or the media in detecting fraud.[2]

Indeed, whistleblowers have featured prominently in numerous high-profile SEC enforcement cases. In late 2008, for instance, Glen and Karen Kaiser provided the SEC with information and documents that enabled the agency to reopen its investigation into insider trading at Pequot Capital Management, formerly the nation's largest hedge fund, leading to a $28 million settlement.[3] And the public is now well aware of the attempts by Harry Markopolos to provide the SEC with detailed evidence of Bernie Madoff's Ponzi scheme.

Whistleblowers often take tremendous personal and professional risks in order to expose corporate misconduct. Yet, the SEC often fails to make use of tips and to encourage more whistleblowers to come forward with relevant information. The SEC Office of Inspector General (OIG) has criticized the agency for failing to act on tips provided by Markopolos and other whistleblowers seeking to expose the Madoff and Stanford Ponzi schemes.[4] A separate OIG audit exposed some serious shortcomings in the SEC's previous whistleblower award program, which was limited to tips on insider trading. For instance, the audit revealed that only five people had received an award payment during the program's 20-year history. The OIG put forth a number of sensible recommendations for increasing awareness of the program and improving the agency's communication with whistleblowers.[5]

In some cases, the SEC's actions may have actively discouraged whistleblowers from coming forward with tips. For instance, POGO has written about an OIG investigation which found that an SEC enforcement attorney disclosed non-public information about a whistleblower from JPMorgan, and even encouraged JPMorgan's counsel to use the information against the whistleblower in a retaliation proceeding.[6]

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[1] Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse*, http://www.acfe.com/documents/2008-rttn.pdf (Downloaded December 17, 2010); Alexander Dyck, Adair Morse, and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?" http://www.afajof.org/afa/forthcoming/4820p.pdf (Downloaded December 17, 2010)

[2] Alexander Dyck, Adair Morse, and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?" http://www.afajof.org/afa/forthcoming/4820p.pdf (Downloaded December 17, 2010)

[3] Securities and Exchange Commission, "SEC Awards $1 Million for Information Provided in Insider Trading Case," July 23, 2010. http://www.sec.gov/litigation/litreleases/2010/lr21601.htm (Downloaded December 17, 2010)

[4] Securities and Exchange Commission, Office of Inspector General, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* (Report No. OIG-509), August 31, 2009. http://www.sec.gov/news/studies/2009/oig-509.pdf; and Securities and Exchange Commission, Office of Inspector General, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Case No. OIG-526), March 31, 2010. http://www.sec.gov/news/studies/2010/oig-526.pdf (Downloaded December 17, 2010)

[5] Securities and Exchange Commission, Office of Inspector General, *Assessment of the SEC's Bounty Program* (Report No. 474), March 29, 2010. http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf (Downloaded December 17, 2010)

[6] Michael Smallberg and Adam Zagorin, "Long Island Congressional Candidate Cited or Giving Up JPMorgan Whistleblower," *Politics Daily*, January 28, 2010.

Dodd-Frank reforms

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 21F to the Securities Exchange Act of 1934 and called for a major overhaul of the SEC's whistleblower award program. Section 21F provides several new tools to strengthen the program:

- Under the previous program, the SEC could only provide awards for tips related to insider trading; the SEC can now provide an award related to any administrative or judicial action that results in sanctions of more than $1 million
- Under the previous program, whistleblowers could only receive up to 10 percent of the amount recovered; under the new program, if an award is provided, it can be anywhere between 10 and 30 percent of the amount recovered
- Whistleblowers can make disclosures anonymously, as long as they're represented by counsel
- Whistleblowers can appeal the SEC's decision to not provide an award
- Whistleblowers cannot be retaliated against for providing a tip to the SEC, and can file for relief in U.S. District Court including reinstatement and back-pay if they are retaliated against
- The SEC must take steps to protect the confidentiality of whistleblowers, but can release information related to the substance of the whistleblower tips in response to public records requests[7]

A Senate report accompanying the Dodd-Frank bill elaborates on Congress's reasons for including Section 922:

> The Committee, having heard from several parties involved in whistleblower related cases, has determined that enforceability and relatively predictable level of payout will go a long way to motivate potential whistleblowers to come forward and help the government identify and prosecute fraudsters.
>
> The Committee intends for this program to be used actively with ample rewards to promote the integrity of the financial markets.[8]

The SEC should implement Section 21F in keeping with Congress's intent that the award program be strengthened and expanded in order to assist the government with its prosecution of corporate fraud.

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http://www.politicsdaily.com/2010/01/28/long-island-congressional-candidate-cited-for-giving-up-jpmorgan (Downloaded December 17, 2010)

[7] 111th Congress, "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Public Law 111-203), July 21, 2010, Section 922. http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf (Downloaded December 17, 2010)

[8] Senate Committee on Banking, Housing, and Urban Affairs, *The Restoring American Financial Stability Act of 2010* (Report No. 111-176), April 30, 2010, p. 112. http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf (Downloaded December 17, 2010)

POGO offers the following comments on the SEC's proposal for Regulation 21F to implement Section 21F of the Exchange Act.

REGULATION 21F

Internal compliance programs

POGO's concern is that the SEC's proposed rules might be overly deferential to the internal compliance programs that were established at many firms in the aftermath of Enron and after the passage of the Sarbanes-Oxley Act.

Despite the fact that Section 21F makes no mention of internal compliance programs, a public comment recently submitted by the Chamber of Commerce and other groups proposed that whistleblowers be required to report problems internally before going to the SEC.[9]

POGO urges the SEC to reject this reporting requirement, which is plainly contrary to the meaning and intent of Section 21F. In many cases, forcing a whistleblower to report a problem internally will undermine the SEC's ability to learn about corporate fraud. This is especially true in cases where senior managers and executives are implicated in the alleged fraud. For instance, the Association of Certified Fraud Examiners found that "internal controls were not as effective at detecting frauds committed by top-level perpetrators, as these individuals are often uniquely positioned to override even the best-designed controls."[10]

A recent survey conducted by KPMG revealed that many employees lack confidence in their firms' internal reporting systems. Nearly 75 percent of employees reported that they have personally observed or have firsthand knowledge of wrongdoing within their organizations during the previous 12 months (roughly 50 percent of the employees reported that the wrongdoing they observed could cause a "significant loss of public trust if discovered.") However, only 50 percent of the employees believed they would be protected from retaliation if they reported the wrongdoing to management, and even fewer believed they would be satisfied with the outcome of the internal investigation.[11]

An internal reporting requirement could do great harm to whistleblowers. Eric Havian, a prominent attorney with decades of experience working on False Claims Act cases, stated

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[9] Letter from Americans for Limited Government, Ryder Systems, Inc., *et al.*, to Securities and Exchange Commission regarding "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934," December 7, 2010. http://sec.gov/comments/s7-33-10/s73310-110.pdf (Downloaded December 17, 2010)

[10] Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse*, p. 19. http://www.acfe.com/documents/2008-rttn.pdf (Downloaded December 17, 2010)

[11] KPMG Forensic, *Integrity Survey 2008-2009*. http://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/Documents/KPMG%20Integrity%20Survey%202008.pdf (Downloaded December 17, 2010)

that an internal reporting requirement would "eviscerate the SEC program" from the outset and put whistleblowers in harm's way:

> If formal internal reporting is a requirement, the instant the SEC begins its investigation and serves its first subpoena, the corporation will have a short list of possible whistleblowers—i.e. those persons who formally reported the fraud to internal compliance. It will not be difficult for corporate attorneys to hone in on the likely turncoats. Nothing will create a greater chilling effect on the SEC whistleblower program than this proposed internal reporting requirement.[12]

Havian also challenged the claim made repeatedly by industry groups over the past few months that the award program will result in a deluge of whistleblowers circumventing their employers and going directly to the SEC in search of a big payout. Similar concerns were raised about the False Claims Act and the Internal Revenue Service's (IRS) whistleblower program, yet Havian notes that in his firm's "20-plus years of filing whistleblower cases, in almost every instance, whistleblowers seek to report their concerns internally, only coming to us as a last resort."[13]

Furthermore, if internal compliance programs were as effective as industry groups claim, we wonder why they failed to detect and avert the widespread financial fraud that precipitated the current economic crisis. In fact, there's a good chance that a strong SEC whistleblower award program will pressure companies to make substantial improvements to their own compliance programs in order to fix the problems before the employees have to go to the SEC.[14] POGO strongly recommends that the SEC resist any calls from industry to make internal reporting a requirement.

POGO is also deeply concerned by a statement in the commentary attached to the proposed rules suggesting that the SEC will occasionally send disclosures directly to the firms cited for misconduct and let them investigate the problems internally:

> We expect that in appropriate cases, consistent with the public interest and our obligation to preserve the confidentiality of a whistleblower, our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back.[15]

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[12] Some of this inflammatory rhetoric has also been repeated by senior DOJ officials such as Preet Bharara, U.S. Attorney for the Southern District of New York, who recently made statements to industry representatives about "whistleblowers run amok." Dena Aubin, "Prosecutor warns of 'whistleblowers run amok,'" *Reuters*, November 12, 2010. http://www.reuters.com/article/idUSTRE6AB4U720101112 (Downloaded December 17, 2010)

[13] Eric Havian, "Solution: Don't Let Wall Street Get Away With It! Protect and Reward SEC Whistleblowers," *Truthout*, December 15, 2010. http://www.truth-out.org/solution-dont-let-wall-street-get-away-with-it-protect-and-reward-sec-whistleblowers65971 (Downloaded December 17, 2010)

[14] David Childers, "Protect Against the Perils of the Dodd-Frank Whistleblower Guidelines," *Corporate Compliance Insights*, December 2, 2010. http://www.corporatecomplianceinsights.com/2010/protect-against-the-perils-of-the-dodd-frank-whistleblower-guidelines (Downloaded December 17, 2010)

[15] Securities and Exchange Commission, "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934" (17 CFR Parts 240 and 249, Release No. 34-63237,

Furthermore, according to sources, SEC Enforcement Director Robert Khuzami recently stated at a securities industry conference[16]:

> I am sure that it will be not uncommon, in the appropriate case, to contact the company and indicate that we have received this and have them undertake at least the same kind of initial review that they would currently do or hopefully that they would have done even if it had never come to our attention and it had stayed within the company.

POGO has serious concerns about the SEC sending whistleblower disclosures back to the firms accused of wrongdoing and letting them conduct their own investigations. In many cases, sending a tip back to the same firm cited for misconduct jeopardizes the confidentiality of the whistleblower who disclosed the wrongdoing. As such, this proposal contradicts Congress's clear intent to provide for safe and anonymous whistleblowing.[17] Furthermore, POGO is generally skeptical of government programs that rely on companies to investigate themselves.

POGO strongly recommends that the SEC reconsider its position about referring tips back to the companies accused of fraud, and explicitly clarify in the final rules that such referrals will not occur.

Original information

Proposed Rule 21F-4(b)(3) defines "independent analysis" as "your own analysis, whether done alone or in combination with others," and defines "analysis" as "your own examination and evaluation of information that may be generally available, but which reveals information that is not generally known or available to the public."

POGO urges the SEC to clarify that the analysis itself cannot have been previously published in one of the sources listed in Proposed Rule 21F-4(b)(1)(iii) ("a governmental report, hearing, audit, or investigation, or from the news media"), but that a new analysis could draw on facts published in these sources. This clarification would allow the SEC to receive tips from whistleblowers, such as Harry Markopolos, who often perform original analysis based on publicly available sources.

File No. S7-33-10), November 3, 2010, p. 34. http://sec.gov/rules/proposed/2010/34-63237.pdf (Downloaded December 17, 2010) (hereinafter "SEC Proposed Rules")

[16] Practising Law Institute, Securities Law Practice Center, "Securities Regulation Institute: Enforcement Agenda," November 12, 2010. http://seclawcenter.pli.edu/2010/11/12/securities-regulation-institute-enforcement-agenda/ (Downloaded December 17, 2010)

[17] The Dodd-Frank law created a similar whistleblower award program at the Commodity Futures Trading Commission (CFTC). It's worth noting that the CFTC's proposed rules make no mention of the agency sending tips back to the firms accused of misconduct. Commodity Futures Trading Commission, "Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act" (17 CFR Part 165), *Federal Register*, Vol. 75, No. 233, December 6, 2010. http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29022a.pdf (Downloaded December 17, 2010) (hereinafter "CFTC Proposed Rules")

Proposed Rule 21F-4(b)(iv) states that the SEC will not consider information to be derived from "independent knowledge" or "independent analysis" if it is obtained:

> Because you were a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, and the information was communicated to you with the reasonable expectation that you would take steps to cause the entity to respond appropriately to the violation, unless the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith.

Along similar lines, Proposed Rule 21F-4(b)(v) would exclude information that is otherwise obtained "through an entity's legal, compliance, audit or other similar functions or processes for identifying, reporting and addressing potential non-compliance with law, unless the entity did not disclose the information to the Commission within a reasonable time or proceeded in bad faith."

The SEC has asked if "the carve-out for situations where the entity does not disclose the information within a reasonable time promote effective self- policing functions and compliance with the law without undermining the operation of Section 21F."

Again, POGO is concerned that this rule demonstrates unnecessary deference to internal compliance programs. The SEC's commentary suggests a high barrier for demonstrating that a company acted in bad faith: "for example, an effort by company officials to destroy documents or to interfere with witnesses would constitute bad faith conduct."[18] Given the likelihood that the SEC will be receiving many tips from employees who first provided information to internal compliance programs, we urge the SEC to come up with a broader definition of "bad faith." For instance, a broader definition could include the failure to document investigations or to increase ethics awareness within the company.

The SEC is also declining to provide a specific definition of "reasonable time." POGO urges the SEC to consider adopting the Commodity Futures Trading Commission's proposal to define "reasonable time" as 60 days,[19] in order to ensure that internal compliance investigations are conducted in a timely fashion.

Proposed Rule 21F-4(b)(iv) would exclude information obtained "by a means or in a manner that violates applicable federal or state criminal law." The SEC is seeking comment on whether the exclusion should "extend to violations of the criminal laws of foreign countries."

POGO urges the SEC not to extend the exclusion to violations of foreign criminal laws. There may be situations in which a violation of a foreign criminal law is not a violation of a U.S. federal or state law, in which case the whistleblower should be entitled to disclose the information to the SEC.

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[18] SEC Proposed Rules, p. 26.
[19] CFTC Proposed Rules, p. 75730.

The SEC is also seeking comment on "information provided...in violation of judicial or administrative orders such as protective orders in private litigation." POGO believes that protective orders should never be used to conceal violations of federal securities laws from the SEC.

Anti-retaliation measures

Proposed Rule 21F-2 would define a whistleblower as an individual who, alone or jointly with others, provides the Commission with "information relating to a *potential* violation of the securities laws" (emphasis added). In commentary attached to the proposed rules, the SEC explained that using the term "potential violation" makes clear that the anti-retaliation measures set forth in Section 21F do not depend on an ultimate determination that the misconduct disclosed by the whistleblower meets the criteria for a violation of federal securities laws. In addition, Paragraph (b) of Proposed Rule 21F-2 makes clear that the anti-retaliation measures will still apply even if the whistleblower does not satisfy all the conditions to qualify for an award.

The SEC is seeking comment on whether the anti-retaliation measures in Section 21F should be "applied broadly to any person who provides information to the Commission concerning a potential violation of the securities laws."

Given the serious threat of retaliation facing corporate whistleblowers, POGO supports the SEC's Proposed Rule 21F-2, which broadly applies the anti-retaliation measures in Section 21F. Whistleblowers should not be subject to retaliation just because they don't qualify for the terms of the SEC's award program.

Staff communications with whistleblowers

Proposed Rule 21F-16(a) states that "no person may take any action to impede a whistleblower from communicating directly with the Commission staff about a potential securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement...with respect to such communications."

The SEC is seeking comment on whether these provisions would "encourage whistleblowers to provide information to the Commission regarding potential securities law violations."

POGO supports the SEC's proposal to ensure open communications between the agency and whistleblowers. The SEC should be primarily concerned with ensuring the free flow of information between the agency and any whistleblowers seeking to disclose corporate fraud. This proposal is especially important given that many firms require their employees to sign confidentiality agreements.

OIG RECOMMENDATIONS

POGO urges the SEC to consider adding other rules to incorporate recommendations made by the OIG in its audit of the previous whistleblower award program:

- Establish policies on when to follow-up with whistleblowers who submit applications to clarify information in the bounty applications and obtain readily available supporting documentation prior to making a decision as to whether a whistleblower's complaint should be further investigated.
- Examine ways in which the Commission can increase communications with whistleblowers by notifying them of the status of their bounty requests without releasing non-public or confidential information during the course of an investigation or examination.
- Develop a plan to incorporate controls for tracking tips and complaints from whistleblowers seeking bounties into the development of Enforcement's tips, complaints, and referrals processes and systems for other tips and complaints.
- Incorporate best practices obtained from DOJ and the IRS into the SEC bounty program with respect to bounty applications, analysis of whistleblower information, tracking of whistleblower complaints, recordkeeping practices, and continual assessment of the whistleblower program.[20]

If the SEC establishes better policies for communicating with whistleblowers throughout the application process, it could lessen the burden imposed on whistleblowers to explain the importance of their disclosures.

We would just add one note of caution: the SEC may wish to review some criticisms that have been made regarding the IRS whistleblower program. For instance, a 2009 audit by the Treasury Inspector General for Tax Administration found that the IRS's program does not have a good system in place to manage and track cases, and that no awards had actually been paid out under the new program, in part because the claims can take over a decade to process.[21] Recent reports indicate that the IRS has still not made any payments under the program.[22]

BUDGETARY ISSUES

Finally, we want to acknowledge that the SEC is under tremendous pressure to implement dozens of Dodd-Frank provisions in a narrow timeframe, and we appreciate the agency's efforts to strike a number of delicate balances in its implementation of the

[20] Securities and Exchange Commission, Office of Inspector General, *Assessment of the SEC's Bounty Program* (Report No. 474), March 29, 2010. http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf (Downloaded December 17, 2010)
[21] Treasury Inspector General for Tax Administration, *Deficiencies Exist in the Control and Timely Resolution of Whistleblower Claims*, August 20, 2009. http://www.treas.gov/tigta/auditreports/2009reports/200930114fr.pdf (Downloaded December 17, 2010)
[22] Ryan J. Donmoyer, "IRS Paid No Rewards in U.S. Whistleblower Program," *Bloomberg*, December 15, 2010. http://www.bloomberg.com/news/2010-12-15/irs-paid-no-rewards-to-informants-in-u-s-whistleblower-program.html (Downloaded December 17, 2010)

whistleblower award program. We also want to acknowledge that the agency is facing enormous staffing and budgetary challenges, which may create additional difficulties in the implementation of the program. For instance, the SEC recently announced it will be delaying the creation and staffing of the Whistleblower Office due to "budget uncertainty."[23]

However, we would caution the SEC not to scale back its implementation of the whistleblower award program due to exaggerated concerns that the agency will be overwhelmed with a deluge of tips. In fact, the SEC's lack of resources is all the more reason to encourage whistleblowers to help the agency uncover corporate fraud. SEC Chairman Mary Schapiro made this point in testimony before Congress last year:

> You can give us all the money and all the people in the world. And we're still going to need to rely on citizens and the private-sector accounting firms and others, to be able to do our job effectively.[24]

POGO urges the SEC to take every step necessary to facilitate the free flow of information from whistleblowers who can help the agency do its job, and to protect those whistleblowers from retaliation.

Thank you for your consideration of this comment. If you have any questions, please contact Angela Canterbury or Michael Smallberg at (202) 347-1122.

Sincerely,

Danielle Brian
Executive Director

[23] Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Act – Dates to be Determined," December 2, 2010. http://www.sec.gov/spotlight/dodd-frank/dates_to_be_determined.shtml (Downloaded December 17, 2010)

[24] Testimony of Mary Schapiro, "SEC Actions Relating to the Financial Crisis," Hearing before the House Appropriations Subcommittee on Financial Services and General Government Appropriations, March 11, 2009, p. 22. http://appropriations.house.gov/images/stories/pdf/fsdc/Hearing_Volumes/FinServ-FY10-Pt5.pdf#page=7 (Downloaded December 17, 2010)