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December 17, 2010

Mary L. Schapiro  
Securities Exchange Commission  
100 F Street, NE  
Washington, DC 20549

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

Dear Chairman Schapiro:

The National Association of Criminal Defense Lawyers (NACDL) is the preeminent organization in the United States advancing the mission of the nation's criminal defense lawyers to ensure justice and due process for persons accused of crime or other misconduct.<sup>1</sup> A professional bar association founded in 1958, NACDL's more than 10,000 direct members—and 94 state, local, and international affiliate organizations with another 35,000 members—include private criminal defense lawyers, public defenders, active U.S. military defense counsel, law professors and judges committed to preserving fairness within America's criminal justice system.

NACDL's members represent both individuals and entities who have come under government scrutiny. NACDL has an interest in orderly and fair internal investigations of suspect conduct and the proper functioning of compliance and ethics programs. It is with this goal in mind—fairness—that NACDL offers the comments that follow.

The Commission seeks comments on proposed rules that are intended to implement the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In doing so, the Commission has emphasized its goal to strike the right balance between the Commission's

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<sup>1</sup> NACDL wishes to acknowledge the following members of its White Collar Crime Committee for their assistance with this letter: Carol Elder Bruce, Christopher Hall, and Roger Heaton.

need for an effective whistleblower awards program and the preservation of robust corporate self-policing and reporting. Specifically, the Commission has requested comment on the intersection between section 21F and established internal systems for the receipt, handling, and response to complaints about potential violations of law.

**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? If so, are there appropriate ways to limit the nature or extent of the exclusion so that any recognition of relationships of professional trust does not undermine the purposes of Section 21F?*

**Comment:**

As the Commission recognizes in its own Commentary, “[c]ompliance with the federal securities laws is promoted when individuals, corporate officers, and others consult with counsel about potential violations, and the attorney-client privilege furthers such consultation.” 75 Fed. Reg. 70492 (Nov. 17, 2010). There are seven circumstances proposed by the Commission in which that information will not be considered to derive from an individual’s “independent knowledge” or “independent analysis,” as defined by Proposed Rules 21F-4(b)(2) and (3). The fourth exclusion to Proposed Rule 21F-4(b)(4) applies when a person “with legal, compliance, audit, supervisory, or governance responsibilities for an entity receives information about potential violations, and the information was communicated to the person with the reasonable expectation that the person would take appropriate steps to cause the entity to respond to the violation.” “The fifth proposed exclusion is closely related, and applies any other time that information is obtained from or through an entity’s legal, compliance, audit, or similar functions or processes for identifying, reporting, and addressing potential non-compliance with applicable law.” *Id.* at 70493.

NACDL supports these exceptions, but takes issue with the failure to honor the confidences obtained during the performance of these legal, auditing, and compliance functions. The proposed Rule provides that “each of these two exclusions ceases to be applicable, with the result that an individual may be deemed to have ‘independent knowledge,’ and therefore may become a whistleblower, if the entity does not disclose the information to the Commission within a reasonable time or if the entity proceeds in bad faith.” *Id.* Such a “safety valve” clause, especially one with such subjective triggers, eviscerates one of the most essential components of any legal, audit, and compliance function—that is, that the people employed in these trusted positions will always act in the interest of the company and not act in their own financial or personal self interest.

The Commission seriously devalues the importance of these confidences in its unsuccessful attempt to “strike a balance between two competing goals.” The Commission writes, “[o]n the one hand, [the proposed rule] is designed to facilitate the operation of effective internal compliance programs by not creating incentives for company personnel to seek a personal financial benefit by “front running” internal investigations . . . .” *Id.* at 70494. Further, the Commission states, “[o]n the other hand, it would permit such persons to act as whistleblowers *in circumstances where the company knows about material misconduct but has not taken appropriate steps to respond.*” *Id.* (emphasis added). Thus, the Commission believes it is

providing a safety valve for frustrated internal lawyers, auditors, and compliance personnel. But this “safety valve” assumes that there is no alternative for impressing management with the need for corrective action and/or disclosure to the Commission when compliance personnel have identified material misconduct and no action is promptly taken by management. In fact, there are valid and often-times required alternatives in such instances, including conferring with outside company counsel and/or reporting to the Board of Directors and/or a company’s Audit Committee.

Notably, this proposed rule does not require an internal lawyer, auditor, or compliance officer to exhaust his or her “internal” reporting options, regardless of whether such actions are required under a company’s compliance system. Also of note, this proposed rule does not purport to establish a reasonable timeframe for the lawyer, auditor, or compliance officer to give the entity to investigate the alleged conduct, to take any necessary remedial action, or to self-report before the trusted employee unilaterally files his or her own report with the Commission and seeks to reap a reward as a whistleblower. NACDL respectfully submits that the Commission creates a false “tension,” where none should exist, between the importance of maintaining an effective corporate compliance program and the importance of permitting whistleblowers to report violations of the securities laws. If the exclusion were to be absolute and have no safety valve as created by these proposed rules, corporate officers, boards, shareholders, bondholders, lenders, and the public could be confident that the internal compliance and review teams of lawyers, auditors, and compliance personnel would not behave individually as anarchists, acting in their own financial self-interest to gain a large bounty, but, instead, could always be counted on to behave as dedicated investigators committed to the singular and honorable goal of keeping the company in compliance with the securities regulations and the law.

The holding and reasoning of the unanimous *Upjohn* decision, *Upjohn Co. v United States*, 449 U.S. 383 (1981), almost 30 years ago, in which the Court held that a company could invoke the attorney-client privilege to protect communications made between company lawyers and a company’s employees, is as valid today as it was then. The ethical obligation of a lawyer to hold inviolate the confidences of his or her client not only facilitates the essential development of all facts necessary to the proper representation of the client, but it also encourages the company to seek legal assistance. *Id.* at 391. NACDL is concerned that this rule comes close to a government-mandated reporting obligation on members of the legal profession or persons assisting lawyers to the extent the rule presumes that all entities should self-report to the Commission in every instance (see below). NACDL is further troubled by the inclusion of any incentive in this rule that would encourage the erosion of the attorney-client privilege or that might create a conflict with a lawyer’s legal and ethical obligation to his or her clients.

Additionally, NACDL believes that allowing legal, compliance, and other governance personnel to reap economic rewards for sharing information with the government learned through the natural course of their duties for the company undermines the purpose and powerful impact of the Federal Sentencing Guidelines for Organizations (FSGO), which were promulgated by the United States Sentencing Commission ten years after the *Upjohn* decision. The enormous growth of effective internal compliance and audit programs, and securities reporting obligations in the 20 years since the organizational guidelines came into being, has helped create a corporate culture that places a high value on the confidential nature and quality of the communications that occur within the internal legal, audit, and compliance functions. The effectiveness of these

compliance programs demands that its compliance personnel not be fickle players scrambling to be the first to claim some imagined pot of gold, and that the confidential nature of their work not be regarded as a fleeting inconvenience for the Commission. If the confidences are that fragile and fleeting, then the programs will cease to be effective.

Lastly, the proposed rules appear to presume that entities should self-report in every instance. Persons with “legal, compliance, audit, supervisory, or governance responsibilities” can present as “independent analysis” information they obtain during the scope of their employment if “the entity did not disclose the information to the Commission within a reasonable time.” This definition—and a similar regulatory scheme in subsection (b)(4)(v)—presume that reports of information by whistleblowers to their employer entities as part of a robust compliance program should always result in a disclosure by the entity. This policy presumes that all reports by whistleblowers always warrant disclosure, regardless of whether the alleged infraction is material or supported by credible evidence. The logical consequence of this policy will be (a) numerous, low quality referrals to the Commission (precisely what the Commission does not want), and (b) the evisceration of the vital role that compliance officers, senior executives, and independent directors play in exercising their judgment about when to self-disclose.

**Request for Comment 17:** *Is the 90-day deadline for submitting Forms TCR and WB-DEC 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? Should a longer time period apply in instances where a whistleblower believes that the company has or will proceed in bad faith?*

**Comment:**

As currently drafted, proposed rule 21F-4(b)(7) provides a 90-day marker for whistleblowers who provide information to others, including to their employer’s compliance officials. The stated intention for this provision is to encourage whistleblowers who work for companies that have robust compliance programs to first report violations to appropriate company personnel, while preserving the whistleblower’s status as an original source and eligibility for an award.

The proposed provision does not provide adequate time for a responsible company in typical circumstances to conduct a thorough investigation and assessment. The Commission states that it wants the whistleblower incentive program to yield high quality information. High quality information will often relate to complex transactions. Today’s era of electronic communication has spawned extensive communication and commerce, which is typically all recorded. The identification of records custodians and the recovery of stored communications and documents pertaining to complex transactions can take months; and the review and analysis of these records much longer. This review, in turn, provides the foundation for essential witness interviews that necessarily follow. Given these circumstances, the proposed 90-day marker fails to afford companies with robust compliance programs a meaningful opportunity to conduct an internal investigation. A longer grace period—double the proposed 90 day period *at a minimum*—is warranted. Without this leeway, whistleblowers will feel compelled to report unresolved allegations to the Commission before the 90 day period expires, resulting in the filing of unfiltered, untested, and uncorroborated TCRs and WB-DECs—just what the Commission does *not* want.

In addition, because proposed rule 21F-4(b)(7) as written does not require whistleblowers to wait 90 days before they file a TCR, entities will, in practice, assume they have less than 90 days to conduct and complete their internal assessments. This will force entities to rush to judgment and, again, will likely result in numerous tentative and qualified self-disclosures, precisely the type of low quality information the Commission wants to avoid.

Lengthening the marker timeframe will not likely prevent the Commission from conducting an effective supplemental investigation should a whistleblower determine that, after a fair opportunity to conduct an investigation and respond appropriately, an entity has failed to do so. There is no statute of limitations for injunctive relief and disgorgement under the securities laws. Extending the window for an internal assessment to at least six months will not compromise the Commission's ability to later enforce its laws as necessary in the event a corporation fails to respond appropriately.

**Request for Comment 18:** *Should the Commission consider other ways to promote continued robust corporate compliance processes consistent with the requirements of Section 21F? If so, what alternative requirements should be adopted? Should the Commission consider a rule that, in some fashion, would require whistleblowers to utilize employer-sponsored complaint and reporting procedures? What would be the appropriate contours of such a rule, and how could it be implemented without undermining the purposes of Section 21F? Are there other incentives or processes the Commission could adopt that would promote the purposes of Section 21F while still preserving a critical role for corporate self-policing and self-reporting?*

**Comment:**

The Commission should consider other ways to promote robust corporate compliance processes consistent with the requirements of Section 21F. The Commentary to the proposed rule asserts that internal processes will not be bypassed because the Commission intends "in appropriate cases" to contact companies, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back. The Commission, however, does not specify how it will identify "appropriate cases," leaving entities to guess about when the Commission will afford them the opportunity to investigate internally. NACDL proposes that the Commission require whistleblowers in the first instance to follow their entity's internal reporting processes where a company has adopted a compliance program that meets the criteria for an effective compliance and ethics program as outlined by the United States Sentencing Commission at §8B2.1 of the United States Sentencing Guidelines.

**Request for Comment 19:** *Would the proposed rules frustrate internal compliance structures and systems that many companies have established in response to Section 10A(m) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act of 2002, and related exchange listing standards? If so, consistent with Section 21F, how can the potential negative impact on compliance programs be minimized?*

**Comment:**

As discussed above, the proposed rules appear to presume that entities should self-report in every instance. This underlying presumption, which is incorrect and ill-advised, is most evident in the

definition of “original information” set forth at proposed Rule 21F-4(b), and discussed above in our Comment in response to Request for Comment 11.

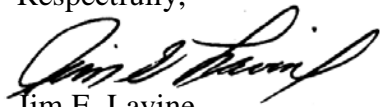
In addition, the proposed system for setting financial rewards will also work to frustrate internal compliance structures and systems that many companies have established at great expense. For example, footnote 40 of the Commission’s Commentary states that the Commission will give credit in award calculations to whistleblowers who use established corporate internal procedures, but does not explain how. Will the Commission reward whistleblowers at the low end of the 10% - 30% range if they do not first report internally? Or will the Commission conversely reward whistleblowers at the high end of the range if they report internally first? Or both? If the Commission intends to reward whistleblowers who avail themselves of established ethics and compliance programs, what specific conduct will the Commission require for the enhanced payment? NACDL urges the Commission to speak clearly on this point, and to use the award system to encourage whistleblowers to report first to internal compliance officials. Clear monetary incentives to use compliance processes established by entities will result in higher quality self-referrals to the Commission by entities themselves—precisely the conduct the Commission wants to encourage.

The vagueness in footnote 40 carries over to proposed rule 21F-6. Subsection 21F-6(d) states that when making awards the Commission will consider whether the award will enhance its ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information from whistleblowers. In the Commission’s Commentary to the proposed rule, it presents examples of conduct that meets these criteria, including the submission of information by a whistleblower through a company’s compliance procedures. But the Commentary then appears to backtrack, as the next sentence states that a whistleblower who does not report to an entity first out of “fear of retaliation or other legitimate reasons” will not be given less credit than a whistleblower who does follow internal reporting processes. Federal Register, Vol. 75, No. 221, Wednesday, November 17, 2010, at 70500. This policy completely conflicts with the stated objective of encouraging employees to use internal compliance processes and, in any event, is not necessary. Section 21F(h)(1) of the Exchange Act, 15 U.S.C. 78u-6(h)(1), prohibits retaliation. In short, the statute already protects whistleblowers from retaliation. An enhanced financial reward for a whistleblower who does not report internally first represents a gratuitous windfall. The rule as written will eviscerate the Commission’s stated intention of supporting corporate compliance mechanisms in the first instance.

### **Conclusion**

NACDL hopes that these comments help the Commission to strike the right balance between whistleblower incentives and protection, on the one hand, and fair processes for the internal investigation and assessment of suspect conduct by entities on the other.

Respectfully,



Jim E. Lavine

President, National Association of Criminal Defense Lawyers