December 17, 2010

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

Re: ***File Number S7-33-10***
Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

Dear Ms. Murphy:

Deloitte LLP ("Deloitte") is pleased to submit this letter in response to the request by the Securities and Exchange Commission ("SEC" or "Commission") for public comments on its Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (the "Proposed Rules"). The Proposed Rules are designed to implement a whistleblower program (the "Whistleblower Program") that seeks to encourage individuals voluntarily to provide "original information" to the SEC relating to actual or potential violations of the securities laws. The SEC issued the Proposed Rules, and the accompanying release (the "Proposing Release"), pursuant to Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act").

Deloitte supports the ultimate goal of the Whistleblower Program: promoting "greater deterrence" of securities law violators by identifying "high-quality information" that will enhance the "effectiveness and efficiency" of securities law enforcement.[1] Deloitte is committed to providing high quality audits, and, to this end, encourages steps to help ensure that strong controls are in place both to deter and to detect wrongdoing. Deloitte also appreciates the important role that a robust system of enforcement plays in maintaining public and investor confidence in the financial markets.

Our comments address two broad aspects of the Proposed Rules. First, Deloitte agrees with the Commission's efforts to exclude from the Whistleblower Program instances of auditors reporting on the suspected violations of audit clients, and strongly supports implementation of an exclusion in the Proposed Rules for individuals who obtained their information through the audit of a company's financial statements and for whom making a whistleblower submission would be contrary to the requirements of Section 10A of the

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[1] Proposing Release, 75 Fed. Reg. at 70,489, 70,496.

Securities Exchange Act of 1934 ("Section 10A"). The compelling policy reasons that support the exclusion for auditors reporting on clients also justify extending the final rule, so that the exclusion in Proposed Rule 21F–8(c)(4) covers individuals whose information was obtained through any services provided by an accounting firm or its affiliates to an audit client.[2] Deloitte believes that the Proposed Rules also should expressly exclude from the Whistleblower Program personnel within an accounting firm reporting on the suspected violations of the firm or its personnel. These exclusions are further supported by considerations related to the utility of internal compliance procedures discussed immediately below.

Second, Deloitte believes that the final rules should focus on protecting the efficacy of companies' and accounting firms' internal compliance procedures. In this regard, we are concerned that the Proposed Rules could create a monetary incentive for whistleblowers to bypass established and effective internal reporting procedures and report their concerns directly to government regulators. There is no countervailing incentive or requirement in the Proposed Rules for whistleblowers to channel their concerns first through the very internal systems that Congress and government regulators have encouraged companies to establish. Without such a countervailing requirement or incentive, the Proposed Rules could diminish the quality of financial reporting by increasing the incidence of financial reports or earnings results that include inaccurate information that otherwise might have been corrected had management been alerted through internal procedures. Deloitte also believes that by discouraging the use of internal procedures the Proposed Rules may raise concerns about the design effectiveness of an issuer's internal controls over financial reporting ("ICFR"). To avoid these serious unintended consequences for the audit process, we encourage the Commission to adopt final rules that limit eligibility for monetary awards to whistleblowers who first use company-sponsored complaint and reporting procedures.

A. The Exclusions For Accounting Firm Personnel Reporting On Clients Are Appropriate And Should Be Extended.

Under Dodd-Frank, to be eligible to receive a monetary award, a whistleblower must "voluntarily" provide "original information" to the Commission that leads to a successful enforcement action.[3] The Act defines "original information" to include, among other necessary elements, information that "is derived from the independent knowledge or analysis

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[2] Deloitte anticipates that the scope of the exclusions discussed in this letter would encompass work performed on an engagement of the accounting firm by its personnel and that of its affiliates (collectively, "accounting firm"), as well as work on the engagement by personnel of member firms that may be associated with the global networks of such firms.

[3] Pub. L. 111-203, § 922, 124 Stat. 1376, 1842 (2010).

of a whistleblower."[4] In addition, the Act directs that no monetary award shall be made to a whistleblower whose information was gained "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."[5] This latter provision means that auditors who are required to report on the suspected violations of an audit client in an engagement for audit services will generally be ineligible to receive a whistleblower award.

Tracking the statutory exclusion for information obtained during the course of an audit, Proposed Rule 21F–8(c)(4) excludes from eligibility to receive a whistleblower award individuals whose information was obtained "through an audit of a company's financial statements, and making a whistleblower submission would be contrary to the requirements of Section 10A." In addition, in defining the term "independent knowledge or analysis," the Proposed Rules provide for the non-eligibility of a whistleblower whose information was obtained "[t]hrough the performance of an engagement required under the securities laws by an independent public accountant, if that information relates to a violation by the engagement client or the client's directors, officers or other employees."[6] This latter exclusion effectively extends the scope of the exclusion set forth at Proposed Rule 21F–8(c)(4).[7]

Deloitte supports the Proposed Rules' exclusion of information obtained during the course of an audit, but believes that the final rules should extend the exclusion beyond reporting based on audit services. Without such exclusion, there may be a harmful effect on auditor-client relations, the audit process, and public confidence in financial reporting. Therefore, Deloitte respectfully requests that the final rules clarify and extend the exclusions at Proposed Rule 21F–8(c)(4) or 21F–4(b)(4)(iii) to cover individuals who provide information obtained through an engagement with an audit client for audit or nonaudit services. An extension of the exclusion in this manner is "consistent with the purposes" of Section 922 of Dodd-Frank. The SEC may clarify and extend the exclusion for auditors pursuant to the Commission's broad authority to "issue such rules and regulations as may be

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4 *Id.*

5 *Id.* at 1843.

6 Proposed Rule 17 C.F.R. § 240.21F–4(b)(4)(iii).

7 *See* Proposing Release, 75 Fed. Reg. at 70,502 n.68. The Proposed Rules also define the term "voluntary" to exclude individuals who are "under a pre-existing legal or contractual duty to report the securities violations that are the subject of" the whistleblower submission to the SEC or other named governmental or self-regulatory authority. Proposed Rule 17 C.F.R. § 240.21F–4(a)(3).

necessary or appropriate to implement the provisions of this section consistent with the purposes of this section."[8]

1. The Final Rules Should Clarify That The Exclusion Extends To All Services That An Accounting Firm Provides To Audit Clients.

The Proposed Rules recognize that Dodd-Frank's exclusion for accountants should be expansive. As the Commission noted, in addition to Section 10A, "there are other Commission-required engagements by an independent public accountant, such as audits of broker-dealers and custody exams of investment advisers that require the external accountant to report instances of noncompliance."[9] Further, "[p]rofessional standards for independent public accountants also prescribe responsibilities when a possible illegal act is detected."[10] For these reasons, the Commission has proposed to extend the whistleblower exclusion through Proposed Rule 21F–4(b)(4)(iii).

In describing the scope of this exclusion in footnote 32 of the Proposing Release, the Commission states that "independent knowledge" and "independent analysis" would not include information obtained through an independent public accountant's review of interim financial statements included in quarterly reports on Form 10–Q pursuant to Rule 10–01(d) of Regulation S–X.[11] Footnote 32 further states that the Commission "anticipates" the exclusion would also encompass information obtained through other engagements by an independent public accountant for an audit client.[12] The guidance in footnote 32 is helpful, but Deloitte believes that the final rules should more clearly exclude from the Whistleblower

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[8] Pub. L. 111-203, § 922, 124 Stat. 1376, 1847–48. The Proposed Rules include many instances of the SEC exercising its broad rulemaking authority to supplement the statutory text. One example is the exclusion under Proposed Rule 21F–8(c) for members, officers, and employees of a foreign government. This exclusion is not one of the enumerated exemptions in Dodd-Frank and reflects the SEC's desire to avoid creating "negative repercussions for United States foreign relations." Proposing Release, 75 Fed. Reg. at 70,502. Nor does Dodd-Frank set forth an exclusion for family and household members of SEC employees, an exclusion which the SEC sensibly proposes "in order to prevent the appearance of improper conduct." *Id.* These and other examples show that the SEC recognizes that its rulemaking authority under Section 922 of Dodd-Frank is broad.

[9] Proposing Release, 75 Fed. Reg. at 70,493 (footnotes omitted).

[10] *Id.*

[11] *See* 17 C.F.R. § 210.10–01(d) (requiring review by an independent public accountant of interim financial statements included in Form 10–Q reports).

[12] Proposing Release, 75 Fed. Reg. at 70,493 n.32.

Program reporting by accounting firm personnel based on information that is obtained from nonaudit, as well as audit, engagements. Such a clarification would provide a sound basis in the final rules for the types of engagements discussed in footnote 32 of the Proposing Release. Accordingly, Deloitte urges the Commission to provide expressly in the final rules that whistleblowers whose information was obtained through any services to public company audit clients provided by an accounting firm are excluded from eligibility to receive a whistleblower award.

The independent audit process works best when registrants and investors have confidence in the objectivity and independence of accounting firms and their personnel. The prospect that personnel from an accounting firm may collect a monetary award from a regulator by providing information obtained through an audit or nonaudit engagement would undermine orderly audit processes and could disrupt the relationship between auditors and the companies they audit. Auditors hold a position of confidence, due in part to the existence of established procedures they follow to address the potential illegal acts of the client that are covered by the Whistleblower Program. Among other things, these established procedures provide mechanisms to identify and rectify problems at an early stage. As reflected in the Act, Section 10A sets forth detailed procedures that accounting firms must follow when suspected illegal acts are identified during the course of an audit, including the requirement that the accounting firm report its findings directly to management, and in some cases to the independent audit committee. If accounting firm personnel working on nonaudit engagements for an audit client are incentivized to report outside this process, such reporting may adversely affect, and undermine confidence in, the audit process.[13]

Clarification of the exclusion is also necessary to avoid internal conflicts of interest within the accounting firm. For example, personnel who serve a particular client as part of an audit team may have an obligation to report information in accordance with Section 10A, and would be barred from engaging in whistleblowing by the Proposed Rules. Other personnel who become aware of the same information while serving the same client in a *nonaudit* capacity might be perceived to have a conflicting incentive *not* to notify the client or *not* to report internally, and instead seek an award by reporting to the SEC.[14] Without

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[13] Our clients and the investing public value the Deloitte name for the high standards of professionalism and integrity it represents. Deloitte professionals strive continuously to uphold the firm's reputation, not only through the provision of high-quality audits to our attest clients, but also through a firm-wide culture of open and ethical dealing with all of our clients. That is among the reasons why we are concerned by the prospect—or even merely the perception—that any segment of Deloitte professionals has a personal financial motive to bypass established internal procedures, ignore ethical standards, and betray client confidences.

[14] Although the Proposed Rules provide for a 90-day grace period during which a whistleblower may report to the SEC after having reported internally and still receive the benefit of the earlier

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clarification, the latter group may be of the view that the exclusion in Proposed Rule 21F–4(b)(4)(iii) is not applicable to them, report directly to the SEC, and expect to be eligible for a financial reward. If a rule is established that treats information obtained through audit and nonaudit engagements differently, thereby potentially allowing personnel who obtain information through nonaudit engagements to act as whistleblowers without regard to the procedures or rationale of Section 10A, then the company's confidence that the auditor is objective may erode.

These concerns relate directly to an accountant's professional obligations. As described below, Rule 301 of the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct requires accountants to keep client information confidential. In addition, the AICPA Code of Professional Conduct provides: "Integrity . . . is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions."[15] To that end, the AICPA Code of Professional Conduct instructs that "[s]ervice and the public trust should not be subordinated to personal gain and advantage."[16]

A final rule that expressly excludes information gained through both audit and nonaudit engagements of an accounting firm with an audit client of that firm would mitigate the concerns described above.[17]

2. Services Provided To Nonaudit Clients.

Accounting firms may be engaged to perform a range of services for nonaudit clients. For virtually all of these services, the firm and its personnel will owe professional duties of confidentiality to the clients. For example, Rule 301 of the AICPA Code of Professional Conduct states: "A member in public practice shall not disclose any confidential client information without the specific consent of the client."[18] State licensing rules for accounting

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reporting date, that provision is not an *incentive* for employees to report internally. In the absence of a requirement or an incentive to report internally, employees may opt to report exclusively to the SEC so as to minimize the risk that the company will correct the purported misconduct before a report is filed or an announcement is made.

15 AICPA Code of Professional Conduct ET Section 54.01.

16 *Id.* at 54.02.

17 In addition, there may be circumstances where an individual may claim that there is uncertainty regarding whether the individual is performing audit or nonaudit services for an audit client, making exclusion of the latter desirable for prophylactic reasons.

18 AICPA Code of Professional Conduct ET Section 301.

firm professionals may impose additional duties of confidentiality.[19] Signaling "[t]he need to maintain and broaden public confidence," the AICPA Code of Professional Conduct also, as noted, instructs members not to subordinate public trust to "personal gain and advantage."[20] Notwithstanding these requirements, individuals providing services to clients could be incentivized by the Proposed Rules to breach those obligations of confidentiality and integrity. We are concerned that in the absence of an exclusion for services to nonaudit clients, the Proposed Rules could lead to confusion, and could even promote an impression that it would be permissible for personnel on certain engagements to breach their professional responsibilities to clients by reporting under the Whistleblower Program. Such breaches have the potential to do tremendous harm to the relationships between the accounting firm and nonaudit clients.

Deloitte also recognizes that compliance is best achieved when personnel know the rules by which they are governed, and, to the extent possible, have bright lines to guide them. Confusion and conflicts of interest may result under the Proposed Rules because personnel serving audit clients and those serving nonaudit clients may be subject to different rules regarding the reporting of suspected violations.

The Commission, as part of the rulemaking process, needs to consider and address these issues. We believe that the most appropriate way to avoid the problems described above is by imposing an exclusion for services performed for nonaudit clients as well.

B. The Final Rules Should Focus On Protecting Companies' Internal Compliance Procedures.

The Proposed Rules create a financial incentive for individuals to disregard their companies' internal compliance procedures and report suspected violations directly to the SEC. While the Proposed Rules include a 90-day grace period to prevent individuals from being penalized for first reporting their concerns through internal channels, there is no financial incentive for would-be whistleblowers to do so. A whistleblower may choose not to report internally, absent a requirement to do so, because he or she believes that the company may rectify the problem and therefore be subject to lesser or no monetary sanctions. Thus, from a whistleblower's perspective, internal reporting may *lessen* the likelihood of receiving a monetary award and/or reduce the potential size of the award.

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[19] *See*, *e.g.*, 21 N.C. Admin. Code 08N.0205 (2004) ("A CPA shall not disclose any confidential information obtained in the course of employment or a professional engagement except with the consent of the employer or client."); Code of Professional Conduct of the New York State Society of Certified Public Accountants ET Section 301 ("A member in public practice shall not disclose any confidential client information without the specific consent of the client.").

[20] AICPA Code of Professional Conduct ET Section 54, Art. III; *id.* at 54.02.

Without effective internal procedures for detecting and deterring wrongdoing, the accuracy of reported financial information may be at risk. Deloitte respectfully submits that the final rules should strike a more constructive balance between ensuring the operation of effective internal compliance programs, and encouraging appropriate whistleblowing.

Any final rule should require, as a condition of eligibility to receive a monetary award that whistleblowers report their concerns fully and in good faith through company-sponsored whistleblower systems before reporting externally. At a minimum, the final rules should require the concurrent submission of internal and external reports.[21] In the alternative, any final rule should expressly state that good-faith internal reporting prior to making any external report will be considered a strongly positive factor in determining the amount of a whistleblower award, and that a whistleblower's failure to use internal whistleblower systems prior to reporting to the SEC will be considered a strongly negative factor.

The SEC has broad authority to promulgate a final rule that requires timely internal reporting prior to external reporting as a condition for eligibility to receive a whistleblower award, or that considers the existence or absence of such internal reporting as strongly positive or negative factors, respectively, in determining the amount of an award. The SEC may, for example, limit the definition of "whistleblower" to one who first uses internal whistleblower procedures. Or it may provide that "such additional relevant factors" in "determining the amount of an award" may include the existence or absence of prompt internal reporting.[22]

1. The Auditor's Internal Compliance System Could Be Negatively Impacted By The Proposed Rules.

Deloitte believes that the final rules should exclude all instances of auditors reporting suspected violations of other auditors. We are concerned that the Proposed Rules may encourage accounting firm personnel to report alleged violations by the firm first to the SEC, rather than initially through the firm's internal procedures. This possibility—auditors reporting on auditors—could adversely impact the audit process itself. As an initial matter, to the extent these situations arise, it is likely that the information reported would include some aspect of the client's conduct, including its financial reporting, and could implicate the auditor's confidentiality obligations to the client. For the reasons described above, reporting

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[21] Deloitte believes that a sequential reporting requirement is preferable to a concurrent reporting requirement, as it would allow companies to demonstrate their commitment to integrity in financial reporting using their existing internal procedures and resources and would enhance the likelihood that the Section 10A process will operate as intended.

[22] *Cf.* Pub. L. 111-203, § 922, 124 Stat. 1376, 1843.

in these situations should occur through existing procedures. Specifically, Section 10A includes "requirements for the auditor if the auditor detects or otherwise becomes aware of information indicating an illegal act, which in certain circumstances can include reporting directly to the Commission."[23] "Professional standards for independent public accountants also prescribe responsibilities when a possible illegal act is detected," as the Commission has noted.[24] For example, auditing standards promulgated by the Public Company Accounting Oversight Board direct an auditor to "assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor's attention."[25]

Deloitte also has systems in place to assist its personnel with professional and compliance matters. Deloitte's ethics and compliance program's Integrity Helpline, for example, allows personnel to ask questions and express concerns over possible noncompliance. It can play an important role in detecting and preventing violations, safeguarding client information, and maintaining the firm's reputation for integrity. Similarly, Deloitte's consultation process is available to assist personnel in making professional determinations, and its effective operation is also important to the high-quality services that we provide our clients. Deloitte is concerned that the Proposed Rules may inadvertently incentivize personnel not to use these systems.

An increase in the incidence of external reporting by auditors on the conduct of other auditors, as noted above, may have a corrosive effect on public trust in the accounting profession and a negative impact on the audit process itself. Personnel within accounting firms should be able to consider professional accounting matters and audit requirements without enhanced risk that a dissenting colleague will preempt the orderly dispute resolution processes and take his or her concerns directly to the SEC. When issues have not been fully deliberated internally, premature disclosures by clients of financial results may convey incomplete or unreliable information.

To be sure, Deloitte firmly believes that employees have a right, and, in appropriate circumstances, a duty to communicate their concerns regarding potential illegal acts to management, and in appropriate circumstances to the SEC. We do not, however, support a system of enforcement that could undermine an accounting firm's quality assurance procedures.

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[23] Proposing Release, 75 Fed. Reg. at 70,493.

[24] *Id.*

[25] Public Company Accounting Oversight Board Interim Standard AU Section 317.17, *Illegal Acts by Clients*.

2. Companies' Internal Compliance Systems And ICFR Evaluations Under Sarbanes-Oxley Could Be Negatively Impacted By The Proposed Rules.

The Proposed Rules would also have negative impacts on companies' internal compliance systems. Deloitte's concern in this regard is twofold: we have an interest in ensuring that our clients have accurate financial reporting; and both our clients and we are required to evaluate the effectiveness of companies' ICFR, which may be impacted by the Proposed Rules.

a. Not Requiring Good-Faith Reporting In The First Instance Through Companies' Internal Compliance Systems May Result In Less Accurate Financial Statements.

A rule that rewards whistleblowers who bypass internal reporting procedures will not necessarily result in more accurate financial statements—and may in fact result in *less* accurate financial statements. Internal reporting gives the registrant and its auditor an opportunity to correct problems *before* they impact the financial statements that are included in reports filed with the Commission or results that are announced before filing. When suspected wrongdoing is reported internally, management often can move quickly to investigate, prevent the violation from occurring, or mitigate the impact of an error. This may include preventing any misleading disclosure to investors, removing culpable individuals from positions of responsibility, adopting additional measures designed to prevent future violations, disciplining employees who had prior knowledge of the wrongdoing but failed to intercede, and making appropriate disclosures in SEC reports or to the SEC or other regulatory authorities.

If whistleblowers report their information directly to the SEC, however, the responsibility for the effectiveness of the whistleblower control would be shifted to the SEC, and the opportunity for companies and their auditors to help ensure accurate financial reporting may be delayed or even lost if allegations are not promptly communicated to registrants as they are received.

An example illustrates how this may occur in practice. If an employee of a registrant sees a problem late in the fourth quarter and reports his or her concerns to the registrant internally, then the registrant would be expected to address those concerns before it issues its year-end financial statements. But if that same whistleblower bypasses internal channels and reports his or her concerns directly to the SEC, then there is an elevated risk that the report will not be reviewed by the staff—or shared with the registrant's management—before year-end financial statements are released or results are announced. As a result, the company later may need to restate its financials, and the accountant may need to withdraw its report. The delay in identifying the issue thus could result in these adverse consequences, which may increase the risk of shareholder litigation. In this scenario, the SEC's Proposed Rules would

not serve the interests of registrants, investors, and the auditors in providing accurate and reliable financial reporting.

In the event that the SEC's approach is to notify companies of whistleblower allegations, there is a related danger that regulatory efficiency will diminish as the SEC assumes the burden of providing notice and conducting more of the investigations previously carried out by companies. This shifting responsibility, coupled with the expected dramatic increase in investigations arising from both meritorious and unmeritorious tips from whistleblowers seeking large financial awards, could result in a strain on regulatory resources and delayed communications to the company about reports of wrongdoing. An increase in the number of formal interactions between companies, auditors, and the SEC may also delay administrative response time, and may impose a substantial additional burden on all three parties. Deloitte is concerned that the Proposed Rules may bring about this unintended consequence, which does not further the SEC's, the public's, or the auditing profession's interest in accurate financial reporting.

Because of the important role internal compliance systems can play in helping to ensure that investors receive accurate financial information from the company, the SEC should use this rulemaking as an opportunity to encourage whistleblowers to turn first to their companies' internal reporting procedures when they have concerns over possible wrongdoing. Existing frameworks, such as regulations promulgated under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and standards established by the Institute of Internal Auditors, were created to encourage internal reporting; those frameworks should be allowed to continue to operate as intended. Section 301 of Sarbanes-Oxley, for example, directs registrants' audit committees to establish procedures for receiving and processing complaints and confidential, anonymous tips regarding "accounting, internal accounting controls, or auditing matters." Many companies now *require* their employees to report actual or suspected illegal acts or violations of a corporate code of conduct through internal channels. A final rule requiring employees first to report their concerns fully and in good faith through internal reporting procedures would mitigate confusion that may arise between a company's need to enforce its code of conduct and the Proposed Rules' prohibition on retaliation and the taking of any action to "impede" whistleblowers from reporting directly to the SEC.[26]

While there may be instances where a potential whistleblower believes that the company program is ineffective or reporting would place them in jeopardy, the Proposed Rules already have taken that into consideration by including anti-retaliation provisions and by allowing potential whistleblowers essentially to preserve their place in line with the SEC if they first use their internal systems. We believe that the potential risks to the financial reporting system of allowing a whistleblower to bypass internal compliance programs are greater than the possible effect of discouraging some reporting by requiring reporting

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[26] *See* Proposed Rule 17 C.F.R. § 240.21F–16(a).

through company systems first.

b. Not Requiring Good-Faith Reporting In The First Instance Through Companies' Internal Compliance Systems May Adversely Impact Managements' And Auditors' Evaluations Of ICFR Under Sarbanes-Oxley Sections 404(a) And 404(b).

The monetary incentive to bypass internal reporting procedures may impact the assessment of a registrant's ICFR, whether the assessment is performed by management or is an assessment by external auditors of management's opinion on ICFR. Companies have implemented whistleblower hotlines and other means of confidential reporting, designed to detect and deter securities and other violations. A company's internal whistleblower process is an "entity-level" control—one of the very few controls that can be effective in reducing the risk that management is overriding other internal controls.[27] A recent study by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO")—finding that the SEC named in its accounting and auditing enforcement releases the chief executive officer and/or chief financial officer in *89 percent* of financial statement fraud cases from 1998 to 2007—demonstrates the importance of mitigating the risk of management override of internal control by having effective corporate whistleblower systems.[28]

Because the Proposed Rules may encourage employees to bypass the entity-level controls that companies have put in place to detect and deter wrongdoing, fundamental assumptions that informed the design of those controls will be impacted, and the design of the controls themselves may henceforth be deemed flawed through no fault of the company and outside its ability to repair. In Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 17 C.F.R. Part 241, the SEC noted management's duty to evaluate "whether it has controls in place to address the entity-level and other pervasive elements of ICFR" that are deemed "necessary to an effective system of internal control," including "controls over management override." Existing controls were put in place in a legal and regulatory environment that encouraged the *internal* detection and resolution of potential accounting problems.

Under the Proposed Rules, however, because of the shift in employee motivations, management and external auditors may no longer be able to find that controls that were once

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[27] *See* AICPA, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* 7 (2005) ("A key defense against management override of internal controls is a whistleblowing process that typically incorporates a telephone hotline.").

[28] COSO, *Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies* 2 (2010).

effective in detecting and deterring wrongdoing remain so. As a result, there may be concerns that in the absence of required reporting to the company before using the SEC's Whistleblower Program, the design of the key entity-level controls relating to the risk of management override is not effective. The Commission can and should mitigate this significant problem by implementing in the final rules measures to ensure that whistleblowers use internal procedures before reporting their concerns to the SEC. At a minimum, the Commission should provide guidance to management and auditors as to how to approach ICFR issues given these concerns.

3. The Proposed Rules Should Be Amended To Require Whistleblowers To Use Company-Sponsored Complaint And Reporting Procedures.

In light of these concerns, the Proposed Rules should be amended to require, as a condition of eligibility to receive a monetary award, that whistleblowers first report their concerns through company-sponsored complaint and reporting procedures.[29]

First, a rule limiting whistleblower awards to individuals who first report their concerns through internal channels would strengthen—not diminish—existing reporting procedures. In the case of accounting firms, it would be most consistent with the approach embodied in Section 10A. Such a rule would also serve the need for timely reporting of violations. In addition, it would be most consistent with allowing for the continuing operation of effective internal controls, including effective controls relating to audit committees that were put in place and strengthened as a result of Sarbanes-Oxley. We urge the Commission to use its rulemaking as an occasion to reinforce these important objectives.

Second, a rule requiring internal reporting as a condition of eligibility for a whistleblower award would harmonize with other governmental regulations and policy. For example, Department of Justice policy favors corporate self-policing by advising federal prosecutors, when evaluating whether to indict a business organization, to consider such factors as "the corporation's timely and voluntary disclosure of wrongdoing;" "the existence and effectiveness of the corporation's pre-existing compliance program;" and "the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies."[30] At the criminal sentencing stage, the United States Sentencing

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[29] All such reports should be complete in the information provided and made in good faith.

[30] United States Attorneys' Manual, Ch. 9-28.300 (2008). Implicit in each of the identified factors is a need for companies to have effective internal reporting and compliance procedures. "[T]imely and voluntary disclosure" assumes the organization's ability to know of the

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Guidelines call for courts to consider the existence of an effective compliance and ethics program when determining such factors as the organization's culpability score and its conditions of probation. An effective compliance and ethics program must be "designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct."[31] A whistleblower rule that diverts most employee reports of wrongdoing away from internal processes will render internal compliance programs less effective, and registrants could lose the potential reduction in sentence provided by the Guidelines in Section 8B2.1.[32] The SEC's cooperation rules also set forth criteria that the Commission will evaluate in considering whether, and how much, to credit a cooperating company's "self-policing, self-reporting, remediation and cooperation"—criteria that ask, among other things, "How was the misconduct detected and who uncovered it? * * * How long after discovery of the misconduct did it take to implement an effective response? * * * [and] What steps did the company take upon learning of the misconduct?"[33] The SEC's final rule should reinforce, not undermine, these important considerations.

Finally, if the SEC does not wish to make internal reporting a requirement for eligibility to receive a whistleblower award, then Deloitte respectfully requests that the Commission consider various alternatives. These would include a requirement that

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violation—presumably through internal channels—before government investigation. The "effectiveness" of internal compliance procedures presumes that employees are willing to use them. And pre-indictment "remedial actions" are most easily demonstrated by organizations capable of detecting wrongdoing and voluntarily taking prompt corrective measures.

31 U.S. Sentencing Guidelines Manual § 8B2.1(a)(2) (2010). By a wide margin, tips are the single source most responsible for detecting fraud in the workplace. Association of Certified Fraud Examiners, *Report to the Nations on Occupational Fraud and Abuse* 20 (2010). Thus, to be effective, a corporate compliance program should include whistleblower reporting processes that employees are willing and able to use to report fraud and other wrongdoing.

32 Registrants may also lose the benefit of Section 8C2.5 if the final rules do not require whistleblowers to report internally before reporting to the SEC. That provision of the Sentencing Guidelines allows for the reduction of a company's culpability score for self-reporting a violation "prior to an imminent threat of disclosure or government investigation." U.S. Sentencing Guidelines Manual § 8C2.5(g). A loss of credit under Sections 8C2.5 or 8B2.1 may have lasting effects, for it will tend to reduce the number of past successes that companies may claim—a factor that could inform a compliance program's overall effectiveness. *See id.* § 8B2.1 cmt. n.2(D) ("Recurrence of similar misconduct creates doubt regarding whether the organization took reasonable steps to meet the requirements of this guideline.").

33 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Release No. 1470 (Oct. 23, 2001).

whistleblowers report internally and externally on a concurrent basis. Another alternative is to require an additional explicit criterion to be considered in determining the amount of a whistleblower award, namely, whether, and the extent to which, the whistleblower used the company's whistleblower system to report the violation fully and in good faith before reporting it to the SEC. Deloitte appreciates that the Commission has indicated its willingness to consider the existence and extent of a whistleblower's internal reporting as one of several "permissible considerations" in making an award determination.[34] Given the importance of maintaining the effectiveness of internal whistleblower systems, Deloitte respectfully requests that—absent a rule *requiring* prior internal reporting, or at a minimum, concurrent reporting—the SEC make the existence and extent of internal reporting a mandatory criterion in the award determination.

At a minimum, we believe that the final rule should make clear that the Commission will regard prior internal reporting as a strongly positive factor in determining the amount of a whistleblower award, whereas a failure to use internal reporting procedures before reporting externally will be regarded as a strongly negative factor.

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Thank you for considering Deloitte's comments to the Proposed Rules. We would be pleased to discuss any concern that we have raised in this letter, or any other matter that you believe would be helpful. Please contact Robert Kueppers at (212) 492-4241 or William Platt at (203) 761-3755.

Sincerely,

Deloitte & Touche LLP

cc: SEC
Mary L. Schapiro, Chairman
Kathleen L. Casey, Commissioner
Elise B. Walter, Commissioner
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner

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[34] Proposing Release, 75 Fed. Reg. at 70,500.