JONES DAY

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

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

Dear Ms. Murphy:

Jones Day is one of the largest law firms in the world and represents many publicly traded companies. We write to provide comments with respect to the Commission's Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, issued on November 3, 2010 (the "Proposed Rules"). We appreciate the opportunity to submit comments on this important matter, and hope that our perspectives will assist the Commission in the formulation of final rules.[1]

I. INTRODUCTION

Since the passage of the Sarbanes-Oxley Act ("SOX") in 2002, publicly held companies have invested significant resources in the development of internal compliance and reporting systems. These systems enable companies to uncover, investigate and correct misconduct by company employees; their effective functioning has benefited the companies, their employees and their investors. They have also benefited the Commission, by making it easier for companies to detect misconduct, correct it and, if appropriate, report it to the Commission.

As attorneys representing publicly traded companies, we regularly counsel clients concerning the establishment and refinement of internal compliance systems, the investigation of potential misconduct brought to light as a result of such systems, and decisions regarding self-reporting to governmental agencies. The experience of our attorneys in these matters also includes years of service in the Commission's Enforcement Division, and many years as global head of compliance for an international financial institution operating in more than 40 countries. All of that experience informs a practical view of the likely consequences – both intended and unintended – of several provisions in the Proposed Rules.

[1] The views expressed in this letter are those of the firm, and not those of any of the firm's clients.

In its Release No. 34-63237 regarding the Proposed Rules (the "Proposing Release"), the Commission correctly recognizes that "[c]ompliance with the federal securities laws is promoted" when companies have effective internal compliance programs, and states that a key objective of the Proposed Rules is "to support, not undermine" such systems. (Proposing Release, p. 33.) Any rule that weakens internal compliance, or that incentivizes companies to abandon effective internal measures, not only imperils the overall goal of effective enforcement, but risks damaging the effectiveness of the Commission's own enforcement efforts by inundating the Commission with massive quantities of unreliable or immaterial allegations.

While we believe that in many respects the Proposed Rules reasonably resolve the tension between effective internal compliance and external whistleblowing, we are concerned that several provisions, if promulgated in their current form, would disrupt companies' internal compliance efforts, and would therefore have the unintended consequence of reducing overall compliance with the securities laws.

For each of these provisions, we will identify and analyze the problem, and propose a concrete revision to the text of the rule in question. Where our comment corresponds to an enumerated Request for Comment contained in the Proposing Release, we will so indicate.[2]

II. SPECIFIC COMMENTS

A. Proposed Rule 21F-2(a) should be modified to deter bad-faith accusations by would-be whistleblowers.

<u>The Problem</u>: The Commission acknowledges that it has expanded the definition of "whistleblower" contained in Section 21(a)(6) of the Exchange Act to include persons who "provide the Commission with information relating to a *potential* violation of the securities laws" (emphasis added). While we understand the Commission's stated reasons for the expansion of the definition, the expansion also greatly increases the potential for employees making bad-faith allegations to benefit from Act's whistleblower protections. While there will always be a tension between the protection of whistleblowers and the legitimate rights of companies to manage their workforces, we believe that employees who make bad-faith allegations should not be protected as whistleblowers.

<u>Proposed Solution</u>: Insert language into Rule 21F-2(a) clarifying that in the event a person's allegations did not relate to an actual violation of law, the person would not be considered a whistleblower if it is determined that he or she acted in bad faith. The text would then read as follows (new language underlined; deleted language stricken through):

[2] Throughout this letter, the Proposed Rules will be referred to in abbreviated form, e.g., Proposed 17 CFR Section 240.21F-2(a) will be referred to as "Rule 21F-2(a)."

> "(a) You are a whistleblower if, alone or jointly with others, you provide the Commission with information relating to a potential violation of the securities laws. <u>You are not a whistleblower if the information you provide does not relate to an actual violation of the securities laws, and it is determined that you acted in bad faith.</u> A whistleblower must be an individual. A company or another entity is not eligible to be a whistleblower."

<u>Rationale</u>: Under the Proposed Rules, there is little to deter individuals from making unjustified accusations of wrongdoing. While the Proposed Rules do require the submission of statements under penalty of perjury, and therefore raise the possibility that a *knowingly false* statement could be the basis for a prosecution under 18 U.S.C. § 1001, that possibility is remote at best. In addition, it is easy to imagine a scenario in which a *literally true* statement might relate to a *potential* violation but not to an *actual* violation.

Consider the following scenario: During a mid-quarter conference call with investors and analysts, Company A's CFO makes optimistic statements about the company's prospects. At the end of the quarter, the company reports disappointing results and the stock falls. Employee X makes a "whistleblower" allegation to the effect that prior to the optimistic statements, the CFO had made statements during an internal meeting that suggested the company faced significant challenges. While the contrast between the internal statements and the more-optimistic public statements might suggest a *possible* violation of Section 10(b) of the 1934 Act, Employee X knows the full context of the earlier statements, which makes it apparent that the CFO has not engaged in any misrepresentation. Here, Employee X's allegation is literally true, and it relates to a *possible* violation of the securities laws; but even if Employee X acted in bad faith, she is absolutely protected in her employment due to the Commission's expansion of the definition of a "whistleblower" to include information relating to "potential" violations.

The change we propose in no way impinges on the Commission's goals; in fact, it preserves them. If the whistleblower's allegations relate to an actual violation of the securities laws, her motives in making them should be irrelevant. If there is no actual violation *and* it can be shown that the would-be whistleblower acted in bad faith, however, she should not be entitled to the broad protections of the Act's anti-retaliation provisions.

Finally, this change will make the Rule more consistent with the statutory language, which prohibits retaliation "because of any *lawful* act done by the whistleblower" (1934 Act § 21F(h)(1)(a) (emphasis added)). Congress clearly intended to protect good-faith action by whistleblowers, whether or not it resulted in determination that an actual violation had occurred. But it could not have intended to protect bad-faith accusations that do not relate to violations of law. In its present form, the Proposed Rule unintentionally provides such protection. The solution we suggest removes it, restoring the balance intended by Congress.

B. [Request for Comment No. 2] Proposed Rule 21F-4(a)(1) should be revised to eliminate whistleblower status for an employee who learns information as a result of being questioned in the course of a company's internal compliance efforts.

The Problem: As currently drafted, this Proposed Rule permits a person to be treated as a whistleblower even if he or she had no knowledge of potential misconduct until being questioned in the course of the company's own investigation. That this precise scenario is contemplated is made clear by Note 11 of the Proposing Release. Such a rule would create a series of perverse incentives and unintended consequences. The more broadly a company investigates potential misconduct, the more likely it will be that at least one of the persons interviewed in the course of an internal investigation will have had no prior knowledge of possible misconduct, but will nonetheless seek to become a "whistleblower." Indeed, the greater the number of employees who are contacted in the course of an investigation, the more these employees will be motivated to engage in a "race to the Commission" to be the first to report the allegations the company is already investigating. Such behavior will interfere with legitimate internal compliance efforts, will multiply the number of "false alarms" and the quantity of poor or unreliable information being received by the Commission, and is wholly inconsistent with the Commission's stated goal of preserving and strengthening existing internal compliance programs.

Proposed Solution: Insert language into Rule 21F-4(a)(1) clarifying that if a person first receives a request from his or her employer concerning certain information, the later submission of that information will not be considered "voluntary." Rule 21F-4(a)(1) would then read as follows:

> "(1) Your submission of information is made voluntarily within the meaning of § 240.21F of this Chapter if you provide the Commission with the information before you or anyone representing you (such as an attorney) receives any request, inquiry, or demand from the Commission, the Congress, any other federal, state, or local authority, any self-regulatory organization, ~~or~~ the Public Company Accounting Oversight Board, or a representative of your employer conducting an investigation or inquiry on behalf of the employer about a matter to which the information in your submission is relevant. If the Commission, your employer, or any of these other authorities make a request, inquiry, or demand to you or your representative first, your submission will not be considered voluntary, and you will not be eligible for an award, even if your response is not compelled by subpoena or other applicable law."

Rationale: In order to investigate effectively, companies need to have the ability to investigate broadly, which means that they will often interview, or request information and documents from, persons who turn out not to have any relationship to possible misconduct, and who might not have known anything about the allegations in issue until they were approached by compliance personnel.

In its current form, the Proposed Rule potentially turns these “bystander employees” into whistleblowers. Even worse, it has the potential to give rise to an unseemly “race to the Commission” by bystander employees who may perceive themselves to be in competition with other employees for a potential whistleblower bounty. It does nothing to reward employees who have been harmed by misconduct, or who have uncovered it by their own efforts; instead, it rewards those who receive information as a result of the company’s own good-faith compliance efforts, and who then win the race to report that information externally.

Moreover, if left unchanged, the Proposed Rule would actually incentivize companies to *restrict* their internal investigations as narrowly as possible, or perhaps not to investigate at all. If a company knew that a vigorous inquiry would greatly increase the likelihood of a whistleblower complaint, the company might rationally elect to limit the scope of its investigative effort. This is counterproductive to the goal of increased overall compliance.

We understand that elsewhere in the Proposing Release, the Commission suggests that such “bystander employees” should not be credited as whistleblowers unless the company fails to report the alleged violation promptly or acts in bad faith. (Proposing Release at 25.) For the reasons set forth in Part II.D, we believe that the exceptions are so vague as to be unworkable. More fundamentally, however, we submit that there is no basis in either public policy or the Congressional mandate to ever confer whistleblower status on persons who had no knowledge of potential misconduct until they were contacted by their employer in the course of an internal investigation.

C. [Requests for Comment Nos. 18 and 19] Proposed Rule 21F-4(a)(3) should be revised to require employees in companies with robust internal compliance systems to initially report possible wrongdoing through internal channels.

<u>The Problem</u>: The Commission has asked whether the Proposed Rules would “frustrate internal compliance structures and systems that many companies have established in response to [SOX]” (Request for Comment No. 19.) The answer is yes: the Proposed Rules would frustrate functioning internal compliance mechanisms, because they would leave potential whistleblowers with no reason to consider using them. When an employee compares the potential for personal gain from serving as an external whistleblower with the prospect of following internal channels, there is little or no reason for the employee to ever utilize internal systems. The Commission, in turn, will be overwhelmed with whistleblower complaints and will lose the beneficial effect of good-faith, robust internal compliance systems that separate wheat from chaff, investigate complaints and report to the Commission those matters that are truly worthy of the Staff’s attention.

The Commission has also asked whether "the potential negative impact on compliance programs [can] be minimized" (*id.*); and whether the Commission should "consider other ways to promote robust corporate compliance processes consistent with the requirements of Section 21F." (Request for Comment No. 18.) We believe there is a way to retain the benefits provided by robust internal compliance mechanisms, while at the same time ensuring that the intended benefits of a whistleblower program are realized in the event that internal systems do not function as intended.

<u>Proposed Solution</u>: Amend Proposed Rule 21F-4(a)(3) to include language clarifying that if an employee is subject to a written obligation to report potential wrongdoing internally, whether based on an employment contract or a company policy, the employee's submission to the Commission will not be considered "voluntary" unless the employee has first reported internally and the Company has failed to self-report to the Commission within 120 days. Proposed Rule 21F-4(a)(3) would then read as follows:

> "In addition, your submission will not be considered voluntary if you are under a pre-existing legal or contractual duty to report the securities violations that are the subject of your original information to the Commission, or to any of the other authorities described in paragraph (1) of this section, <u>or if your employer has an established mechanism for the confidential reporting of suspected wrongdoing, and you are subject to a written requirement of your employer to report your information to your employer. If this is the case, you may make your submission to the Commission 120 days after reporting your information to your employer. Your submission will be considered voluntary if the employer has not reported the information to the Commission within 120 days, and the Commission will consider that you provided information to the Commission as of the date of your original report to your employer.</u>"

<u>Rationale</u>: As the Commission recognizes, the twin goals of the Proposed Rules are to "encourage the submission of high-quality information" to the Commission, while "encourag[ing] strong company compliance systems" (Proposing Release, p. 35). These internal systems are the most effective first line of defense against misconduct. The Proposed Rules would eviscerate internal mechanisms by failing to encourage or require their use in the first instance. Left unused, these mechanisms will wither and die.

The Commission acknowledges that it considered "requiring potential whistleblowers to utilize in-house complaint and reporting procedures," but was concerned that "while many employers have compliance processes that are well-documented, thorough, and robust . . . others lack such established procedures and protections." (Proposing Release, p. 34.) This logic fails to distinguish between "robust" and ineffective (or non-existent) compliance programs, and leads to rules that weaken the robust programs of "many employers" due to the failings of a few. The Commission's overall resource allocation and enforcement goals, the intent of Congress and the public interest, by contrast, are best served by strengthening the robust systems by supporting their use. The revision we propose would encourage even more companies to strengthen their compliance programs, knowing that they would be able to address and correct misconduct more quickly and efficiently, and in doing so receive more favorable treatment by the Commission.

In order to ensure that companies with functioning compliance systems are not permitted to "bury" or ignore worthwhile complaints, our proposal would fix a deadline for the company to report to the Commission. We believe that 120 days is a reasonable time period, in that it will permit companies to begin to undertake a thorough internal investigation. Even if the investigation cannot be completed within 120 days, companies will likely have sufficient information to decide whether to report to the Commission that an investigation is under way, and to provide the Commission information concerning its progress and the timetable for remaining investigative actions. We have borrowed from Proposed Rule 21F-4(b)(7) the "relation back" provision that treats a report to the Commission after the expiration of the 120-day period to have been made at the time of the employee's original report to the company.

This change will give the company time to investigate the allegations and determine whether further action is warranted, yet incentivize the company to make progress in its investigation. The use of a finite time period will give predictability to the process, and will lead to more certain outcomes regardless of the nature of the allegations.

- If, before the end of the 120-day period, the company decides the allegations may have merit, it will be motivated to self-report to the Commission, describing also what further investigative and/or disciplinary steps it has taken or intends to take.

- If the company decides the allegations are without merit or immaterial, it can either report the allegations and its own conclusions to the Commission, or decide not to report.

- In any event, the potential whistleblower can report to the Commission after 120 days.

- If the Commission believes the allegations may have merit but the company has not self-reported, the Commission may inquire of the company after receiving the whistleblower's allegations.

Under any of these scenarios, companies will be motivated to investigate employee allegations and to report the results of their own inquiries to the Commission if they believe the allegations might have merit, in order to demonstrate their seriousness of purpose and qualify for more lenient treatment by the Commission. The benefit of this change is that it places initial reliance on functioning internal compliance mechanisms, while retaining the ability of whistleblowers to report to the Commission and to be rewarded for doing so.[3]

We believe that this proposal appropriately balances competing interests, and furthers all of the key goals of Congress and the Commission. It supports robust internal compliance efforts and will encourage companies to strengthen their internal systems; it increases the quality of the information provided to the Commission; and it rewards employees as whistleblowers in appropriate circumstances.

D. [Request for Comment No. 13] Proposed Rule 21F-4(b)(4)(iv) and (v) should be revised to eliminate "whistleblower" status for persons with legal, compliance or audit functions.

The Problem: Proposed Rules 21F-4(b)(4)(iv) and (v) permit persons to be considered whistleblowers even if they have "legal, compliance, audit, supervisory, or governance responsibilities" within an entity, and information was reported to them in that capacity, if the entity "did not disclose the information to the Commission within a reasonable time" or "proceeded in bad faith." Compliance personnel are thus presented with strong incentives to report to the Commission, because they have no way to know, at the time they receive information concerning possible misconduct, whether the company will in fact act within a reasonable time or in good faith. "Reasonable time" and "bad faith" are undefined terms, and the Proposed Rules give little indication as to how these concepts will be adjudicated, when or by whom. Thus compliance personnel are tempted to gamble that early reporting will result in a windfall recovery for them personally.

While the Proposing Release suggests that "this approach is intended to strike a balance" between facilitating the operation of internal compliance programs and punishing companies that fail to act appropriately (*id.*, pp. 25-26), the result of such a rule would be to tip the balance. Compliance personnel would have a strong incentive to "front-run" internal investigations and diminished incentive to exercise restraint in reporting to the Commission, because a compliance person who *incorrectly* reports to the Commission when it later turns out that there is no possibility of gaining a personal recovery suffers no adverse consequence, whereas a compliance person who gives the company the opportunity to investigate and self-report, and consequently fails to report to the Commission when he otherwise could have qualified as a whistleblower (or when someone else has reported before he does), suffers the loss of the potential award.

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[3] We note that the Commission suggests that "in appropriate cases" the Commission would "contact a company . . . and give the company an opportunity to investigate the allegations and report back." (Proposing Release, p. 34.) The possibility that the Commission might provide this "opportunity," however, does nothing to encourage companies to maintain an effective compliance mechanism, since the point of an effective mechanism is to spot problems in the first instance so that they can be investigated and resolved promptly and effectively. In addition, the criteria to determine what is an "appropriate case" are too vague to give companies any predictability with respect to their compliance programs, or to encourage companies to maintain internal investigatory capacity in the hope that it may be called upon by the Commission.

Proposed Solution: Delete the exception clauses in Proposed Rules 21F-4(b)(4)(iv) and (v) that permit a compliance person to report to the Commission if the company fails to act within a "reasonable time" or proceeds in "bad faith." As revised, the rules would provide as follows:

> "(4) The Commission will not consider information to be derived from your independent knowledge or independent analysis if you obtained the knowledge or the information upon which your analysis is based:
>
> * * *
>
> (iv) 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~~; or
>
> (v) Otherwise from or 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~~ .

Rationale: Companies hire compliance personnel to entrust them with sensitive information to be used for the benefit of the company and its investors. Incentivizing them to act as whistleblowers based on information they received in the course of performing their duties will almost certainly turn them into whistleblowers, effectively eviscerating internal compliance efforts.

In addition, it is particularly inappropriate to incentivize inside counsel to report out matters pertaining to their clients for whom they are performing a legal function. This type of incentive is fundamentally incompatible with the role of the attorney, and undermines the confidence that clients place in attorneys, with the result that companies may hesitate to seek legal counsel.

The statutory language actually excludes compliance personnel from being whistleblowers. In section 21F(a)(3)(A) of the 1934 Act, Congress defines "whistleblower" as a person possessing "original information" that is based on "independent knowledge or analysis." This language does not permit the deputizing of a company's internal watchdogs. They do not possess "independent knowledge" because they are *recipients* of information provided by others; and they cannot have conducted an "independent analysis" because any analysis they perform on the job is that which their employer requires them to perform on its behalf.

In addition, at a conceptual level there is every reason to distinguish between employees who are in compliance-related positions and those who are not. The former are already performing critical tasks related to uncovering and investigating possible misconduct; the latter are not, and would therefore appear to be within the group of persons to whom the statute's protections are directed.[4]

The Commission's attempt to define the circumstances under which compliance personnel could qualify as whistleblowers creates more problems than it solves. Because the terms "reasonable time" and "bad faith" are undefined, compliance personnel and companies will have no guidance as to the circumstances under which reporting to the Commission will result in a whistleblower award. As a result, employees who stand to realize a significant recovery will have a powerful incentive to err on the side of the earliest possible disclosure. Moreover, because a compliance function generally consists of more than one person, the draft proposal promotes a "race to the Commission" among compliance employees who have been asked to investigate potential misconduct, which will further compromise meaningful internal compliance efforts.

In sum, both logic and the statutory language require that compliance employees be excluded from the universe of possible whistleblowers in all circumstances. There is one final irony here: a compliance employee's use for personal gain of information that came to him in his employment capacity could be analogized to insider trading – the appropriation of company information for personal enrichment.

We expect that the principal objection to this modification would be that it would permit companies and their compliance personnel to prevent disclosure of misconduct by conducting an ineffectual internal investigation. The answer to this is that even in this situation, the original source of the information, presumably an employee outside the compliance function, retains the right to serve as a whistleblower if the allegations are not resolved within the prescribed 90-day time frame. Also, if a compliance employee happens upon potential misconduct *other than in connection with her compliance function* – as in overhearing a problematic conversation, or being erroneously copied on a suspicious email – she would retain the right to serve as a whistleblower.

III. CONCLUSION

We believe that these modifications to the Proposed Rules will preserve the Commission's ability to receive timely information concerning potential misconduct, while preserving critical incentives for companies to maintain effective internal compliance efforts. The combination of reliance on internal compliance where proper systems are in place, and

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[4] The Commission appears to acknowledge this distinction, inasmuch as it has not proposed a rule that would automatically qualify compliance personnel as whistleblowers, but rather one that would qualify them as whistleblowers only in certain limited circumstances.

whistleblowing when they are not, will best fulfill the Congressional mandate and the Commission's overriding goal of investor protection.

We appreciate the opportunity to submit these comments and would welcome the opportunity to discuss them further. Please contact William S. Freeman (650-687-4164) or Henry Klehm III (212-326-3706).

Very truly yours,

Jones Day

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