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U.S. Chamber of Commerce

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December 17, 2010

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OFFICE OF THE SECRETARY

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

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

Dear Ms. Murphy:

We are submitting these comments on behalf of the U.S. Chamber of Commerce Center for Capital Markets Competitiveness ("CCMC") and the U.S. Chamber Institute for Legal Reform (ILR). The U.S. Chamber of Commerce (the "Chamber") is the world's largest business federation representing the interests of more than three million companies of every size, sector, and region. The Chamber created CCMC to promote a modern and effective regulatory structure for capital markets to fully function in a 21 century economy. ILR is an affiliate of the Chamber, dedicated to making our nation's overall civil legal system simpler, fairer and faster for all participants.

Businesses have a strong self-interest in detecting and eliminating illegal conduct within their organizations. Unlawful activity is, of course, wrongful, and businesses strive to comply with the law. Such misconduct also hurts investors by driving down a company's value, damages a company's reputation, drives away business partners and customers, and otherwise harms a company in the marketplace.

For these reasons, large numbers of companies have implemented strong internal reporting systems to obtain information about potential wrongdoing. Recent regulatory developments, including adoption of Section 301 of the Sarbanes-Oxley Act of 2002 ("SOX"), Pub. L. No. 107-204, and revisions to the federal Sentencing Guidelines,[1] have accelerated this trend. Businesses invest substantial resources in these programs, and the

[1] U.S. Sentencing Commission, Guidelines Manual § 8B2.1 ("Effective Compliance and Ethics Program") (Nov. 2010).

data indicate that internal reporting systems that satisfy these standards are effective in identifying and remediating wrongdoing.

We recognize that Congress in Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, directed the Commission "to create and enhance incentives and protections for whistleblowers providing information leading to successful Commission enforcement actions."[2] And we have no objection to the establishment of a reasonable whistleblower program that allows individuals to bring actionable information to the attention of the SEC *when the company itself is unwilling or unable to engage in effective self-policing.* But we share the concerns of Commissioner Paredes and Aguilar that the proposed rule might create perverse incentives if implemented as drafted, including most significantly the concern of Commissioner Paredes that the rule "might not do enough to preserve the important role that corporate compliance programs serve."[3]

Put simply, the proposed rule creates a set of incentives that are skewed overwhelmingly in favor of direct reporting to the SEC—even when companies are willing to, and fully capable of, addressing reports through their internal compliance programs. As the preamble itself correctly acknowledges, there is a risk that the whistleblower program "could provide financial incentives for employees to report violations to the Commission rather than follow their employers' internal compliance procedures," and "[t]his could undermine the effectiveness of internal compliance programs."[4] The preamble also acknowledges a related concern: that the program "could result in an increase in spurious allegations, forcing innocent companies and individuals to incur substantial cost to investigate into and defend against the false allegations."[5]

Despite the Commission's recognition of these risks, the proposed rule does almost nothing to address them. Rather, at the same time that it holds out the prospect of a massive potential award, the rule affords those with knowledge of wrongdoing no meaningful reason to look first to their companies' own internal reporting processes, or to hold back from reporting information that is trivial or frivolous. If implemented as proposed, therefore, the rule would have a number of harmful consequences, including eviscerating corporate compliance and reporting programs; giving rise to unjustified negative publicity about, and unnecessary SEC investigations of, a large number of innocent

[2] 75 Fed. Reg. 70488, 70514 (Nov. 17, 2010).
[3] *See* Troy A. Paredes, Commissioner, SEC, *Statement at Open Meeting to Propose Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934* (Nov. 3, 2010) ("Paredes Statement").
[4] 75 Fed. Reg. at 70514.
[5] *Id.*

companies; and overwhelming the Commission with an avalanche of poor-quality information. These results are directly contrary to the well-documented fact that companies and employees benefit, and scarce government enforcement dollars are preserved, when companies have the first chance to address financial wrongdoing. These outcomes would also fly in the face of the legislative purpose reflected in Section 301 of SOX, which *requires* public companies to develop sophisticated internal reporting programs.

Changes are needed to address these concerns, and the Commission has ample discretion under Section 922 to make them.[6] The interests of investors, employees, and taxpayers would be better served by an approach that recognizes and preserves legitimate internal compliance mechanisms as the first line of defense against wrongdoing, with the SEC whistleblower program serving in an important supporting role. In particular, as discussed below, we urge the Commission to put in place regulatory safeguards that limit the ability of whistleblowers to unnecessarily bypass companies' compliance programs, as well as other measures to ensure that only high-quality information regarding actual wrongdoing is provided to the Commission. An incentive program structured in this way would ensure that legitimate evidence of wrongdoing is addressed promptly and effectively, preserving corporate compliance programs as a critical supplement to government enforcement efforts—rather than simply overriding those programs, as the current proposal would do.

Internal reporting of potential wrongdoing benefits investors and society at large

The experience of the many companies with robust internal reporting programs, as well as the empirical evidence, demonstrate that all stakeholders benefit when those with knowledge of potential securities law violations report internally, thus enabling management to promptly investigate and take remedial action. With timely access to information about potential problems, companies can address and punish wrongdoing, avoid lawsuits, improve efficiency, and reduce costs. Without voluntary reporting up the corporate hierarchy, however, it is unlikely that company decision-makers will be able to obtain the facts they need to take the necessary corrective action. Indeed, the preamble to the proposed rule itself acknowledges that "[c]ompliance with the federal securities laws is promoted when companies have effective programs for identifying, correcting, and self-reporting unlawful conduct by company officers or employees," and that "encouraging [internal reporting] is consistent with the Commission's investor protection mission."[7] As one of the leading researchers in the field has explained, internal reporting

[6] *See* 15 U.S.C. § 78u-6(a)(6) (requiring whistleblowers to submit their allegations "in a manner established, by rule or regulation, by the Commission").
[7] 75 Fed. Reg. at 70496, 70500.

> facilitat[es] the prompt investigation and correction of wrongful conduct and minimiz[es] the organizational costs of whistleblowing by permitting employers to rectify misconduct confidentially, with little disruption to the employer-employee relationship. Internal whistleblowing also enables the correction of misunderstanding, which reduces the likelihood that the organization and its employees will unfairly suffer harm.[8]

More generally, internal reporting improves corporate governance by affording employees an opportunity to participate in the compliance process, thus improving morale and efficiency and fostering a culture of cooperation, trust, and respect for the law. Internal reporting also complements the activities of the SEC and other government agencies by freeing them to focus their resources and energies on those companies that are unwilling or unable to take remedial action on their own.

Moreover, internal reporting works. As a group of the leading researchers on this question recently have reported, "empirical studies have shown few substantial differences in antecedents or outcomes of whistle-blowing as a function of type of channel [*i.e.*, external or internal] used."[9] And internal reporting can precipitate more timely corrective action than external reporting, while imposing fewer costs on companies and the overall economy. Commissioner Paredes has trenchantly observed that companies "may be able to respond in a more timely manner—thus acting more quickly to remedy any misbehavior—than the Commission could given the SEC's many other responsibilities."[10]

Most companies do, in fact, vigorously investigate the tips that they receive through their internal compliance systems. For example, a recent survey of approximately 117,000 whistleblower reports received by the hotline operator the Network in 2009 found that companies investigated 73 percent of reports, and declined to investigate only 23 percent of reports (companies referred 2 percent, and resolved the remaining 2 percent in other ways).[11] This is a sharp improvement over as recently as 2005, when companies investigated 64 percent of reports, and declined to investigate 26 percent.[12] Since, according to a recent paper by the Deloitte Forensic Center, approximately half of whistleblower reports relate to

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[8] Terry Dworkin, *SOX and Whistleblowing*, 105 Mich. L. Rev. 1757, 1760 (2007).
[9] Marcia P. Miceli *et al.*, *Whistleblowing in Organizations* 7 (2008).
[10] Paredes Statement.
[11] *See* The Network, 2010 Corporate Governance and Compliance Hotline Benchmarking Report, at 70 ("Network Report"), *available at* http://www.tnwinc.com/downloads/2010BenchmarkingReport.pdf.
[12] *See id.*

personnel issues,[13] the 73 percent investigation rate in 2009 suggests that companies are highly responsive to information they receive internally regarding actionable wrongdoing—and becoming more so over time.

Companies also take appropriate corrective action once the internal investigation is complete. In the Network study, 40 percent of investigations led to action by the company[14]—a response rate that compares quite favorably with the rates in analogous contexts. For example, the Government Accountability Office ("GAO") reported in 2005 that the Department of Justice decided to pursue only approximately 26 percent of qui tam cases filed by relators under the False Claims Act, 31 U.S.C. § 3729.[15] The reality is that many investigations of internal reports will determine that no wrongdoing took place, or that there is insufficient evidence of wrongdoing to support action by the company. Accordingly, a 40 percent response rate supports the conclusion that corporate compliance systems are, in general, responsive and effective.

Significantly, one prominent study that the Commission relied upon in preparing the proposed rule, a working paper titled "Who Blows the Whistle on Corporate Fraud?,"[16] acknowledged that "[m]onitoring by the board of directors might be very effective in deterring fraud and in stopping fraud early on."[17] The report attributed 34 percent of fraud detections to internal governance, but also stated that "this is undoubtedly a vast under-estimate of how many frauds are prevented and corrected by internal corporate governance."[18]

Furthermore, the costs imposed by external reporting on companies and the economy appear to be significant, and much higher than the costs imposed by internal reporting. Target companies and their shareholders can suffer substantial harm from negative publicity and disruptive government investigations, even where no actual wrongdoing has taken place. A survey of external financial whistle-blowing events from 1989 to 2004 reports that whistleblowing allegations have an immediate adverse economic effect on target firms, with an average market-adjusted return of almost -3 percent in the five

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[13] *See* Deloitte, *Whistleblowing and the New Race to Report* 3 (Dec. 2010), *available at* http://www.deloitte.com/view/en_US/us/Services/Financial-Advisory-Services/Forensic-Center/fb02b4b17deaa210VgnVCM2000001b56f00aRCRD.htm.
[14] Network Report at 22.
[15] GAO, Briefing for Congressional Requesters, *Information on False Claims Act Litigation* 29 (Dec. 15, 2005), *available at* http://www.gao.gov/new.items/d06320r.pdf.
[16] Alexander Dyck, Adair Morse, Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* (September 2009), *available at* http://faculty.chicagobooth.edu/luigi.zingales/research/papers/whistle.pdf.
[17] *Id.* at 9.
[18] *Id.*

days around the day the allegation became public.[19] Thus, even ill-founded allegations can impose a significant deadweight loss on shareholders. Moreover, the survey indicates that employees who report externally are disproportionately likely to target those companies that are growing, successful, and highly-regarded.[20] The reasons are not entirely clear, but the survey's authors suggest that one explanation may be that well-respected companies—by virtue of their prominence and newsworthiness—are more likely to attract the ire of employees who are disgruntled or desire publicity.[21]

Of course, when internal reporting systems are nonexistent or illusory, it is appropriate and beneficial for employees to report information of wrongdoing directly to the SEC. However, the available empirical evidence as well as the experience of the business community demonstrate that external reporting works best when it functions as a backstop to internal controls.

The critical challenge faced by the Commission in this rulemaking is to design a whistleblower program that reinforces the important role played by internal reporting systems—and does not instead drain these programs of all vitality by incentivizing employees to ignore them and report only to the Commission in order to obtain the large financial rewards provided for in the Dodd-Frank Act. Section 922, while mandating the creation of financial incentives for whistleblowers who report to the SEC, left the structure of the program primarily to the Commission. We are extremely concerned that the approach set forth in the proposed rule, if adopted, would severely undercut companies' internal fraud detection efforts.

Companies' internal compliance systems have improved significantly in recent years

Over the past decade, changes in federal law and an emerging understanding of the importance of internal reporting have driven significant improvements in the sophistication and effectiveness of most companies' internal compliance systems. The SEC's whistleblower program should encourage, not short-circuit, these promising developments.

The most important recent change in federal law in this area was the enactment in 2002 of Section 301 of SOX, which requires publicly traded companies to establish internal compliance systems that meet stringent criteria. Under section 301, the audit committees of covered companies must establish channels for employees to report organizational

[19] *See* Robert M. Bowen *et al.*, *Whistle-Blowing: Target Firm Characteristics and Economic Consequences*, at 29 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890750.
[20] *Id.*
[21] *See id.* at 9.

misconduct relating to auditing or accounting.[22] Covered companies also must allow employees to submit reports confidentially and anonymously. The requirements are backed by a strong enforcement mechanism: the national securities exchanges and associations must by law delist companies that fail to comply.[23]

Since the enactment of Section 301, most public companies have responded to this mandate—and their own real world experience—by developing well-publicized, effective, and secure internal reporting programs, and integrating those programs into their corporate cultures. Many of these programs are highly sophisticated, consisting of comprehensive training and education of employees and management, hotlines, designated compliance officers, and ombudsmen specifically designated to receive complaints. Audit committees now routinely review, investigate, and seek to address anonymous complaints.

Studies show that organizations with effective internal compliance systems have an increased amount of internal reporting.[24] Indeed, "two of the most prominent social science researchers of whistleblowing behavior contend that the best approach for encouraging whistleblowing is to 'set up internal complaint procedures where concerned employees could report, and make sure that those procedures provide for speedy and impartial review.'"[25] Section 301-compliant systems are particularly likely to result in more internal reporting because they ensure high-level attention to complaints, and allow employees to report anonymously and confidentially. These features minimize the ability of wrongdoers to retaliate against whistle-blowing employees or to obstruct investigations. They also bolster the confidence of prospective whistleblowers that companies will take their reports seriously, ensure their safety, and respond with prompt and decisive action if warranted.

Some have expressed concern that internal reporting is an ineffective, second-best alternative to external reporting because companies have reason to suppress reports of wrongdoing. In fact, however, independent directors—who must be the recipients of reports under Section 301—have nothing to gain and much to lose by engaging in such a cover-up, and thus have every reason to promptly investigate and disclose evidence of misconduct that comes to their attention.[26] Accordingly, by channeling complaints to a company's independent directors, Section 301 places the responsibility for overseeing

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[22] *See* 15 U.S.C. § 78j-1(m)(4)(B).
[23] *See id.* § 78j-1(m)(4)(A); Proposed 17 C.F.R. § 240.10A-3(a)(1), (2).
[24] *See* Richard E. Moberly, *Sarbanes-Oxley's Structural Model To Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. Rev. 1107, 1142-43, 1147.
[25] *Id.* at 1147 (quoting Marcia P. Miceli & Janet P. Near, *Blowing the Whistle: The Organizational and Legal Implications for Companies and Employees* 249 (1992)).
[26] *See id.* at 1151.

internal compliance systems in the hands of those most likely to take responsive action. As the SEC itself observed in issuing regulations to implement Section 301, "[t]he establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences."[27]

The federal Sentencing Guidelines also afford strong incentives to all companies—not just publicly traded ones—to maintain effective internal reporting programs. The Guidelines provide for a business organization to reduce potential penalties for wrongdoing (and perhaps avoid prosecution altogether) if it can demonstrate that it had in place an "effective compliance and ethics program" that is well-publicized and monitored by the company's board, and that protects whistleblowers from retaliation.[28] Recent amendments to the guidelines create further incentives for companies to provide for direct reporting from the Chief Compliance Officer to the Board of Directors, and for the Board to promptly report any criminal conduct to the government.[29] Because of the substantial benefits that can result from meeting the guideline standards, companies are likely to modify their reporting programs as necessary to come into compliance.

These changes in federal law have had a significant effect. The evidence suggests that employees have become increasingly comfortable in recent years with the idea of reporting fraud through internal compliance programs. In the Network study discussed earlier, the share of internal reports that concerned fraud increased from 10.9% in 2006 to 20.2% in the first quarter of 2010.[30] And according to the Ethics Research Center, the percentage of employees who reported misconduct when they saw it increased from 58 percent to 63 percent between 2007 and 2009, with almost all of that reporting directed internally.[31] These developments suggest a dramatically increased level of employee confidence that company compliance systems will protect their confidentiality and safety, and lead to effective corrective action.

The proposed rule does not provide adequate incentives for employees to report internally and to self-censor trivial or frivolous complaints

The SEC should design the whistleblower program to support and promote internal reporting. There can be little doubt, however, that the proposed rule—if implemented as

[27] 68 Fed. Reg. 18788, 18798 (Apr. 16, 2003).
[28] *See* U.S. Sentencing Commission, Guidelines Manual § 8B2.1.
[29] *See* 75 Fed. Reg. 27388, 27394 (May 14, 2010) (changes effective November 1, 2010).
[30] Network Report at 12.
[31] *See* Ethics Resource Center, *2009 National Business Ethics Survey* at 35-36.

drafted—would encourage a large number of employees with knowledge of wrongdoing to go directly to the SEC rather than make use of internal reporting channels. The minimum bounty under the program, $100,000 (10 percent of $1 million), is about twice the median household income in the United States—an enormous enticement for almost any employee. Moreover, penalties in SEC cases routinely amount to tens or even hundreds of millions of dollars, meaning that qualifying whistleblowers will have the potential to attain millionaire status many times over.

And the empirical evidence shows, consistent with common sense, that employees are more likely to make external allegations of wrongdoing when the potential benefits to doing so increase.[32] In the face of these incentives, it is difficult to imagine that many employees would forego the opportunity for a life-changing award by reporting their concerns internally.[33]

To be sure, as the preamble to the proposed rule points out, the available research indicates that whistleblowers often have multiple motivations, and may sincerely wish to promote change within their organization.[34] Even such principled employees, however, may find it difficult to resist the temptation of a large whistleblower award. By affording no countervailing reason for these employees to report internally, the proposed rule could have the unfortunate, and surely unintended, consequence of forcing the most loyal employees to choose between the company's health and their own financial benefit.

Moreover, experience suggests that a fair number of reports do not consist of actionable information. Many tips are trivial or frivolous, whether because an employee misunderstood something he saw, desires to neutralize a rival, or wishes to obtain protected status in order to protect himself against a pending or impending discharge or disciplinary proceeding grounded in wholly legitimate reasons. Significantly, Section 240.21F-2 of the proposed rule would extend the anti-retaliatory protections of Section 21F of the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act,[35] to anyone who provides the SEC with information relating to a potential violation of the securities laws, even if that person does not follow the specified procedures and conditions. This broad application of the anti-retaliatory protections will increase the incentive for misuse and overuse of the SEC

[32] *See* Bowen *et al.*, supra note 19.
[33] *See* T.M. Dworkin & E.S. Callahan, *Internal Whistleblowing: Protecting the Interests of the Employee, the Organization, and Society,* 29 Am. Bus. L. J. 267, 273 (1991) (noting that "substantial financial rewards" under False Claims Act provide "a great incentive to report the wrongdoing externally . . . rather than report the wrongdoing internally and have it corrected or reported by the organization").
[34] *See* 75 Fed. Reg. at 70514 n.103.
[35] 15 U.S.C. § 78u-6(h)(1).

reporting option. Although the Justice Department has announced that it will pursue employees who make false reports, criminal liability will be extremely difficult to prove, and the Department has limited resources and a myriad of other enforcement responsibilities. In addition, a sizeable proportion of the reports that do involve some type of inappropriate behavior likely will not concern conduct that violates the securities laws. The corporation is clearly better positioned than the SEC to handle such matters.

The preamble notes the risk of "an overflow of noisy signals—that is, a large number of tips of varying quality—causing the Commission to incur costs to process and validate the information."[36] Moreover, government officials—including those responsible for policing fraudulent reporting—already have expressed the concern that the reward program will attract a significant number of nuisance reports. For example, the U.S. Attorney for the Southern District of New York has noted "a lot of concern and discussion about whistleblowers run amok."[37] And Commissioner Paredes has observed that "the SEC will be inundated with allegations, not all of which will be fruitful for [the Commission] to pursue," and that "[g]iven the Commission's limited resources, separating the wheat from the chaff when faced with thousands upon thousands of complaints is very challenging."[38] By its own estimate, the SEC expects to receive approximately 30,000 tips under the program, half of which will lead to formal money claims.[39]

Even at this early stage, reports on the ground suggest that the concerns of reporting overload are becoming a reality: The SEC's associate regional director for examinations in the N.Y. office recently observed that the Office of Compliance Inspections and Examinations is "being deluged" with reports from whistleblowers.[40] And the recent postponement of the establishment of the whistleblower office due to the SEC's current funding uncertainties will only exacerbate the problem by forcing the SEC's existing enforcement staff to carry the load.[41] Thus, there can be little doubt that the rule as drafted threatens to overwhelm the Commission and degrade its ability to thoroughly investigate those allegations of wrongdoing that are actually well-founded.

Finally, by undermining the incentives to use internal reporting programs, the proposed rule risks undermining trust and fostering an adversarial culture within many

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[36] 75 Fed. Reg. at 70516.
[37] Dena Aubin, *Prosecutor warns of whistleblowers "run amok,"* Reuters (Nov. 12, 2010).
[38] Paredes Statement.
[39] John Eaglesham & Ashby Jones, *Whistleblower Bounties Pose Challenges*, Wall St. J. (Dec. 13, 2010).
[40] *SEC's Friestad Anticipates More Cases under Upcoming Fund Registration Regime*, BNA Securities Law Daily (Nov. 23, 2010).
[41] *See* Eaglesham & Jones, supra note 39.

companies. Employees who become aware of evidence of potential securities violations will have a tremendous financial incentive to take their concerns to the SEC rather than the company's directors. Such divergence between the incentives of employees and management is detrimental to companies, employees, and the long-term enforcement of the securities laws. The dangers of a poorly drafted rule are indicated by the results of a survey of 400 corporate board members conducted during an annual summit held by Corporate Board Member and NYSE Euronext. Only one percent of directors selected the whistleblower program as the regulation in the Dodd-Frank Act most likely to improve corporate governance (the lowest percentage of any of the choices), and 67 percent of directors selected the whistleblower program as the regulation most likely to damage corporate governance (the next most popular choice garnered only 17 percent).[42]

The Commission exhibited some understanding of the danger to internal compliance in drafting the proposed rule, and has included several provisions intended to preserve the effectiveness of internal reporting programs. *First*, the rule provides generally that an award cannot be made to those with "legal, compliance, audit, supervisory, or governance responsibilities for an entity" who report information communicated to them with the reasonable expectation that they would have the entity respond,[43] and also cannot be based on information otherwise obtained "from or through an entity's legal, compliance, audit or other similar functions or processes."[44] These exclusions would not apply, however, if the entity does not disclose the information to the Commission within a "reasonable time," or acts in "bad faith."

Second, the proposed rule would allow individuals who report information through internal compliance channels to still qualify for an award if, within 90 days, they also submit the necessary forms to the Commission.[45]

Third, the preamble explains that the Commission, in determining the amount of an award, may (but need not) consider "whether, and the extent to which, a whistleblower reported the potential violation through effective internal whistleblower, legal or compliance procedures before reporting the violation to the Commission."[46] Although "[t]he Commission will consider higher percentage awards for whistleblowers who first report

[42] Survey available at http://www.boardmember.com/Directors-Vote-Best-and-Worst-of-Dodd-Frank-Act.aspx.
[43] Proposed 17 C.F.R. § 240.21F-4(b)(4)(iv).
[44] *Id.* § 240.21F-4(b)(4)(iv). The preamble is clear that these exclusions "would not . . . apply to individuals with knowledge of potential violations who report their knowledge to supervisors, compliance or legal personnel." 75 Fed. Reg. at 70494 n.35.
[45] *See* Proposed 17 C.F.R. § 240.21F-4(b)(7).
[46] 75 Fed. Reg. at 70500.

violations through their compliance programs," this consideration "is not a requirement for [granting] an award above the 10 percent statutory minimum."[47]

Even considered in combination, these provisions will do little if anything to counteract the baseline incentive to bypass internal procedures generated by the award program. In the absence of an affirmative restriction on external reporting when effective internal compliance channels are available, or provision of a significant incentive for using those internal channels, employees will face an irresistible temptation to go to the SEC with their report. Enticed by this seriously skewed incentive structure, many employees with weak or dubious claims may adopt a lottery mentality, filing those claims in the hopes of beating the odds and garnering a substantial windfall. Employees may also seek to hedge their bets by lodging complaints with both the SEC and the company at the same time. If the Commission wishes to limit this type of harmful strategic behavior, which Congress cannot have intended to encourage or condone in creating this program, it must build robust safeguards into the rule.

The 90-day grace period—while eliminating one possible disincentive to internal reporting that the rule might otherwise create—does not itself establish an affirmative reason for employees to report internally. It is not at all clear why an employee with actionable information would take advantage of the 90-day window in the absence of some incentive to do so. To be sure, the rule does leave open the possibility that the Commission will provide larger awards to whistleblowers who report internally first. But, as provided for at present, this uncertain possibility—which is not even written into the rule itself—is unlikely to be sufficiently concrete and substantial to meaningfully affect reporting behavior. Significantly, the rule does not require the SEC to take this factor into account, but rather permits it to do so in its discretion, and when warranted in a particular case. This is hardly a compelling reason for a whistleblower to report through the company's internal mechanisms, particularly if the alternative available from the SEC is a guaranteed minimum of 10 percent of sanctions recovered. Thus, it seems clear that, despite the Commission's intentions, the various measures adopted will do little to prevent individuals from "report[ing] suspicious finding[s] [to the SEC] as soon as possible."[48]

Recommended modifications to the rule

To address the concerns expressed above, we recommend the following modifications to the rule:

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[47] *Id.*
[48] 75 Fed. Reg. at 70516.

I. Condition awards on whistleblowers first making use of available internal reporting options, and giving companies a reasonable time to respond

Section 240.21F-8(c) of the proposed rule ("Eligibility") should be modified to provide that a whistleblower can only qualify for an award if the whistleblower has first reported the information through the entity's internal reporting program, and has afforded the entity a reasonable opportunity to address the alleged violation. The rule could establish an exception to this requirement where the whistleblower can demonstrate to the Commission that the internal reporting program fails to comply with Section 301 of SOX (where applicable), or the standard set forth in the federal Sentencing Guidelines, or otherwise fails to adequately protect against retaliatory action. A number of states—including Ohio, Florida, New York, Maine, Indiana, New Jersey, and New Hampshire—have statutory whistleblower regimes that function in essentially this manner.[49] Section 10A of the Securities and Exchange Act similarly requires auditors who believe they have discovered an illegal act at a company to first report it to company management and the audit committee. To address the concern that a "reasonable opportunity" standard is too vague to afford proper guidance to whistleblowers and entities, the rule could specify a minimum time—for example, ninety days—that the whistleblower must allow for remedial action before taking the complaint to the SEC.

According to the preamble, the Commission "considered," but rejected, "the possible approach of requiring potential whistleblowers to utilize inhouse complaint and reporting procedures, thereby giving employers an opportunity to address misconduct, before they make a whistleblower submission to the Commission."[50] Among the Commission's "concerns was the fact that, while many employers have compliance processes that are well-documented, thorough, and robust, and offer whistleblowers appropriate assurances of confidentiality, others lack such established procedures and protections."[51]

Our proposal addresses these concerns by dispensing with the requirement of internal reporting if the whistleblower can demonstrate that the internal program fails to comply with applicable standards for effective internal reporting systems. We note, moreover, that our proposal—by limiting only the circumstances in which a whistleblower is entitled to an award—would not affect the scope of the statutory retaliation protections

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[49] *See, e.g.*, Ohio Rev. Code Ann. § 4113.52(A)(1)(a); Fla. Stat. Ann. § 448.102(1); N.Y. Lab. Law § 740(2)(a), (3); Me. Rev. Stat. Ann. tit. 26, § 833(2); Ind. Code § 22-5-3-3(a); N.J. Stat. Ann. § 34:19-4(II); N.H. Rev. Stat. Ann. § 275-E:2.
[50] 75 Fed. Reg. at 70496.
[51] *Id.*

afforded whistleblowers under the rule.[52] Moreover, as discussed above, the past decade has been a time of tremendous improvement in the area of corporate compliance, and most companies now have reporting systems that provide for the procedures and protections identified by the Commission as the critical components of an internal reporting program. The structure of the SEC whistleblower program should not be driven by the small minority of companies that are failing to establish systems that meet these standards.

II. Require bad faith by the company before allowing awards based on reporting to the SEC of information obtained through compliance processes or by compliance personnel

We support the current exclusion from the definition of "original information" applicable to information received and reported by legal and compliance personnel and information obtained through compliance or audit functions. We are concerned, however, that the carve-out to these exclusions where an entity does not disclose the information in a "reasonable time," or acts in "bad faith," could have the effect of encouraging both compliance and non-compliance employees to forego internal procedures in favor of direct reporting to the SEC. To address these concerns, we recommend modifying the carve-out so that it is not triggered merely by the passage of an "unreasonable" amount of time—a vague standard that provides little guidance—but rather requires in all circumstances some showing of bad faith on the part of the company.

Without these changes, the carve-out could have the pernicious effect of incentivizing those tasked with detecting and investigating fraud to take information to the SEC any time a company does not take immediate corrective action in response to a report. It would then be up to the SEC to decide—based on an *ex post* review of "all of the circumstances"[53]—whether the delay was reasonable and in good faith. The possibility of such an after-the-fact inquiry into reasonableness would subject companies and covered individuals to uncertainty about their rights and obligations. It also would place companies under a tremendous pressure to rush their investigations and to disclose their findings as soon as possible—potentially before they have had adequate time to collect and process all the relevant evidence. Moreover, even early on in a company's investigation, the carve-out as proposed might encourage compliance personnel to report to the SEC just in case the company does not wrap up its investigation right away. And an employee outside the covered categories who is considering reporting internally may decide instead to go directly to the SEC based on a concern that someone in the company's compliance department could seek the

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[52] *See* 15 U.S.C. § 78u-6(h)(1); *see also* Proposed 17 C.F.R. § 240.21F-2(b).
[53] 75 Fed. Reg. at 70494.

whistleblower award for himself. The changes we have proposed to this rule thus are essential to ensuring that the internal and external systems work together effectively.

III. Exclude from award eligibility information reported after employer has initiated an investigation

Companies should not be penalized for initiating an internal investigation into suspected wrongdoing. Yet the proposed rule does precisely that by permitting a person who submits a report to the SEC to qualify for an award even if the person submits the information ***after*** receiving a request about possible violations from employer personnel conducting an internal investigation, compliance review, audit, or similar function.[54] We urge modifying the definition of "voluntarily" in proposed Rule 21F-4(a) to bar recovery in this situation. The Commission considered but rejected such an exclusion, reasoning that the purposes of section 21F of the Dodd-Frank Act would be undermined if such a bar were in place and an employer did not disclose the results of its internal investigation to the Commission.[55] This concern is overstated: the vast majority of employers that have initiated an investigation have little incentive to bury its results without taking corrective action. And to address the concern regarding employer stonewalling, the Commission could include a "bad faith" exception in the rule that would permit the whistleblower to qualify for an award if the whistleblower can show that the employer conducted a bad-faith investigation.

IV. Categorically exclude reports of information subject to the attorney-client privilege, or information obtained by an attorney as a result of legal representation of a client, from award eligibility

As the preamble acknowledges, the "provi[sion] [of] financial incentives for attorneys and others to breach the attorney-client privilege in order to seek an award . . . would interfere with the ability of companies and individuals to share information with an attorney while seeking legal advice."[56] To address this concern, proposed Rule 21F-4(b)(4) generally bars eligibility for an award based on information derived from communications subject to the attorney-client privilege or obtained by an attorney as a result of legal representation of a client. But it establishes exceptions for disclosures "authorized by § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise."[57] We believe that these exceptions are dangerous and unwise. Attorneys occupy positions of great trust and responsibility within most companies, and often are afforded access to the most sensitive

[54] *See* Proposed 17 C.F.R. § 240.21F-4(a).
[55] *See* 75 Fed. Reg. at 70490 n.11.
[56] *Id.* at 70514.
[57] Proposed 17 C.F.R. § 240.21F-4(b)(4).

corporate information. If adopted, the proposed exceptions would render even more difficult the fine distinctions that section 205.3(d)(2) and state attorney conduct rules require attorneys to make between permissible and impermissible disclosures. Attorneys should not make decisions about whether to disclose client confidences in the shadow of a potential financial windfall.

To avoid placing attorneys in such a compromised position, the Commission should provide for a blanket exclusion by eliminating the exceptions for authorized disclosures. This modification would render the rule for attorneys similar to the blanket exclusion applicable to independent public accountants performing engagements required under the securities laws.

V. Provide further protection for information covered by companies' attorney-client privilege

Proposed Rule 21F-16(b) would authorize Commission staff to communicate directly with whistleblowers who are directors, officers, members, agents, or employees of an entity that has counsel without first seeking the consent of the entity's counsel. According to the preamble, such direct contacts are consistent with ABA Model Rule 4.2 (which every jurisdiction has adopted in some form) because they are "authorized . . . by law," namely, section 922 of the Dodd-Frank Act.[58] The Commission asks whether it should "consider rules to address other potential issues that may arise from state bar professional responsibility rules when the Commission staff receives information about potential securities law violations from whistleblowers."[59]

We believe that it should. In particular, we are concerned that proposed Rule 21F-16(b), by excluding company counsel from the process whereby the SEC contacts potential whistleblowers, threatens to seriously erode the protections afforded companies by the attorney-client privilege. To be sure, the preamble states that "[t]he proposed rule is not intended, and will not be used, to obtain otherwise privileged information about the entity."[60] And the proposed rules elsewhere afford some protection for corporate information covered by the attorney-client privilege.[61]

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[58] 75 Fed. Reg. at 70510.
[59] *Id.*
[60] *Id.* at 70510 n.89.
[61] *See* Proposed 17 C.F.R. § 240.21F-16(a) (excluding confidentiality agreements dealing with information covered by the privilege from the general prohibition on the enforcement of confidentiality agreements relating to communications with Commission staff about potential securities law violations).

In light of the significant dangers presented by the rule's abrogation of ABA Model Rule 4.2, however, these measures do not suffice. In particular, if the rule is to permit the SEC to bypass company counsel in communicating with whistleblowers, we think that it must also establish clear and binding safeguards that are adequate to protect each company's right to assert the attorney-client privilege with respect to privileged information, including any conversations that company counsel may have had with the whistleblower.

Accordingly, at minimum, the rule should provide that whistleblowers who contact the SEC directly must immediately be read a cautionary statement informing them of the company's right to protect privileged information and asking whether the whistleblower's report includes information received in the context of communications with corporate counsel, or any otherwise privileged information. If the answer is yes, the SEC should be obligated to contact the company and provide it with a reasonable amount of time to assert any relevant privilege before receiving any information from that individual.

VI. Exclude wrongdoers from award eligibility

The preamble recognizes that the payment of awards "to individuals who have violated the federal securities laws . . . could result in perverse incentives by potentially encouraging violations of the law."[62] But the proposed rule does not, at present, categorically exclude wrongdoers from eligibility for an award. Instead, the rule provides merely that the SEC must calculate the whistleblower's eligibility for, and the amount of, an award without taking into consideration any monetary sanctions (i) against the whistleblower or (ii) against an entity with liability based substantially on conduct for which the whistleblower is responsible.[63]

Although the preamble states that "[t]he rationale for th[ese] limitation[s] is to prevent wrongdoers from financially benefitting by, in essence, blowing the whistle on their own misconduct,"[64] the limitations do not in fact accomplish this goal. A whistleblower can recover for reporting on his own misconduct, so long as his report concerns an entity with a total liability that is not based "substantially" on the whistleblower's actions. As noted by Commissioner Aguilar, "wrongdoers already have significant incentives to come forward as they may receive a reduced sanction and other credit for their assistance," and "[t]aking the proposed whistleblower program in conjunction with our cooperation program could lead to

[62] 75 Fed. Reg. at 70514.
[63] *See* Proposed 17 C.F.R. § 240.21F-15.
[64] 75 Fed. Reg. at 70509.

the unjust result that wrongdoers receive both reduced sanctions and profit financially."[65] It could also create pernicious incentives for employees or others to participate in misconduct in a strategic effort to lay the groundwork for a possible future report to the SEC, thus potentially furthering the scheme and doing immediate harm to the company and its shareholders. Even if the employee ultimately does report to the SEC, and the SEC takes remedial action, these losses may be irrecoverable.

To address these concerns, the rule should provide categorically that any person with any responsibility for an entity's liability is ineligible to receive an award. Even if wrongdoers do sometimes "have the most significant and relevant information,"[66] the dangers of rewarding those wrongdoers with a monetary award are simply too great to justify.

VII. Exclude frivolous claims from scope of anti-retaliation provisions

The Commission asks whether "application of the anti-retaliation provisions [should] be limited or broadened in any . . . ways," and in particular whether the Commission should "consider promulgating a tule to exclude frivolous or bad faith whistleblower claims from the protections afforded by the anti-retaliation protections."[67] We strongly recommend that the anti-retaliation provisions not cover those who make frivolous or bad faith reports to the SEC. Nothing in the statute requires such broad protection. And given the significant costs that false reports can impose on companies, shareholders, and employees, the rules should not hamstring the ability of companies to take appropriate action against those who have no evidence of securities law violations, but rather simply seek to use the reporting process to inflict harm for inappropriate reasons or to garner attention. We believe that the following modification of Rule 21F-2(b) would address this concern, while retaining an appropriately broad protection for those whistleblowers who report bona fide information regarding violations: "the retaliation protections afforded to whistleblowers by the provisions of paragraph (h)(1) of Section 21F of the Exchange Act (15 U.S.C. 78u-6(h)(1)) apply irrespective of whether a whistleblower satisfies the procedures and conditions to qualify for an award. <u>The protections do not apply, however, if the employer can demonstrate that the whistleblower did not have a good faith belief that the information reported concerned a violation of the securities laws</u>."

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[65] Luis A. Aguilar, Commissioner, SEC, *Speech by SEC Commissioner: Enlisting Whistleblowers in the Battle Against Securities Fraud* (Nov. 3 2010).
[66] 75 Fed. Reg. at 70517.
[67] *Id.* at 70511.

The CCMC and ILR are committed to providing the views of the business community to the SEC and other government agencies. Businesses have a strong interest in detecting and eliminating illegal activity within their organizations—and they have acted on that interest by establishing effective internal reporting and remediation systems. The Commission should not adopt a rule that will have the effect of rendering those systems a nullity.

We thank you for your consideration and would be happy to discuss these issues further with you and your staff.

Sincerely,

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CC: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Mr. Robert Khuzmai, Director of Enforcement