

May 11, 2011

Testimony of
Ken Daly, President and CEO of NACD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Chairman Scott Garrett

Hearing on:
Legislative Proposals to Address the Negative Consequences of the Dodd-Frank Whistleblower Provisions

Chairman Garrett, Members of the Subcommittee, and fellow guests, thank you for the opportunity to speak with you this afternoon about whistleblowing—a critical issue for Corporate America.

I'm Ken Daly, president and CEO of the National Association of Corporate Directors, the membership organization for America's boards of directors. Our 11,000 members represent men and women who oversee millions of American jobs.

We applaud you for holding these hearings to discuss the **whistleblower bounty and protection provisions** of the Dodd-Frank Act. NACD has significant concerns about these provisions—and about the proposed implementing rule from the Securities and Exchange Commission (SEC). To help solve some of these issues, Rep. Michael Grimm (R-NY) has drafted a bill to amend Dodd-Frank (or more precisely the law that Dodd-Frank amended). We support the Grimm bill, which is consistent with our views.

The NACD Comment Letter Parallels the New Grimm Bill

We have submitted a comment letter (attached herewith) to the SEC with our concerns, as follows:

- Under the proposed SEC rule, a person possessing “independent knowledge” can report it directly to the SEC and collect a large bounty—in some cases worth many times the person's typical annual salary. This program could actually create a perverse incentive to let a problem grow and then report it, rather than to solve the problem in its earliest stages.

NACD believes that such individuals should be required to report allegations or violations to the internal compliance system prior to submitting them to the SEC. We would therefore agree with the Grimm bill, which states “In order to be eligible for an award, a whistleblower shall “first report the information...to his or her employer before reporting such information to the Commission.” (The Grimm bill does state that an employee may still report to the SEC prior to his employer if the

company's whistleblowing system is deficient in some way, but this would be an exception in Corporate America today.)

- Furthermore, the rule does not clearly exclude all internal and external compliance personnel from being able to claim "independent knowledge."

NACD believes that to avoid any dilution of professional integrity and effectiveness, the definition of "independent knowledge" should exclude anyone involved in compliance work—including but not limited to external auditors but also government employees, attorneys, other professionals, and internal auditors.

- *NACD believes the proposed rule should exclude from the definition of "independent knowledge" all communications with attorneys, even in cases where the privilege has been waived for any reason. The concept of "privilege" has never been well defined. The rule should define some types of communication that under all circumstances and without exception should be included in the definition of privilege.*
- *It must be made clear that individuals in an internal audit function, or those individuals working in the capacity of internal audit, are not deemed to have "independent knowledge." Oftentimes, an employee in a different department or an organization may have temporary duties that aid the internal or external auditors. Such individuals should also be excluded from the bounty system.*
- *Also, under the proposed rule, the time frame for corporate cure prior to government action would be 90 days. NACD believes that this grace period for corporate reporting should be three to six months.*
- *Finally, the proposed rule leaves no recourse to a company if an employee circumvents the compliance system or makes false allegations against a company. Employers should have the ability to use existing disciplinary measures to respond to employees who make false claims. We would also support the added clarifications of the Grimm bill, which provides employers with an ability to remove employees who violate established employment agreements, workplace policies, or codes of conduct.*

Additional Observations Concerning "Independent Knowledge"

Corporations and their directors today operate in a complex global economy, with risks of greater magnitude and unpredictability than ever before. At the same time, directors face heightened expectations from shareholders, regulators, and the general public. Consequently, directors need and are seeking more advice from outside advisors, including advice on compliance matters.

By creating a perverse incentive for reporting allegations directly to the government rather than to the company, the Dodd-Frank legislation makes directors less inclined to ask for outside perspectives. This reduces the information flow to the board at precisely a time when the board needs it most.

Legislative Proposal from NACD

As mentioned earlier, NACD believes that the proposed Grimm bill has merit. We acknowledge that Grimm's bill requires a study conducted by the U.S. Comptroller General to determine whether the whistleblower incentive program has had an impact on shareholder value. We agree that this study should move forward if Grimm's bill is passed. However, we believe a study should also be conducted to ascertain the effectiveness of the whistleblower systems put in place at substantial costs pursuant to Sarbanes-Oxley.

Congress should consider asking the SEC to delay taking any action on the Dodd-Frank whistleblowing bounty and protection program until there is a thorough study of current whistleblowing programs. It is worth emphasizing that the Sarbanes-Oxley Act, passed in 2002, **already mandates a whistleblowing system** (Section 301) with up-the-ladder reporting for attorneys (Section 307). Sarbanes-Oxley says companies may not retaliate against whistleblowers (Section 806). These provisions, after a decade, have taken hold in Corporate America. Let us see if they are working as intended. I believe they are.

Thank you for your attention.

Submitted by Ken Daly on behalf of the National Association of Corporate Directors.