Americans For
Limited Government

9900 Main Street Suite 303 · Fairfax, VA 22031 · Phone: 703.383.0880 · Fax: 703.383.5288 · WWW.GETLIBERTY.ORG

December 7, 2010

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

Submitted Electronically Via Regulations.gov

Re: File S7-33-10, Comments of Americans for Limited Government on Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

Dear Ms. Murphy:

These comments are submitted in response to the Securities and Exchange Commission's ("Commission") Notice of Proposed Rulemaking on Section 21F of the Securities Exchange Act of 1934 entitled "Securities Whistleblower Incentives and Protection," published November 17, 2010, at 75 Fed. Reg. 70,488.

Americans for Limited Government ("ALG") is a national research and advocacy organization that is dedicated to putting the principles of limited government into action by working to keep the government within the confines set for it by the U.S. Constitution.

Introduction

In creating this program the Commission is putting a potential "golden whistle" in everyone's hand in order to derive "higher-quality" tips in its endeavor to battle any securities violations. The Commission should carefully consider the consequences and implications of the current proposal. It may very well discover that it has neutered a key partner in companies' internal compliance programs, who could do much to help shoulder the burden by vetting investigations.

The major point addressed in these comments is how this new proposal undermines the Commission's past rules which require covered entities to set up internal compliance programs. It should strongly consider keeping such programs involved by requiring whistleblowers to first report internally or at least simultaneously to the Commission. Additionally, this comment discusses the tension between the interests of whistleblowers, the entities, victims, and the establishment of rules governing conduct of attorneys. First however, a brief review of current law is in order.

Current Law

Eight years ago Congress passed the Sarbanes-Oxley Act of 2002[1] ("Sarbanes-Oxley"), in which Section 301 amends the Security Exchange Act of 1934 by adding Section 10A(m).[2] It mandates "issuers" (companies) put in place internal procedures designed to ensure accurate financial disclosure or they will be prohibited by the national securities exchanges and national securities associations from listing securities. The companies shall also "establish procedures for internal reporting and compliance by employees."[3] Section 302 requires signing officers to certify they are "responsible for establishing and maintaining internal controls."[4] Furthermore, in Section 404, companies are required to submit an annual internal control report that states the "responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting" and "contain an assessment… of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."[5] Congress added this measure to beef up internal compliance programs because auditors are *required*, under previous sections, when they detect information indicating an illegal act, to first report internally to an appropriate level of management, then to the board of directors, and finally to the Commission itself if nothing has been done.[6] Many of these requirements were developed in response to accounting scandals of the late 1990s.

Rather than comment on all questions posed by the Commission in its proposal, a few key issues are discussed below. These issues are listed in order of importance.

[1] Pub. L. No. 107-204, 116 Stat. 745, enacted July 30, 2002.
[2] 15 U.S.C. § 78j-1(m).
[3] *Id.*
[4] 15 U.S.C. § 7262.
[5] *Id.*
[6] *See*, 15 U.S.C. § 78j-1(b).

A. ***Response to Request for Comment Number 19:*** **The proposed rule undermines an entity's internal compliance programs by allowing whistleblowers to side-step such programs and go directly to the Commission.**

While the current law applies only to audits, the Dodd-Frank bill significantly broadens the reporting to *any* violation of securities law by practically *anyone*.[7] Instead of standing in support of the company internal compliance programs, which were mandated be put in place just a few years ago, the Commission is now putting potentially golden whistles in everyone's hands, and allowing bounty hunting informers and their contingency fee seeking attorneys to side-step the process of internal reporting entirely. Therefore, in answer to the Commission's request for *comment number 19*, this proposed rule does frustrate and undermine internal compliance structures called for in past legislation. Former Commission Chairman Harvey L. Pitt echoes this sentiment: "The new law contains seeds for undermining corporate governance and internal compliance systems. Compliance departments will now be competing with the S.E.C. for who gets the tip first."[8]

The Commission is very clear about the purpose of this proposal:

> The Commission's primary goal, consistent with the congressional intent behind Section 21F, is to encourage the submission of high-quality information to facilitate the effectiveness and efficiency of the *Commission's enforcement program*.[9] (emphasis added)

This goal seems very government oriented, as it seeks to bolster the effectiveness of "its own" enforcement program and potentially destroys the companies' internal compliance programs. The Commission is fully aware, having openly admitted, that one of the gravest concerns with this regulation is the great potential it has to undermine companies' internal compliance programs. It claims, however, to have addressed this concern.

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[7] While the proposal does exempt attorneys, accountants, and those whose job it is to monitor such things, it does widen the scope of people who can report beyond current or former employees. This could include independent contractors, consultants, sales agents and many others who are familiar enough with a company to be privy to such information.

[8] Edward Wyatt, *For Whistle-Blowers, Expanded Incentives*, N.Y. TIMES, November 14, 2010, at B1, available online at: http://www.nytimes.com/2010/11/15/business/15whistle.html?_r=2&scp=2&sq=whistle%20blower&st=cse (accessed November 30, 2010).

[9] Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Security Exchange Act of 1934, 75 Fed. Reg. 70,488, 70,496 (November 17, 2010) (to be codified at 17 C.F.R. pts. 240 and 249).

> [W]e have included provisions in the proposed rules intended not to discourage whistleblowers who work for companies that have robust compliance programs to first report the violation to appropriate company personnel, while at the same time preserving the whistleblower's status as an original source of the information and eligibility for an award.[10]

While it is true that it does not "discourage" the reporting of information internally first, it certainly does very little to encourage the use of these programs. Two ways this proposal seeks to "encourage" reporting to internal compliance programs is to, first, hold a whistleblower's place in line when they choose to report internally first, giving them 90 days to then follow up with a report to the Commission (Proposed Rule 21F-4(b)); and secondly, the Commission says it will take this act of first reporting internally into account when calculating the percentage of the reward, potentially awarding more. But will these proposals really have the effect of encouraging whistleblowers to initiate their reports internally?

In the first instance, it seems the Commission has made the option to first report internally a wasted effort for the whistleblower. Not only will it cause delay in getting the Commission involved, but as one commentator noted, "There is no mandate for a company to let an employee know within 90 days whether it has investigated or resolved a complaint, which could undermine any potential incentive for a tipster to turn first to an employer."[11] Furthermore, if the whistleblower is an employee, they will no doubt feel more protected against retaliation once the government is there to protect them and investigate the reported violation. This proposal lacks incentive for whistleblowers to keep things internal.

In the second instance, the Commission says it will potentially award more money to whistleblowers for reported violations for those that opt to first report internally. However, the proposal fails to define how much this will be taken into consideration when calculating the award. Furthermore, since the whistleblower is already set to net more than twice the medium household income for the United States[12] (calculated from the minimum SEC award of 10%), will the "potential" increase really prove to be incentive enough to make a person choose to go internally first?

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[10] *Id.* at 70,488.
[11] Wyatt, *supra*, note 8.
[12] Based on U.S. Census Bureau Report, *Income, Poverty, and Health Insurance Coverage in the United States: 2009*, September 2010. Median household income in the United States is $49,777. *See*, http://www.census.gov/prod/2010pubs/p60-238.pdf (accessed November 30, 2010).

It makes little sense that since current law mandates that companies put in place internal compliance programs, that the Commission now makes them pointless. The result will be to destroy the companies' current compliance programs and negate much of the resources spent creating and developing these mandated programs.

Not only does it frustrate the compliance programs it affects the company climate and morale. Now anyone a company deals with, employee or not, has a golden whistle ready to turn on the company should anything smack of suspicion. Instead of being motivated to do the right thing out of a sense of pride and honor, the law motivates with greed and a get rich quick mentality. Instead of fostering a corporate environment of trust and commitment to the company, we are closer to a "police-state" where we are encouraged to turn each other into the government instead of dealing internally. As put by Jacob Frenkel, a former Commission enforcement lawyer, the proposed whistleblower program, "reverse[s] a decade of effort promoting integrity, self-remediation, and corporate self-reporting."[13] What Commissioner Frenkl is referring to used to be called, "The American Way."

B. ***Response to Request for Comment Number 18*: The Commission should consider the benefits of requiring internal reporting first or at the very least require simultaneous reporting to the Commission.**

In response to question for *comment number 18*, Section 21F *should* require internal reporting first, or at the very least, simultaneous filing of the complaints with the Commission. The Commission already receives 300 tips and complaints a day,[14] totaling approximately to 750,000 last year.[15] To handle the expected increase in reports, the Commission had created a team of 70 enforcement attorneys, and was recently granted $230 million for the 2010 fiscal year by the Senate Committee on Appropriations, with a promised $256 million for 2011 to hire approximately 375 more staff.[16] How does the Commission plan to utilize these vast resources? A law partner at

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[13] Bruce Carton, *Pitfalls Emerge in Dodd-Frank Whistleblower Bounty Provision*, SECURITIES DOCKET, September 9, 2010, available online at: http://www.securitiesdocket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision (accessed November 30, 2010).

[14] John Filar Atwood, *Panelists Discuss Dodd-Frank's Impact on SEC Enforcement*, SEC FILINGS INSIGHT, October 7, 2010, HighBeam Research, *available at*: http://www.highbeam.com/doc/1P3-2171912041.html, (accessed November 18, 2010).

[15] John Morgan, *Bulked-Up SEC to Take On Asset Managers; OCIE Pursuing Headline-Making, Groundbreaking Cases*, MONEY MANAGEMENT EXECUTIVE, May 31, 2010, HighBeam Research, available online at: http://www.highbeam.com/doc/1G1-227803133.html, (accessed November 30, 2010).

[16] *Id.*

K&L Gates states that the "new SEC will be relying more on tips and complaints to locate misconduct, rather than trying to do a routine inspection of everyone."[17] If this is the case, then nothing changes – the Commission will continue to play defense in the world of securities violations despite the increase of funding.

Therefore, though such resources may be helpful, the Commission should require whistleblowers to first report internally. The benefit is three-fold. First, it shows consistency by the Commission in promoting the development of internal compliance programs it has previously mandated. Second, it promotes a working relationship between the company and the Commission. Finally, internal compliance programs are able to do what they were designed to do – respond quickly to remedy violations, and handle misleading reports internally. The Commission can certainly monitor them and become involved later if necessary.

Even if whistleblowers are required to first report internally, the proposed rule would not solve all the problems. Not all companies have strong internal compliance programs. The Commission itself makes this implicit distinction by not wanting to discourage whistleblowers from reporting internally to those who have "robust compliance programs."[18] What about those who do not have "robust compliance programs"? In a recent survey conducted by SEI[19], chief compliance officers feel that the greatest impediment to being effective is that they have too many other responsibilities, with another 14 percent noting a lack of resources or funding being a major contributor.[20] As Jim Volk, the Chief Compliance Officer ("CCO") for SEI's Investment Manager Services division stated:

> The harsh reality is that CCOs are being asked to do more and more and their resources aren't growing to meet the need. With Dodd Frank and ongoing SEC rulemaking activity, the regulatory environment is constantly changing and CCOs need all the help they can get to keep up.[21]

The proposed regulation does little to address this. Rather, it pushes people to side-step mediocre compliance programs and come directly to the Commission which is holding

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[17] *Id.*

[18] 75 Fed. Reg. 70,488, 70,488 (November 17, 2010).

[19] "SEI (NASDAQ: SEIC) is a leading global provider of asset management, investment processing and investment operation solutions for institutional and personal wealth management." *About SEI*, available online at: http://www.seic.com/enUS/about.htm, (accessed November 30, 2010).

[20] *Compliance Poll: Too Many Responsibilities, Too Few Resources Greatest Impediments to CCO Effectiveness*, October 26, 2010, available online at: http://www.seic.com/enUS/about/4303.htm, (accessed November 30, 2010).

[21] *Id.*

a treasure chest of $452 million, ready to dole out to anyone who step forward with a "hot tip."[22] Instead of placing the emphasis on whistleblowers and play towards mankind's greed, why not focus on bolstering internal compliance programs? Instead of paying lip service, shouldn't the government be creating incentives for companies to develop the type of "robust compliance programs" to which the Commission refers? By doing so, the Commission would be operating consistent with past legislation and create a first line of defense to weed out frivolous claims and be able to direct their resources towards any "high quality" tips and monitoring the security community. One way they could promote the use of internal procedures is to allow monetary awards to be distributed through such programs. While this would require new legislation, it would go a long way to creating a more even balanced, self-policing system where the Commission works together with internal compliance programs and not against, stepping in only where necessary. As David Hirschmann, President and CEO of the U.S. Chamber's Center for Capital Market Competitiveness, suggests:

> [The SEC should] create a system where regulators work with the robust compliance programs already in place to best protect from corporate wrongdoing. We urge the SEC to study the potentially devastating consequences of this rule on businesses and to work with shareholders to create a manageable system.[23]

This makes more sense than paying lip service to companies' programs, while simultaneously providing whistleblowers with an avenue to bypass internal procedures. The Commission should go out of its way to promote the use of internal compliance programs by requiring whistleblowers to report there first, and preserve a most needed ally in the monitoring of the securities world.

C. *Response to Request for Comment Number 37:* The Commission's proposal wrongly gives preference to the whistleblowers over victims.

The proposal asks for comment on the tension created between the interests of whistleblowers and victims in the foreseeable circumstance where there is not enough

[22]*Annual Report on Whistleblower Program, Securities and Exchange Commission*, October 2010, available online at: http://www.sec.gov/news/studies/2010/whistleblower_report_to_congress.pdf, (accessed November 30, 2010).

[23]*U.S. Chamber Urges SEC to Consider Potential Consequences of Whistleblower Bounty Program*, U.S. Chamber of Commerce, November 3, 2010, available online at: http://www.uschamber.com/press/releases/2010/november/us-chamber-urges-sec-consider-potential-consequences-whistleblower-boun, (accessed November 30, 2010).

money in the Exchange Commission Investor Protection Fund to satisfy both. The proposed rule favors fully rewarding the whistleblower, even at the expense of the victim. This is backwards. While the whistleblower is taking a significant risk in reporting the violation, he still had a choice in facing that risk. However, the victim has no choice. They suffered loss by the wrongful choice of another. The goal should be to make them whole. As explained in the proposed rule, however, the victim would not only stand to lose out by the wrongdoer, but also by those who choose to do the right thing. A whistleblower, then, has everything to gain by reporting a violation, while the victim has everything to lose. To mitigate this tension, the Commission should consider the interests of the victim first. Only after the victim is made whole, should the whistleblower be rewarded.

D. *Response to Request for Comment Number 29:* **Since this legislation is creating more investigations and lawsuits, the Commission should adopt some form of attorney conduct standards since this will be a specialized area of law.**

The Commission needs to look back a few years ago to Section 307 of the Sarbanes-Oxley Act where "standards of professional conduct for attorneys appearing and practicing before the Commission in any in representing of issuers" is addressed. They might adopt some form of 17 C.F.R. § 205.1 *et. seq.*, which details the requirements of Sections 307, and make it applicable to the representation of whistleblowers.

Given that there are already a myriad of law firms advertising and soliciting work on whistleblowing, adopting some sort of attorney conduct standards would be wise.

<u>Conclusion</u>

Before becoming deaf from whistleblowers' shrieks, the Commission should make changes to its proposed rule that not only encourage but also support corporate compliance programs.

Sincerely,

William Wilson
President