Statement by SEC Commissioner: Adoption of Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

by

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Thank you, Chairman Schapiro. I'd also like to thank the staff working on today's rule for their efforts over the past several months. Without a doubt, crafting an effective and efficient whistleblower program of this magnitude is a significant challenge, and the staff involved with this rule have tried very hard to meet that challenge.

Notwithstanding their efforts, however, I am afraid that the program being adopted today materially suffers in key respects and makes it less likely that our whistleblower program will be successful in meeting the important goals of prevention, timely detection, and effective enforcement of securities law violations.

Most fundamentally, the rule suffers in two overarching ways:

> (1) It significantly underestimates the negative impact on internal compliance programs; and
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> (2) It significantly overestimates our capacity to effectively triage and manage whistleblower complaints.

As I mentioned at the proposing stage, the whistleblower provisions of the Dodd-Frank statute are particularly challenging to implement because of the important and sometimes conflicting public policy interests that are at stake: in particular, between promoting robust internal compliance reporting programs and encouraging high quality tips from whistleblowers. It is a delicate balancing act. And, striking the right balance between these at times competing interests is imperative because there are trade offs that affect the overall effectiveness and efficiency of our enforcement efforts, as both play an important role in our investor protection scheme.

In our proposing release, the Commission noted the importance that the securities laws and our enforcement efforts place on robust internal compliance programs; it highlighted concerns that large whistleblower financial incentives might unduly undermine these useful and complementary resources and functions; and it queried how best to approach the task of balancing these interests.

While I appreciate that today's release seeks to provide additional incentives for whistleblowers to use internal reporting channels, I remain deeply concerned that they are not sufficient to preserve the value of internal compliance programs and their contribution to our enforcement efforts.

An inherent risk of the approach adopted in the final rule, is that the monetary sums at stake will provide a significant enough incentive for whistleblowers to completely bypass internal reporting in favor of coming straight to the Commission. A fundamental failure of today's release is that it underestimates this dynamic and the ensuing impact on internal compliance reporting mechanisms.

Corporate compliance programs depend on a robust flow of information in order to be effective. Indeed, information is the lifeblood of such programs. Diverting a large portion of that flow of information to the government will impair companies' ability to step in and interrupt violations at an early stage. This does not benefit investors, and it is at odds with the purposes of the securities laws.

Reporting such information exclusively to our Division of Enforcement will not have the same effect as reporting such information to a company's internal compliance program. Unlike a company engaged in the act of selfpolicing, the Division must observe numerous legal formalities that are required of government actors. As a consequence, the public investigative process can be substantially more ponderous and time-consuming than private investigative processes. And there is a danger in not addressing matters quickly and decisively. By diverting tips and complaints from private channels to the Commission, we may end up permitting violations to last longer and grow more serious. This cannot be the result intended by Congress in creating the Dodd-Frank whistleblower program.

Indeed, I fear the Commission has elected to implement a whistleblower program that favors a pound of cure over an ounce of prevention.

The Division of Enforcement's task will only get harder once it starts to receive more and more whistleblower complaints. The volume of these complaints will surely grow as we begin writing some very large checks to successful whistleblowers, which has been the experience of the Justice Department in the False Claims Act area.

This leads me to a second fundamental failure of today's release: namely, it overestimates the ability of the Division of Enforcement to triage and manage incoming tips and complaints. Any triage process like this will be challenging, and a high-volume flow of information will strain our existing triage resources. The staff has assured me that they'll be able to handle the incoming flow of complaints, but I fear they are not being adequately circumspect.

Complex regulatory programs inevitably have unintended consequences, and too little has been done here to anticipate and prepare for such eventualities. A better course, in my view, would have been to adopt some form of contemporaneous reporting to both the Commission and to internal compliance programs, thereby ensuring a greater degree of confidence that potential securities law violations would be timely detected and acted upon without sacrificing the prerogative of the Commission to act as it sees fit in any given case. Indeed, such an approach would have been more incremental in nature, and it would have given the Commission an opportunity to evaluate its program in operation before taking decisions that could irreversibly damage valuable corporate compliance mechanisms.

Today's release suffers from other notable weaknesses as well.

One such weakness relates to the treatment of information provided by attorneys in order to obtain a whistleblower award. Permitting attorneys to be freely eligible for such awards would undermine the attorney-client privilege and have far-reaching, unpredictable consequences. The release has acknowledged as much, noting the importance of protecting the attorney-client privilege. Accordingly, at least in the first instance, the rule excludes information obtained through attorney-client privileged communications from the definition of "independent knowledge" or "independent analysis."

This would appear, at first glance, to prevent attorneys from breaching their duties of loyalty and confidence by becoming whistleblowers. However, what the rule gives with one hand, it appears to take away with the other. The above exclusion will not apply where the attorney whistleblower has a reasonable basis to believe that disclosure of the privileged information is necessary to prevent substantial injury to the financial interest or property of investors.[1]

This exception utterly swallows the rule. Many, if not most, potential securities law violations can be characterized as threatening substantial financial injury to investors and our natural instinct will be to interpret this provision liberally. Thus, this exception to the attorney exclusion will have the effect of allowing attorneys to breach their duties of trust and confidence to their clients, thereby undermining the very privilege that the rule purports to protect.

Finally, while there are equally difficult issues concerning other parts of the rule, I would like to focus on just one of them by revisiting an issue I've discussed in a variety of contexts, including last week's proposal of rules concerning nationally recognized statistical ratings organizations. The Commission has taken the view that it is only required to analyze costs and benefits flowing from the Commission's exercise of its discretionary authority. This approach is too narrow and improperly limits the scope and regulatory value of cost-benefit analysis. In the context of the current rule, this approach has led us to drastically underestimate the costs of the whistleblower program.

As one of many examples, consider the following: to the extent that the rule will tend to convert internal complaints into SEC investigations, the defense costs of companies will increase materially as they are forced to hire outside counsel to represent them before the Division of Enforcement. Yet today's release makes no effort to quantify with specificity the impact of that likely cost increase, and this has prevented the Commission from fully considering the true impact of the rule.

Given the importance of whistleblower complaints to our enforcement efforts, we all share a common interest in establishing a strong and effective whistleblower program. Unfortunately, I don't believe that today's rule will achieve its intended purposes. So, for the reasons outlined, I cannot support today's rule, but I would again like to thank the staff for their hard work at both the proposing and adopting stages of this process.

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[1] The rule excludes information obtained from attorney-client privileged communications, or in connection with the legal representation of a client, from the definitions of "independent knowledge" and "independent analysis" *unless* disclosure of such information would be permitted by, among other things, applicable state attorney conduct rules. *See* Rule 21F-4(b)(4)(i) and (b)(4)(ii). Under Model Rule of Professional Conduct 1.6(b), which has been adopted in some form in most states, "[a] lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: … to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services." Model Rules of Professional Conduct R. 1.6(b)(3).

http://www.sec.gov/news/speech/2011/spch052511klc-item2.htm