December 23, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 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:

The Center for Audit Quality (CAQ or the Center) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 (Proposed Rules). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

Summary

As the Commission's statements in the commentary recognize, corporate compliance programs have evolved to become critical components of sound corporate governance. Many issuers have established effective compliance programs that rely heavily on internal reporting of potential violations of law and corporate policy to identify instances of non-compliance. These internal reporting mechanisms are cornerstones of effective compliance processes because they permit companies to discover instances of potential wrongdoing, to investigate the underlying facts, and to take necessary remedial action. Although the CAQ supports the efforts of Congress and

the SEC to improve the ability to ferret out fraud through additional provisions to promote whistleblower reports and recognizes the value of whistleblowers as an effective method for the deterrence and detection of fraud, we are concerned about several aspects of the Proposed Rules.

The Center is concerned that the 90-day "grace period" and potential "credit" for first utilizing employer compliance processes will not sufficiently encourage potential whistleblowers to report first through a company's internal reporting process. The CAQ strongly urges the SEC in its final rules to, at a minimum, require concurrent whistleblower reporting to the company and the Commission as a condition for an award. A failure or delay in the communication of whistleblower reports of potential securities violations to registrants may reduce their ability and the ability of their independent accountants to rely on the efficacy of company internal control systems and could adversely impact registrants' and independent accountants' evaluations of internal control over financial reporting (ICFR) under sections 404(a) and 404(b) of the Sarbanes-Oxley Act of 2002 (SOX). It may also adversely affect the accuracy of registrants' financial reporting. This could have significant negative consequences for investors, registrants, and the audit process alike.

Further, the CAQ supports the SEC's Proposed Rules to the extent that they will not permit whistleblower awards to independent public accountants who report information about a company obtained through the performance of an engagement required under the securities laws. We are concerned, however, that the Proposed Rules do not go far enough in excluding independent public accountants from obtaining whistleblower awards from the SEC in two respects.

- As suggested in the Release[1], the CAQ believes the final rules should clearly and explicitly exclude awards to independent public accountants for information gained through the performance of all engagements (such as permitted non-audit services) for the same company for which the independent public accountant also performs an engagement required under the securities laws.

- The CAQ has concerns about the Proposed Rules to the extent that they permit whistleblower awards for information reported by an independent public accountant regarding his or her firm's performance of services related to an engagement required under the securities laws (i.e., whistleblower reporting by an accountant with respect to his or her own firm's performance of services).

The CAQ believes that permitting awards to independent public accountants for such information in either scenario above would undermine a certified public accountant's (CPA) duties of confidentiality and integrity and other ethical obligations, as well as undermine the candor among independent public accountants, the company and the audit committee. Additionally, as it relates to an independent public accountant "whistleblowing" on his or her accounting firm's performance of services related to an engagement required under the securities laws, the CAQ believes that numerous means currently exist that provide adequate mechanisms for accountants to report, and firms to address, potential securities law violations with respect to the performance of audit engagements. The potential harm to the accountant's relationship with a company and its audit committee, the audit process, and audit firm internal control systems that could result if independent

[1] Release at 23, footnote 32

public accountants are permitted to benefit financially through whistleblower reporting strongly outweighs any potential incremental benefit to allowing such awards.

Our specific concerns and recommendations are discussed in full below.

I. Importance Of Requiring, At A Minimum, Concurrent Whistleblower Reporting To The Commission And The Company As A Condition To A Whistleblower Award

The CAQ herein responds to Question No. 18:

> *Should the Commission consider a rule that, in some fashion, would require whistleblowers to utilize employer-sponsored complaint and reporting procedures?*

The Center strongly urges the SEC in its final rules to require, at a minimum, concurrent reporting to the Commission and the company as a condition to a whistleblower award. The CAQ is concerned that the Proposed Rules will not sufficiently encourage employees to first report potential securities law violations in accordance with a company's internal compliance programs. In particular, we are concerned that the 90-day "grace" period and the (unspecified) "credit" for those who utilize company compliance procedures first do not sufficiently incentivize a whistleblower to report first through internal company reporting processes. We believe that a registrant's employees likely will seek to maximize the possibility of lucrative whistleblower awards by reporting immediately to the SEC, bypassing these internal processes. Employees will be reluctant to take the risk that they might miss the deadline, or get "scooped" by someone else reporting first. We believe this can be overcome if, at a minimum, the Commission requires reporting to the company concurrent with reporting to the SEC in order to be eligible for an award.

Further, we believe that failure to require, at a minimum, concurrent whistleblower reporting to the SEC and the company through existing processes (including those mandated by SOX) will essentially transfer the responsibility for timely responses to reports of possible fraud from the private sector (i.e., companies and independent public accountants who audit them) to the SEC. The CAQ does not believe this serves the best interests of investors for the following reasons:

- If registrants and independent public accountants are not timely informed of a potential securities law violation because the report is made first to the SEC rather than internally and promptly, as required by most compliance programs, inaccurate financial statements (and audit opinions thereon) could be issued. This might be the case if, for example, the report could have (and should have) been made during the reporting period under audit, prior to the issuance of the financial statements and audit opinion thereon, but the company and the independent accountants were not made aware until a later date. Such an occurrence could have serious consequences for those who rely on the financial statements, most importantly investors. Among other things, the company may have to restate its previously-issued financial statements if it turns out that in fact there was a securities law violation that caused a material misstatement. The fall-out would inevitably include loss of market confidence and damage to investors. Such consequences could be minimized if the final rules condition an award, at a minimum, on concurrent reporting to the SEC and the company through internal processes so the company can investigate and remediate in a timely manner.

- The Center notes that the Release indicates that the Commission expects, in appropriate cases, to contact the company upon receipt of a whistleblower complaint, and provide the company an opportunity to investigate and report back. The CAQ believes that this does not provide certainty that the company will receive notice at the earliest possible time, and therefore will not sufficiently reduce the risk of the issuance of inaccurate financial statements. We are concerned that the volume of whistleblower reports the SEC staff is likely to receive will mean that it will not be possible for them to discern quickly and effectively those reports that seem more credible, and address them in a timely manner. The CAQ believes this risk would be mitigated by requiring an employee to, at a minimum, report concurrently to the Commission and to the company through the use of internal reporting mechanisms, which should facilitate the swiftest attention to potential securities law violations.

Further, we note that the Commission acknowledges in its Release that company programs that require self-reporting promote compliance with the securities laws. SOX currently requires audit committees to establish procedures "for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal control systems over accounting, and auditing," as well as the "confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."[2] Evaluations of ICFR generally will consider the extent to which a company's internal control program includes employee-whistleblower reporting procedures and whether those processes are effective. However, under the Proposed Rules, allowing employees to forego internal reporting and compliance processes may undermine an important "entity-level" control—one that can be effective in reducing the risk that management is overriding other internal controls.[3] As a result, the absence of required reporting to the company concurrently or prior to reporting to the SEC may reduce the effectiveness of a company's anti-fraud programs and controls.

In conclusion, the CAQ believes a whistleblower should be required to, at a minimum, report to the Commission and company concurrently. This should reduce the possibility of delayed reporting and its attendant consequences outlined above. Even if the Commission determines that it will not require concurrent company reporting at a minimum by whistleblowers, the CAQ strongly urges the SEC to implement policies that will require SEC staff to immediately inform the company's chief legal officer, audit committee and/or board of directors of receipt of a whistleblower complaint.[4]

II. Recommendations To Clarify And Expand Exclusion Of Independent Public Accountants From Whistleblower Awards

The CAQ also wishes to respond specifically to Question No. 10:

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2 Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78f(m)(4)

3 *See* AICPA, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* 7 (2005) ("A key defense against management override of internal controls is a whistleblowing process that typically incorporates a telephone hotline.").

4 We request that the SEC consider extending the proposed 90-day grace period to 180-days in order to incentivize initial internal reporting and preserve the possibility for whistleblowers who elect to report internally first the opportunity to obtain an award where warranted through a longer grace period.

Is it appropriate to exclude from the definition of "independent knowledge" or "independent analysis" information that is obtained through performance of an engagement required under the securities laws by an independent public accountant, if that information relates to a violation by the engagement client or the client's directors, officers or other employees? Are there other ways that the rules should address the roles of accountants and auditors?

We generally support the SEC's Proposed Rules to the extent that they will not permit whistleblower awards if an independent public accountant is under a "pre-existing legal or contractual duty to report the securities violations that are the subject of an [accountant's] original information to the Commission."[5] Indeed, as the Release recognizes, the Dodd-Frank Act explicitly precludes whistleblower awards to persons who obtain information as a result of an audit and would be subject to reporting to the Commission in accordance with Section 10A of the Exchange Act.[6] Thus, we specifically support the SEC's Proposed Rule 21F-4(b)(4)(iii), which denies whistleblower awards to those who obtain knowledge of a possible violation "through the performance of an engagement required under the securities laws by an independent public accountant, if that information relates to a violation by the engagement client or the client's directors, officers or other employees."[7] We firmly agree that independent public accountants should not be permitted to obtain whistleblower awards for reporting on companies for which they perform an engagement required under the securities laws. We are concerned, however, that the Proposed Rules do not go far enough in excluding independent public accountants from obtaining whistleblower awards from the SEC in two respects, as discussed below.

A. Clarification Of Proposed Rule To Exclude Whistleblower Awards To Independent Public Accountants For Reporting Information Derived From The Performance Of All Engagements For A Company For Which The Independent Public Accountant Also Performs An Engagement Required Under The Securities Laws

The Proposed Rules as written exclude from "independent knowledge" and "independent analysis" knowledge or information obtained "through the performance of an engagement required under the securities laws."[8] Footnote 32 of the Release states that this would specifically encompass reviews of interim financial statements included in quarterly reports on Form 10-Q, which the Center agrees is appropriate. Footnote 32 further states that the SEC "anticipates" that the exclusion will "also apply to information gained through another engagement for the same client." To avoid any ambiguity, the CAQ asks that the Commission specify in its final rules that it will exclude from the definitions of "independent knowledge" and "independent analysis" information about a company obtained from *all* services performed for the company for which the independent public accountant performs an engagement required under the securities laws. As the Commission notes, there are good reasons for such exclusions, including a CPA's duties of confidentiality and the facilitation of candor between the accountant and the company necessary for a robust audit process, described in further detail below (see II.B.1.).

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5 Proposed Rule 240.21F-4(a)(3)

6 See 15 U.S.C. 78U-6(c)(2)

7 Proposed Rule 240.21F-4(b)(4)(iii)

8 Proposed Rule 240.21F-4(b)(4)(iii).

B. Exclusion Of Whistleblower Awards to Independent Public Accountants For Reporting On Their Public Accounting Firm's Performance Of An Engagement Required Under The Securities Laws

The Center has serious concerns about the Proposed Rules to the extent they permit whistleblower awards to an independent public accountant for reporting information regarding his or her public accounting firm's performance of services related to an engagement required under the securities laws (i.e., whistleblower reporting by an auditor with respect to his or her firm's performance of an audit).

1. CPA's Duties of Confidentiality and Integrity

We believe that permitting an independent public accountant to seek SEC whistleblower awards by providing information about his or her firm's performance of services to a company is highly problematic for several reasons. The Commission (as required by the Dodd-Frank Act) is excluding awards to independent public accountant whistleblowers for reporting based on information about companies obtained through the performance of engagements required under the securities laws. However, whistleblowing by an auditor on his or her firm's performance will generally involve reporting company-specific information (that otherwise is excluded), therefore the CAQ urges the SEC to exclude *all* whistleblower reports related to the public accounting firm's performance of services related to an engagement required under the securities laws. There are at least two critical concerns that support excluding financial awards related to reporting on the firm's engagement performance: breach of the fundamental duty of confidentiality and the potential compromise of integrity and objectivity in the face of financial incentives. Both of these concerns also underlie the exclusions in the Proposed Rules with respect to attorneys.

First, similar to attorneys, accountants are subject to an elaborate set of ethical obligations. Among these obligations, accountants are bound by a duty of confidentiality under most, if not all, of the laws of the states that license CPAs, as well as the AICPA Code of Professional Conduct, ET Section 301 (which has been adopted in form or substance by numerous state boards). Many states have even gone so far as to codify a confidentiality privilege related to the work of accountants[9]. Whether mandated as a CPA ethical obligation or set forth in a statutory privilege, accountants engaged to perform services for a company generally may not disclose company-related information without explicit permission by the company, except in limited circumstances, such as the receipt of a subpoena.

The importance of confidentiality and privilege related to the work of accountants is well-established: "to ensure an atmosphere wherein the client will transmit all relevant information to his accountant without any fear of any future disclosure . . . [w]ithout an atmosphere of confidentiality, the client might withhold facts . . . rendering the accountant powerless to adequately perform the services he renders."[10] As one court has described it, "[t]he accountant-client privilege encourages full and frank communications between certified public accountants and their clients so that professional advice may be given on the basis of complete information, free from the consequences

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9 The same principles underlying privilege apply to duty of confidentiality.

10 Gearhart v. Ethridge, 208 S.E. 2d 460 (Ga. 1974); see also People v. Paasche, 325 N.W. 2d 914, 918 (Mich. 1994); Sears, Roebuck & Co. v. Gussin, 714 A. 2d 188 (Md. 1997).

of the apprehension of disclosure."[11] Indeed, Section 10A of the Exchange Act recognizes this cornerstone of the auditor-company relationship, requiring an auditor to report to the Commission only in specific and narrow circumstances (namely, after the issuer has *failed* to take appropriate remedial steps).

Similar to the Model Rule of Professional Conduct applicable to attorneys (to which the Release cites), many states explicitly recognize that the accountant's confidentiality obligation is not limited to specific client records or client communications, but rather includes all information the accountant comes to possess as a result of the provision of professional services.[12] Whistleblower reports from independent public accountants, related to their firms' engagement performance, would likely include company-specific information. Therefore, permitting awards for such whistleblower reports may encourage auditors to breach their fundamental duties of confidentiality to the companies that they audit.

Finally, the confidential nature of the accountant's relationship with the company and his or her duty of integrity are critical to promoting candor in communications and, in turn, facilitating robust audits. A mutual respect between a company and the independent public accountant must exist for the accounting firm to obtain the unconditional access to information necessary to conduct an effective audit.[13] The ability to obtain this level of communication will likely be hindered if a company suspects that accounting firm personnel may depart from confidentiality duties or established accounting firm procedures in favor of direct reporting to the Commission motivated by potential financial rewards.

2. Adequate Policing of a Firm's Performance of Engagements Already Exists

We believe that numerous means already exist to report and address potential securities law violations with respect to an accounting firm's performance of engagements required under the securities laws. A CPA's general ethical obligations imposed by the States, the AICPA, the Public Company Accounting Oversight Board (PCAOB), and other regulatory and professional bodies distinguish the independent public accountant from corporate directors, officers, and other employees, and will more than compensate for the proposed exclusion that we seek in the final rules.

First, audit judgments are highly complex, and often involve the input of senior firm personnel, specialists and discussions with the company. Because of this, PCAOB Interpretation 102-4 under Rule 102 specifically prescribes the means by which disagreements in the course of an audit should be addressed. Essentially this interpretation sets forth an internal "reporting up" process. In addition, the firms themselves have methods, including internal reporting processes that include whistleblower hotlines and other channels, to address potential violations of firm policies,

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11 Nuesteter v. District Court for the City and County of Denver, 675 P. 2d 1 (Co. 1984).

12 See, e.g., 63 P.S.§ 9.11a (Pennsylvania); 225 I.L.C.S. 450/27 (Illinois); C.R.S.A. § 13-90-107(f)(I) (Colorado); T.C.A. § 62-1-116 (Tennessee).

13 See Thomas J. Molony, "Is the Supreme Court Ready to Recognize Another Privilege? An Examination of the Accountant Client Privilege in the Aftermath of Jaffee v. Redmond," 55 Wash. & Lee L. Rev. 247 at 272 (Winter 1998) (noting study that overwhelmingly indicated that absence of confidentiality protection would inhibit accountant-client communications).

professional standards, regulatory requirements and the securities laws.[14] If accountants fear that others in the firm may bypass the usual processes by which issues are identified, discussed and resolved, candor within the audit process might be chilled. In addition, the concerns described in Section I above relating to an employee bypassing a company's internal reporting processes apply equally to an independent public accountant bypassing an accounting firm's internal reporting processes.

Second, among other things, the AICPA's Code of Conduct, which has been adopted by a host of state accountancy boards, prohibits "acts discreditable to the profession."[15] "Acts discreditable" specifically include "permit[ing] or direct[ing] another to sign a document containing materially false and misleading information."

Lastly, the PCAOB has specifically prescribed rules relating to illegal conduct in the course of an audit. PCAOB Rule 3502 provides that "a person associated with a registered public accounting firm shall not take or *omit to take* an action knowing, or recklessly not knowing, that the act or omission could directly and substantially contribute to a violation" by the firm of, among other things, the federal securities laws. Thus, this rule further requires accountants to act upon knowledge of potential securities law violations. The PCAOB also performs regular inspections of registered public accounting firms, and the firms subject themselves to a host of other practice-monitoring processes, on engagement and firm-wide levels.

There are numerous incentives and means for an independent public accountant to report and/or address potential securities law violations with respect to his or her accounting firm's performance of an engagement required under the securities laws. Absent a specific exclusion, we believe the SEC's Proposed Rules may inadvertently encourage the accountant to disregard his or her duties of confidentiality and create conflicts of interest through the prospect of individual financial gain, thereby discouraging the candor and values critical to an effective audit process. We therefore encourage the Commission to specifically exclude in the final rules whistleblower awards where the reporting is based on information about the performance of services by an accounting firm for a company related to an engagement required under the securities laws.

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We appreciate the opportunity to respond to the request for comment and would welcome the opportunity to discuss any questions you may have regarding any of our comments and recommendations.

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14 PCAOB Interim Quality Control Standard 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC 20), Interim Quality Control Standard 30, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC 30), and Interim Quality Control Standard 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (QC 40).

15 AICPA Code of Professional Conduct, ET 501, *Acts Discreditable*, Interpretation 501-4

Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

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